

**TRANSACTION COST ECONOMICS
AND BEYOND**

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7 SHORT-TERM PREVALENCE, SOCIAL APPROVAL, AND THE GOVERNANCE OF EMPLOYMENT RELATIONS

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Introduction

The convergence of economics and sociology that has been going on for some twenty years by now has also changed organization studies from the core. The main change has been the introduction of a double contracting perspective into organizational analysis. Contracting is now being considered from the point of view of interest alignment (*ex ante*) and from the point of view of adaptation to unforeseen changes (*ex post*). This perspective was impossible within standard neoclassical economics, because, due to complete information, complex contingent claims were supposedly easily drafted. In traditional sociology, this perspective could also not have been developed because role-playing, norm-conforming man would observe the silent agreements, rendering *ex post* governance superfluous. Only the convergence of economics and sociology created models of man that were realistic enough to invite a host of problems around the creation and governance of contracts and still stringent enough to allow relatively tight theory building.

The most prominent example of this development is transaction cost economics (Williamson, 1985, 1993). Its two pillars are deviations from the standard neoclassical model of man. They are "bounded rationality" and

"opportunism." Both concepts were not new, but, applied to contracting, they created a very fruitful emphasis on *ex post* aspects of contracting. This success seems evidence enough that the concepts should be retained and empirical research proved promising. Yet, I will argue that for the analysis of internal organization, transaction cost economics is leading us astray. It is so incomplete that it misses the most important features of governance structures, being prominent among them the impact of households on organizations. Let me develop the argument in some detail.

Myopia versus Farsighted Contracting

Williamson bravely followed Knight's advice to take "human nature as we know it," against the neoclassical tradition to take human nature as it is necessary for model building. But what did he do? He introduced bounded rationality along the lines of Simon to mean that people's cognitive abilities are limited. They just don't have the necessary information to anticipate relevant contingencies when things get complex and when the intended contract is long-term (due to the investment in assets that are specific to the contract). Bounded rationality alone would not be much of a problem were it not for a motivational "frailty" of human beings: opportunism, the most important form of which is "self-seeking with guile." Opportunism is the willingness to strategically exploit the bounded rationality of the other by wilful deceit. Both bounded rationality and opportunism together create the need for a science of organization. The interesting question then for *ex post* aspects of adaptation to future contingencies is how credible commitments can be achieved.

The solution Williamson devised is what he calls "farsighted contracting." "Credible threats are thus those for which a farsighted B perceives that A's *ex post* incentives comport with its claims." B is thus advised "to look ahead and if he discerns potential hazards to take the hazards into account by redesigning the contractual relation—often by devising *ex ante* safeguards that will deter *ex post* opportunism. Accordingly [B] is advised to give and receive "credible commitments." (Williamson, 1993, p.129).

Interestingly enough, Williamson suggests that due to farsighted contracting the vagaries of *ex post* problems can be dwarfed through *ex ante* arrangements that anticipate them. From an institutional design point of view, Williamson's line of argumentation makes sense. Institutional design is first of all an activity in which rules are invented that prevent the

occurrence of problems. For this activity, farsightedness is necessary. Williamson describes it as such:

But for farsightedness, transaction cost economics would be denied access to one of the most important 'tricks' in the economist's bag, namely the assumption that economic actors have the ability to look ahead, discern problems and prospects, and factor these back into the organizational/contractual design" (Williamson, 1993, p. 129).

Yet, by giving such a prominent place to farsightedness, the distance to agency theory (which concentrates on *ex ante* interest alignment) is made much smaller than one would expect from the verbal claims concerning the importance of *ex post* aspects in transaction cost economics. As a matter of fact, bounded rationality is first used to go against the standard theory but then made relatively harmless again in order to have access to the "tricks" of the standard theory. Bounded rationality is seemingly just big enough to make (complex, long-term) contracts incomplete but not big enough to prevent farsightedness from solving this incompleteness *ex ante*.

One of the serious and theoretical damaging consequences of this view of bounded rationality is that the motivational limitation that is assumed to act in concert with bounded rationality is restricted to people's willingness to lie. People's promises are not worth much because of it (Williamson, 1986, p.178). But consider the most interesting case for contract analysis: a long-term contract, in principle more profitable to both partners than an alternative contract. Because of bounded rationality, the contract cannot cover all contingencies, but what does that matter? Why would the parties not agree on a self-enforcing general clause to the effect that each party simply pledges at the outset to execute the contract efficiently (in a joint profit-maximizing manner) and at contract renewal time to seek returns that do not endanger the jointly profitable continuation? Williamson's answer is: because of opportunism (Williamson, 1986, p.178). But why would the parties deceive each other if the long-term contract is the best alternative for both? I do not see the answer in Williamson's arguments. My alternative proposition is: given farsightedness, opportunism can only affect contracts negatively that are not mutually perceived as being profitable on the long run; again given farsightedness, people will make few mistakes about the long-run profitability of contracts. Thus opportunism is really quite irrelevant to contracting—or is it not?

Intuition would have it that opportunism does make a difference, but then it would not be the toothless opportunism envisioned by Williamson. From

a large body of research on time preference and related phenomena (see, for example, Ainslie, 1992; Holcomb and Nelson, 1992; Loewenstein and Thaler, 1989), we know that by and large people's discount rate cannot be rationalized by the interest rate because it is far greater than the interest rate, sometimes by a factor of 100. This means that short-term aspects may easily prevail against all but the largest long-term consequences. Sometimes this is called myopia. If myopia is real then bounded rationality should be more than information impactedness. It should