

## Chapter 2

# Mutual and Self-Enforcing Agreements. Contracts as the Basic Institution of Economics: Network Knowledge Instead of *Rational Choice*

O. E. Williamson sees institution economics as moving “from choice to contract”. This is more than a supplement to previous economics; in its focus on contracts it represents a break with rational choice economics: “economics (moves) in the direction of being a *science of contract*, as against a *science of choice*” (Williamson 2002: 172).

In his justification for this step O. E. Williamson refers to J. M. Buchanan: “thinking contractually in the public ordering domain leads into a focus on the rule of the game. Constitutional economics issues are posed (Buchanan and Tullock 1962; Brennan and Buchanan 2000)” (Williamson 2002: 172). Williamson takes Buchanan’s *constitutional economics* as a basic pattern for a more general case, which, in complementary fashion, he calls *private ordering*. What this means is that the individual *rational choices* assume the existence of a market order which they do not themselves determine in the neo-classical case. Whereas Buchanan – in the context of his *public choice theory* – wishes to leave the determination of the rules of the political game of distribution to the political citizen as far as the public domain is concerned, this is transferred by Williamson to the sphere of the market:

“Whatever the rule of the game, the lens of contract is also usefully brought to bear on the play of the game. This latter is what I refer to as *private ordering*, which entails efforts by the immediate parties to a transaction to align incentives and to craft governance structures that are better attuned to their exchange needs. The object of such self-help efforts is to realize better the ‘mutuality of advantage from voluntary exchange ... (that is) the most fundamental of all understandings in economics’ (Buchanan 2001: 29), due allowance being made for the mitigation of contractual hazard. Strategic issues – to which the literatures on mechanism design, agency theory and transactions cost economics/incomplete contracting all have a bearing – that had been ignored by neoclassical economists from 1870 to 1970, now make their appearance” (Williamson 2002: 172).

In regard to the “mutuality of advantage from voluntary exchange” Williamson differentiates further between the more formal *incentive alignment (mechanisms design, agency theory, the formal property rights theory)* and the “governance of ongoing contractual relations (contractual implementation)” (Williamson 2002:

173). Richter and Furubotn (2005: 161) extend this distinction to one between the *agency-contract theory* on the one hand and the *self-enforcing agreements theory* and the *relational-contract theory* on the other. In the two last cases the incentives do not play as dominant a role as in the first case; but when neither *rational choice* nor *incentives* can model the transaction, what is a contract or, to be more precise, what determines the contractual form of the transaction? And what is the significance of this for economics?

The transaction becomes the “basic unit of analysis” (Williamson 1985: 41). Thus a fundamental difference to neo-classical market theory is introduced almost incidentally. What counts is no longer the efficiency of anonymous *exchanges*. **The rational choice of an individual actor is no longer decisive economically but the cooperation of at least two actors in a contractual arrangement.** The *rational choice* merely offers dispositions for transactional contracts; without the contract the acts of choice of the two rational actors presented are economically irrelevant. Market only takes place when the goods are delivered and paid for; its basic unit is the bilateral transaction.

The neo-classical *exchange* knows the contractual form only as a legal sheath without significance for the rational key decisions. Law comes into play as a legal institution as a third party called upon in cases of conflict (on the one hand as a *law based institution* (Greif 2006: 222) on the other as a *third party enforcer* (Barzel 2002; on this point cf. Brousseau 2008 and Priddat 2010c)). In the *exchange* the *rational actors* choose independently. For the *exchange* the contract is only a technical finale without significance for the actual process of exchange.

In the *exchange* the final contractual form of the transaction is not a kind of cooperation but rather the temporary coordination of two utility functions. Basically they do not come together; their utility curves merely touch one another here and there; their *mutuality of advantage* is configured in an extremely minimalist fashion. To put it more precisely: **in the technical finale of the exchange the two rational actors come together under the condition that they have already decided previously, without negotiating or bargaining what they want to exchange with one another.** The exchange is based on reciprocal acceptance of previous individual decisions, which are only carried out in the transaction but not negotiated (*zero mutuality*). The *exchange* is a quasi contractless transaction; **the essential feature of a contract, its negotiational core, is neutralized.**

The innovation from institution economics is ultimately only a reminder of the preconditions on which neo-classical *exchanges* are based. Williamson et al. see the contract as the socio-economic place which also regulates the preconditions guaranteeing its validity. In the Middle Ages and in the modern era it was generally obvious that contracts require an instance guaranteeing their validity: “Thus the bargaining (‘exchange as a species of contract’) has three constituents which soon became distinguishable; the making of the agreement, the delivery one way, and the delivery the other. As soon as the distinction is made, the agreement itself becomes no more than a promise to deliver. Trading is trading in promises; but it is futile to trade in promises unless there is some reasonable assurance that the promises will be kept. . . . But even in dealings between merchants there can be

misunderstandings and there may be deceptions; and there will be the contingencies for which no provision has been made. Disputes will therefore arise, and there must be a means of settling them, in order that contracts should be reliable. Legal (or at least quasi-legal) institutions are therefore required” (Hicks 1969: 34f.). Avner Greif shows the complex history of the “impersonal exchange” (Greif 2006). Yorim Barzel speaks generally of *third party enforcement* as an agency of stabilization (Barzel 2002). Contracts are accordingly triadic structures in which the legal system takes on the role of providing an institutional guarantee in the case of *non-agreement*, i.e. in the case of a failure of *bargaining*.

## 2.1 Mutuality of Advantage

Let us distinguish here between three forms of *mutuality of advantage*, which Williamson has introduced as a criterion:

1. the neo-classical contract, which is based upon the coincidence of notions of utility decided upon in a rationally independent way (*mutuality* = 0).
2. the contract guaranteed by the legal system which regulates reciprocal conflicts as an external third party; its *mutuality* is configured triadically, as legal mediation ( $1 > \textit{mutuality} > 0$ ), and.
3. the mutuality which places a contract in a focus of things in common (emergent dyadic or bilateral *mutuality*: *mutuality* = 1); mutuality or mutual agreement are particularly valid for relational contracts that leave important commitment clauses open something that can only succeed because the parties enter into exchange relationships (Richter and Furubotn 2003: 176; with reference to Macneil 1978; Scott 2003). “The stronger the relationality determines the character of the contract, the weaker or more imprecise its legally binding effect is and the stronger the role of convention or internal enforcement instruments. The element of self-enforcement becomes increasingly more important” (Richter and Furubotu 2003: 169; see also Brousseau 2008).

After a long phase of negation of the contractual nature of transactions in the economy, Commons, in 1924, is the first to speak again of the contractual construction of the economic relationships of transactions (in the context of a theory of the relations between *economics & law* (Commons 1995 [1924]; also Coase 1937)). The transaction concept is explicitly not an exchange concept; it refers to “buying” and “selling”, both mediated monetarily. Commons comes from the older American tradition of institution economics, which, through Veblen etc., draws on the German historical school. The more recent transaction cost theory which in turn builds on institution economics (Coase 1937; Williamson 1985; North 1990a, b) sees economic contracts as institutional forms whose costs differ (‘new institutionalism’ (see Klaes 2002); Brousseau 2008; Garrouste and Saussier 2008). According to this theory the form of the contract plays a decisive part in the optimization.

“Optimization” is extended here: How does one avoid too high costs of transactional agreements in a sustainable way?

What soon establishes itself as transaction cost theory is in its formation primarily conceived as an unfolding of the transaction as a process of contractual negotiation:

In order to carry out a market transaction it is necessary

- to discover who it is that one wishes to deal with,
- to inform people that one wishes to deal
- and on what terms,
- to conduct negotiations leading up to a bargain,
- to draw up the contract,
- to undertake the inspections needed to make sure that the terms of the contract are being observed
- and so on (Coase 1960: 15).

Coase interprets the contractual process as different stages of communication and negotiation, which are necessary for the realization of a contract. For him transaction costs are “costs of using the price mechanism” (Klaes 2002: 3), i.e. “the cost of discovering what the relevant prices are” (Coase 1937: 390) or “the cost of negotiating and concluding a separate contract for each exchange transaction” (Coase 1937: 391f.). The “costs of using the price mechanism” reveal a significant differentiation between the competitive prices and the price actually paid in the contract (difference between marginal costs and prices). If contracts, the contractual form of the transaction, include the costs of negotiation in addition to the specific agreements laid down in the contract, the prices actually realized in the market through the contracts are singular, as they not only reproduce the “the cost of negotiating and concluding a separate contract for each exchange transaction” but vice versa permit every contract to fix its own price. Instead of the neo-classical *price taking* transactional contracts are economic arenas of *price making*.

It is thus understandable that market theory is divided up through the new institution economics into:

1. a neo-classical sphere in which the buyer and the seller meet in spot markets “to exchange standardized goods at equilibrium prices” (Williamson 2002: 176), and
2. an institutional sphere in which negotiations generate their own prices, which can no longer be weighted as competitive prices because they are unique, i.e. incomparable: every negotiation generates other prices (price = competitive price + transaction costs). We can speak of local equilibria (which are as multiple as the number of negotiated contracts, similar to the multiple Nash equilibria (see Brousseau 2008)).

The market relevant prices can no longer be determined independently of the process of arriving at them, which only means that the kind of communication involved in the transaction process co-determines a selection of the transaction objects and ultimately which goods are open to transaction at what price. In the

transactional negotiations it is not only a question of finding the final price (the transaction costs over and beyond the market or offering price, which is contractually determined according to specific performances), but at the same time of defining the transaction object. For the transaction costs are generated by the scope and the specifications of the performance and the guarantees (both securities and assurances). It only becomes clear in the course of the negotiations how the transaction object is constituted or should be constituted, or possibly even what it is, etc. In negotiations the object is also always negotiated which makes up the contract – with all the necessary open options, as a mutual outcome (with a commonly defined object) must result.

It is only in the course of the negotiations that the room is opened up for possibilities which partners can only concede to one another when they have the reciprocal trust needed to treat each other honestly – *mutuality*. The market only provides the dispositions which are first configured in the *bargaining* of the contractual process. This is the particular performance of the contracts: that they do not exchange what the market offers but create their object in the process itself. Contractual transactions are emergent processes.

Coase considers the various communicative activities from the standpoint of the minimization of their costs, i.e. he wishes them to be organized efficiently. Ultimately this observation serves his configuration of the *theory of the firm* (Coase 1937). This has in the meantime become the dominant reading.

But this is only one of the possible interpretations of the process, which ignores the communicative selection of the final transaction condition, the epistemic operation so to speak. **The communication of the various stages of searching, assessing and negotiating the contractual process is here seen only one-sidedly as a foregoing production process for the creation of the contract, whose performance lies in the efficiency of the process of creation, without taking into account that the other performance is the choice of what is significant.** It is not only a matter of the guarantee or assurance of the fulfilment of the contract which is to be included in the transaction process, but rather a question of the constitution of the transaction itself: its objects and dimensions, including the regulation of the procedure culminating in a trustworthy settlement.

Let us reformulate Coase's elements of the transaction process listed above:

- the search for and identification of potential transaction partners (informing; as a reciprocal process: communication)
- *signalling* the personal desire for a transaction (communication),
- clarification of the conditions of the transaction (communication),
- bringing the negotiations to a close (communication)
- paying attention to the observation of the terms of the agreement on acceptance (interpretation of the agreed contractual process),

It becomes clear that four of the five processes listed are communications, particularly when one is aware that the first two processes are closely intertwined. The transaction contained in the contract is the result of foregoing **communications whose course determines what is transacted.** In its original form the transaction

cost theory includes a transaction process theory which conceals an undeveloped theory of transactional communication.

Analytically two levels must be distinguished: the transactions and the transaction costs. Coase differentiates the transaction as a process in different functional states, which mark differing communicative and above all negotiative stages (Wernerfelt 2008). Negotiations are interactions: a mode of social relationship which differs significantly from the neo-classical coordination of utility functions without interaction. The transaction costs come into play with the interpretation of specific transaction relations as “bilateral dependency conditions” (Williamson 2002: 176). Williamson distinguishes between:

1. generic transactions where ‘faceless buyers and sellers ... meet ... for an instant to exchange standardized goods at equilibrium prices’” (Ben-Porath 1980: 4) and
2. exchanges where the identities of the parties matter, in that continuity of relation has significant cost consequences (Williamson 2002: 176).

Williamson thus emphasizes that the partners in the contractual process get to know one another – in contrast to the anonymity of the exchange – and that through this acquaintance a familiarity or relational specificity arises which generates transactional continuities. The parties continue to transact with one another in the future because they have invested in the relationship: “the key factor here is whether the transaction in question is supported by investments in transaction-specific assets” (Williamson 2002: 716).

The transaction costs arising from the emergence of the specific performances and guarantees in the contractual negotiations are investment costs. The investments are investments in **transaction-specific assets**, i.e. in arrangements for guarantees and specific advantages which can only come about through the negotiations themselves. “Parties to transactions that are bilaterally dependent are ‘vulnerable’, in that buyers cannot easily turn to alternative sources of supply, while suppliers can redeploy the specialized assets to their next best use or user only at loss of productive value. As a result, value-preserving governance structures – to infuse order, thereby to mitigate conflict and to realize mutual gain – are sought” (Williamson 2002: 176).

In the contractual agreement the *exchange* is only secure when, *uno actu*, it establishes a governance, which must be regarded as a kind of constitution of the transaction (see above the methodical analogy to J. B. Buchanan’s *constitutional economics*). Williamson speaks of the “contract as framework” (Williamson 2002: 177; with reference to Llewelly 1931: 36f.). The *constitution* of the contract is not adequately safeguarded by the legal form of the contract (The legal form only safeguards the compensation rights in the case of non-fulfilment, as a kind of *law by exception*), but first by economic stipulations, supervision and trust-building measures (So also Van Aaken 2007; Thüsing 2007; Hermalin 2008; Gomez 2008; Nicita and Pagano 2008; Priddat 2010c).

Avner Greif has traced the difficult process of the crystallization of the “impersonal exchange” in the Middle Ages, “the transition from reputation-based personal exchange to law-based institutions” (Greif 2006: 222). Williamson is working on an

approach transcending the *law-based institution*, which he calls “mutuality of advantage from voluntary exchange” (Williamson 2002: 172) – an economic conception of the emerging formation of the contract which is to be dependent neither on reputation mechanisms nor on legal safeguards, but on the trust which develops during the negotiation (mutuality = 1, essential for the implicit and relational contracts). It is in its mutuality that the contract first proves to be a contract, by passing beyond a coordinative coincidence to a cooperative relationship. That it is put into effect “in the shadow of the law” (Gomez 2008: 101) remains evident, but does not make up its economic content.

The cooperative relationship of the contract involves more than trust and fairness, as, after trust and fairness have been achieved in the contractual process, a third internal phase succeeds, in which results resulting from negotiation can be achieved that cannot be reached by the mere coordination of customary contractual processes. Cooperation as “suitable interplay results in a greater complexity than that of each individual” (An der Heiden 2010: 9). Greater complexity brings alternatives into play which cannot even be made visible by neutral coordination. There is a willingness to commit oneself to opportunities and options in a sphere of mutual trust which remains undeveloped in the latent sphere of mistrust. The greater complexity which can be achieved gives us an innovative potential in every contractual process, which remains latent as long as it cannot be cooperatively heightened or developed.

The *mutuality of advantage from voluntary exchange* requires different *governances*: a different one for the firm (as a *nexus of contracts*) than for contracts within the market (which achieve *governance* through institutions of trust, by again drawing on forms of “reputation-based personal exchange”. D. M. Kahan speaks of a *strong reciprocity* (Kahan 2005; but see also Gintis et al. 2005)).

Williamson refers explicitly to the “classical contracting, according to which disputes are costlessly settled through courts by the award of money damages” (Williamson 2002: 177). The distinction made here between *costless* contracts (neo-classical economics or *classical contracting theory*) and costly contracts (transaction cost theory) refers to “disputes”, i.e. to the communicative dimension of the negotiations in contracts designed to clarify disputed points. The observation of the communication between the contracting partners shows that the legal guarantee is far too abstract for the specificity which the partners can negotiate about. What “under current rules (could) be brought to a court” could “be resolved instead by avoidance, self-help and the like. That is because in ‘many instances the participants can devise more satisfactory solutions to their disputes than can professionals constrained to apply general rules on the basis of limited knowledge of the dispute’”(Williamson 2002: 177).

It is interesting that the reconstruction of transaction cost theory assesses critically Common’s theme of linking economy and law more closely in the contract. Because of its lack of knowledge of the specificity of contracts the law cannot settle disputes about validity and interpretation in the way the partners can with one another when they define, observe and regulate the governance of the contractual process themselves (see Hermalin 2008; Gomez 2008; Katz 2008). The fact that



Williamson develops the governance structure as a form of management in firms does not deprive it of its general validity for every contract, whether as a “nexus of contracts” (Aoki et al. 1990) of a company or simply as a bilateral agreement in the markets.

The transaction argument against the high legal costs of the contractual form is clearly used: every emerging solution lowers the transaction costs, but also requires insight, reciprocity, trust and obligation (precisely what the incentive-oriented departments of institution economics did not include. For a critical approach to this point (see Williamson 2002: 188ff.)). Institution economics is clearly endeavouring to arrive at an economic theory of the contract in order to overcome the classical dominance of the juridical theory.

Through its mode of the negotiating process the transaction becomes the economic site of the production of contractual stability and security. Or, in other words: what was previously regarded simply as an *exchange*, i.e. as technical allocational coordination in markets, becomes a process in the new institution economics, which co-establishes the conditions for its validity by means of contractual cooperation: “simple market exchange thus gives way to credible contracting, which includes penalties for premature termination, mechanisms for information disclosure and verification, specialized dispute settlement procedures and so on” (Williamson 2002: 176).

We distinguished earlier between two segments of the market: (1) the neo-classical exchange and (2) the institutional contracting. The form of interaction of the second segment represents a new element in the description of the market: the aspect of the relationship between contractual partners (“where the identities of parties matters”). This must not fall under the rubric of personal relationships; firms and companies are above all processual identities. Although they are formally clearly defined as juridical persons under property right, as economic units or organizations they are forms which have to be continually defined and configured anew, in order to keep their business relations contractually stable. (H. C. White identifies in this a fundamental structure of *identity & control* (White 1992)). Because firms must continuously re-establish and certify their ability to make contracts, contracts between them are at the same time an assurance of the competence to observe contracts. It thus becomes clear why Williamson (and Coase) cannot consider the economic relationships between firms simply as *exchanges*, as the conditions of exchangeability must be included in the negotiations in each particular case. And it thus also becomes clear that the clarification of these relationships also assumes the clarification of the way firms constitute themselves and win their processual stability: *theory of the firm*. If one understands the firm as a “nexus of contracts” (Aoki et al. 1990), the form of governance becomes decisive for the capacity to enter into contracts in the market and for the amount of the transaction costs of *contracting*.



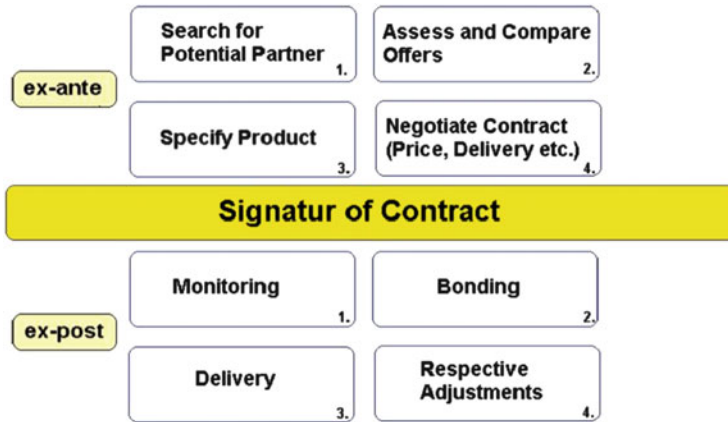


Fig. 2.1 von Sayn-Wittgenstein 2009: 10, with reference to Coase and Williamson

## 2.2 Contractual Processes

Williamson's transaction/contract theory clearly refers to contracts between companies. But the critical unfolding of the processes which make up a contract is generally valid: for every transaction in all markets. What seems to be evident in the case of contracts between firms remains concealed for all other contracts (Williamson assigns them, without further interpretation, to the neo-classical exchange sphere. He does not analyse their specific *governance* of the *mutual agreement*) (Fig. 2.1).

The neo-classical sphere comprises *prima facie* the processes *ex ante* 1 – 4 when we enter it into the elaborated transaction/contract model. *Ex ante* 1 – 4 can function without a contract; basically 1 – 3 are processual implementations of the process, which Walras calls *tatonnement* for the formulation of his equilibrium economics – the processes of searching and comparing which rational actors undertake **before** making their rational choice. For the description of the market process in terms of equilibrium economics only *ex ante* 4 matters, but with a decisive difference: here it is not a question of *negotiation*, but of the technical implementation previously taken individual rational decisions of the independent actors. A process of cooperation, such as contracts are, is neither envisaged nor necessary.

In this sense the process *ex ante* 4 in the above model for the dimension of the neo-classical exchange is to be replaced by 4\*: for *negotiation* we must in neo-classical terms substitute *exchange* (quasi-negotiation). The condition that exchanges must be undertaken to competitive or equilibrium prices cannot be sustained in the contractual process, as it is precisely concerned with the negotiation of the price. Consequently, according to this logic, contracts can be excluded as forms of negotiation. This also means that *ex post* 1-4 represent a post-processing of neo-classical transactions, which no longer belong to the sphere of *rational choice*

coincidence, but arise when exchange conditions are not observed. This calls for the intervention of a third instance: the legal system.

Contracts, however, “(are) dealing with issues of conflict, mutuality and order” (Williamson 2002: 191; A. W. Katz speaks of “coordination and commitment” (Katz 2008)). Only when the three conditions are fulfilled are contracts complete in the sense of Williamson’s theory. On this point we must take a closer look at the contractual process as a process. Contracts are an instance which reflects the fair fulfilment of the transactions. Contractual processes indicate that the result is negotiated: an explicit interaction mode (cooperation instead of coordination).

Contractual processes have their own procedural forms, their own path dependencies. Of course one can always abandon the *bargaining* at any time and ventilate other offers from third parties (= *ex ante* 1 – 4). To this degree the competitiveness of the market has an effect. But in the contractual process a phase turnaround occurs: partners condition each other reciprocally, gain trust, win new options in the collaborative process (which can no longer be equalized by third party alternatives, unless there is mistrust). The trust defines the relative exclusiveness of the contractual consensus (as a *lock-in*). One varies, but *within the partnership* and not in competition with one another. **Once such a state has been achieved competitiveness is transformed into cooperation. Successful contractual processes are mutual agreements with an emerging exclusion of competitiveness.**

Cooperation is not merely a formal finale; it emerges during a process. All *bargaining* is potentially capable of lock-in. Trust is the outcome of the negotiation and not an external precondition. The same is true of fairness (in fulfilling the contract (see Thüsing 2007; Priddat 2010b, c)).

This has consequences for the *rational choice* basis of economics. *Rational choice* is based on competitiveness and mistrust; but contracts are built on trust (i.e. – the exclusion of mistrust in certain phases and hence the exclusion of the tactical exploitation of the partner). If mistrusting actors are assumed, who maximize their own expectational values, trust without mechanisms of control cannot be explained. As games theory predicts, such actors secure for themselves the payment which they can force through with the maximum application of their own means, without having to depend on the goodwill of the others. As is well-known, rational actors prefer guaranteed payments from uncooperative solutions to exploitable cooperations, even if successful cooperations would be more advantageous for all the participants (The Prisoner’s Dilemma).

Trust in people goes hand in hand with the credibility of their promises. The “promise” has been an economic topic for a long time. In the modern period, particularly in modern economics, the older romantic kind of trust in the unconditional credibility of a promise (and hence faithfulness) has been replaced by other time-bound relationships of trust, which resemble more a contract than an eternally valid bond (Priddat 2005, 2010b). What is common to both kinds of trust is that certain behavioural alternatives are suppressed –either totally or temporarily. Such suppression of what is latently there suggests the presence of emotional influences. In trusting relationships possible breaches of trust disappear into unmarked spheres of behavioural space and are for the moment ignored, so that the possibilities of the

marked side can be explored in peace. If emotions steer this suppression, this has not so much to do with normativity as with the construction of social arenas, which is impossible or at least improbable in the neo-classical *default* case.

Contracts (contracts characterized by negotiations) are auto-generative or emergent events which do not exclude alternative evaluations (exogenous phase I), but break off at a certain point (exogenous phase II). In phase II the negotiations are conducted with trust, i.e. in the expectation of reciprocally coinciding benefits (the collective result being estimated as higher than the individual result of both parties = *mutual agreement*). This occurs from the moment the parties have a common model of the possible contract at their disposal (*shared mental model of contract gains* or *contractual frame*), when the mutual advantages outweigh the benefits of the alternatives (which remain *unframed*).

To this end it is necessary to enter openly into the *contracting*: it is only possible to talk with one another, to allow oneself to be convinced when one's position is not already fixed. (Oberwittler 2010: C1: col.2). If one enters into the contracting with the firm intention of winning, the room for manoeuvre of the other party is too narrow; the result will not then be considered as fair, but as a compromise (for many who are unable to deal with conflict the most comfortable but not the best solution). Two basic patterns can be distinguished: overreaching contracts which are unfair but comfortable and fair contracts which however assume a symmetrical starting position (see the *Harvard negotiation concept* (Fisher et al. 2000)).

Contracts are arenas of cooperation gains. The *mutuality* achieved in phase II (*mutuality* = 1) allows the partners to abandon their original ideas of the benefit for themselves on account of the shared positions achieved in the negotiations and to generate new preferences or concepts of benefit (cf. *team preferences* or *team utilities* (Sudgen 2000, 2002, see also Kabalak and Priddat 2010)). Instead of pre-stabilized *rational choice* coincidence we are now dealing with open room for negotiation, which must be characterized on the one hand as innovative and on the other hand as cooperative rationality. **Williamson's transposition from choice to contract must be expanded: from contract to cooperation. When it comes into phase II every contract has a cooperative finale, which pursues a different logic than the logic of coordinative coincidence (Phase I).**

### 2.3 From Choice to Contract (I) from Contract to Cooperation (II)

What is at issue here is not general illusions of community but precisely the exclusion of competition in phase II of the formative process of the contract. At the core of the market process, which we have become accustomed to considering as competitive *sui generis*, the contract first becomes productive when it generates a form of mutuality which, as cooperation, stands in contrast to competition. Just as the companies as hierarchical organizations represent *expressis verbis* non-market

operators – Coase’s discovery in 1937 – the contractual forms of the customary market transactions are in the same way based on non-competitive structures of the final contractual cooperation, and primarily on processes of mutual appreciation.

At the core of the market process we are dealing with an emerging processual form, which provides full freedom to reach an agreement. This means that it is possible to redefine the competitive conditions under which contracts were first negotiated in accordance with their temporary status (Phase II). The contractual freedom refers not only to the transactions but also to the conditions of the contract, to the contractual form and its emerging obligations. Instead of the neo-classical optimization of what is already given it is possible to create new givens in the ongoing contractual process, which develop their own local equilibria. They are, *sui generis*, potentially innovative instances, which have a Hayekian quality: that they pursue their own discovery procedures in the market through which they can change their starting conditions.

It is important to note that in phase II of the bargaining and negotiating process the discovery process is oriented on the reciprocal potentials of the partners and no longer, or only marginally, on the market. We are dealing with an exclusion of third parties in the course of the process (both competitive offers from third parties and safeguarding clauses). This specific intervention of phase II is based on the trust developed in the process, which functionally generates the exclusion of alternatives (on this function of trust as *emotional pre-contracting* (see Muramatsu and Hanoch 2005)). This is often not the result of deliberate decisions taken beforehand, but of agglomerated processual outcomes which have reached a certain level of specificity, so that comparability with third party or external alternative offers no longer seems possible, as negotiations with these parties have not taken place or have come to an end. In phase II the process of contractual negotiations has crossed a threshold and achieved an intrinsic value, a closed recursive form, which can no longer be readily mediated to third parties. The trust-building role of “empathy” in this process (Singer and Fehr 2005) is revealed in some of the more recent research outcomes of neuro-economics, which see the cognitive aspects of decision-making as being systematically linked with the affective aspects.

But independently of “shared feelings” (Singer and Fehr 2005) the contractual negotiations reach shared foci which are unique in regard to their specific relationships (as other negotiations with other partners would create different interventions. Accordingly every phase II process is unique and only conditionally comparable (this bounded comparability could only be done away with again at the expense of the specificity; by bringing price or service offers of third parties into play one would only sketch the naked starting point of possible negotiations) but not the agreements already generated or still to be generated in the course of the negotiations). A decision, for example, to break off phase II would devalue the in the meantime specifically accumulated negotiational gains. The alternative negotiations would first have to be carried out without knowing whether one could achieve the same intervention. In a different terminology: the *social capital* invested in the meantime in the process of negotiating the contract would be completely devalued. It turns out that the advantage of economics allowing comparisons to alternative

offers at any time is restricted by the emerging intervention of phase II. In their final processing phase contracts are subject to a *bounded compatibility*.

Markets consist of many contractual agents who in the processing of contracts create local equilibria (situative *bargainings*), which in the first phase still assess competitive options, but in the second, endogenous-emergent phase explore and determine their own collaborative room for manoeuvre and invest in a specific social capital that generates singular results (i.e. specific emergent returns on investment in each case: gains from cooperation). In the successful achievement of consensus contracts have a relative autonomy which makes them unsuitable for strict systematic comparison.

**They do not optimize what the market wants, but what they mutually determine. Thus in their own local event space they determine what the market is**

- As all contracts do this, the market is formed out of the sum of collaborative local optimizations, not in a general equilibrium, but as a market process involving manifold variations of local events. This would give us a further explanation of evolutionary economics.

Of course these results are instable, challengeable and capable of being drawn into any kind of competitiveness. Contracts are potentially instable. But if they have given rise to trust they work, in phase II, like institutions: the participants follow their (emerging) rules, i.e. they no longer compare alternatives. Until the moment that third party offers come into play again. But again, and this is a new insight, only as contractual processes with a potential dignity, relative autonomy and emergent specificity of their own.

## 2.4 Summa and Amplifications: Contracts and Network Environments

The basic operators of economics are contracts, *prima facie* bilateral agreements on the transfer of goods and services. Contracts are interactive relationships; if markets are constituted through contracts, we are then no longer dealing with *rational actors* who operate freely, independently and purely individually in seeking their own advantage (=markets as the coordinative coincidence of individual advantage takers), but with interactive relationships of at least two actors who enter into a moment of cooperativeness (the market as a cooperative instance with latent emergent values of its own). Thus, at its operative basis, economics is not defined by rational individuals but by “sociological minimum societies” ( $n = \text{at least } 2$ ).

Contracts are – structural – negotiations, i.e. relational contracts with open outcomes. This openness is to be closed emergently in bilateral *mutuality*. This is the cooperative basic structure: to achieve one’s own advantage by taking into account the advantage of the other side – an interaction mode. Many contracts fail

to realize this potential: they remain in the status of opposing, competitive advantage-taking, in a latent mode of outsmarting the other side (extracting more than the other receives).

In most cases (dyadic or bilateral) contracts require a third party who concludes them (see Tirole 2009):

1. either through legal instances (mostly *ex post*): L as the third party;
2. or through managerial instances: M as the third party (based on a complex *theory of the firm* (Coase, Williamson etc.)).
3. or, however, through networks (N as the third party; also MeC (media of advertising (=consumers) and Me (Media)), which provide the contracting partners with dispositions for decisions, which they are all the more ready to take up, as they at the same time experience social or network protection (Every actor is embedded in networks (family, friends, colleagues etc.), which canalize his room for decision by means of the communication of reputation; furthermore they form *linguistic communities*, which define the semantics of what is recognized as relevant)). “However, the contract does not seek to protect against any kind of opportunism. It allows for the creation of mutual trust. Of course, trust can result from sources other than contracts; in particular, from social networks” (Brousseau 2008: 57; Euler 2010; Priddat 2010a).
4. (4) is a special case: that two contracting partners generate a mutual agreement which functions as a specific and temporary emergent *social norm*. Logically this case is potentially valid for every contract, but in fact it is rarer.

This is the decisive point: **that all transactions make up a contract whose significant aspect is its negotiation.** In such a negotiation emergent qualities of the scope for action can arise which develop the local equilibrium into an innovative instance of cooperative benefits. But then the markets are defined through the diversity of incomparable *bargainings* which differ from case to case.

Networks form institutional arrangements in which the actors involved in the shaping of the contract generate *shared mental models* that can further its emergence or, however, merely inform the *rational choice* as to the coincidences they should take up. The cooperative aspect of the contractual process is still structurally maintained, but can be unfolded into two dimensions: I) in the (emergent) cooperation of two partners as *mutual agreement* (horizontal communication) and II (as influence of the networks on each of the partners individually (vertical communication)), but at the same time as a second relationship of influence which runs parallel: N (in general see Granovetter 2005; Jones et al. 1997).

Both dimensions are interlocked. We can assume that *mutual agreement* is more likely to be possible when both contracting partners belong to the same networks (perhaps the same branch). If the networks differ, the chance of achieving an emergent *mutual agreement* during the contractual process sinks, because such an *agreement* assumes a certain exclusion of networks (as both partners are beginning to form a little network of their own). If they are successful both partners create a (micro-) network of their own, which not only excludes third parties but also the network influences from N.

Implicit or emergent contracts as cooperation between two partners are an act of relative autonomy which must be asserted against the competition of the market (against the assumption that externally there are even better possibilities for contracts); hence their stability remains endangered. However, research on the conditions for such a relative autonomy of contractual forms is only beginning (in contrast to research on the *social contracts* of groups (Ostrom 2003, 2006)).

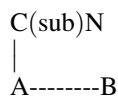
Normatively, however, we can now already assert that the economic theory of the market is based on contracts in its basic operations, i.e. on interaction structures which tend to amount to cooperation. More precisely: phase I of the contractual process operates in the competitive mode, phase II tends towards the cooperative mode. Contracts are thus typical candidates for *co-operations* (differing from phase to phase). This adequately describes the structures of the basis operators.

Markets are consequently processual diversifications of contractual processes, which can take on dyadic, triadic or multilateral forms depending on the degree of relative autonomy they achieve. Every contract forms a local equilibrium with either a more emergent or a more competitive process of price formation. The market thus generates multiple equilibria, which spread or change by means of network communications. A significant factor is the analysis of the various phase transitions (from phase I to phase II; with what form of *governance* relevant to the contract?).

In this sense economic transactions are notoriously embedded in trans-economic determinations, influences and moods which give up the idea of the independence of the actors in favour of a communicative inclusion systematically linking economics with (economic) sociology in a new way (Granovetter 2005). The individual acceptance of advantage no longer stands in the foreground in the market economy but the optimization of network conditions (whereby the contract represents a 2-digit minimum network) – an expanded Williamson model, which focuses not only on organizations but also on network governances (and which Wieland bases on a *new logic of organization: network* (Wieland 2010)).

What Williamson has excellently described for firms and organizations also applies to the organization of a contractual process in markets which arrives at a *mutual agreement*. But it must be taken into account that this form of organization follows its own rules, which are neither rational nor institutional, but are induced by networks. The following points must be the object of separate research:

The contractual process between A and B, which in phase II eliminates the competition of third party offerers (C) = exclusion of competition, continues to be subject to the influence of other third parties: N (=network communication). Substitute C – the competing offerer – by N, the network communicant. **C (sub)** N ((sub) for “substituted”)





Transactions/contracts are only defined in terms of market competition in phase I (C); but even then a second dimension also plays a part, that of network communication (N). In phase II C is eliminated, but N continues to have a potential influence. It is only when A and B have generated emergent cooperations that both C and N are eliminated. A state is then achieved in which they develop their own communication (and their own *governance*) – as cooperation.

Networks are (a) social structures in which the market actors are embedded when they make decisions, i.e. not independently of network communications and interpretations, but (b) they are also independent market structures in which firms and their creation of value are interwoven. Many value chains are networks whose contracts are adapted to network structures (with their own *governance* requirements (Wieland 2010)). The question which arises from our analysis is, however, whether markets themselves have network structures (see White 2004).

The individual acceptance of advantage no longer stands in the foreground in the market economy but the optimization of network conditions (whereby the contract represents a 2-digit minimum network) – an expanded Williamson model, which focuses not only on organizations but also on network *governances*.

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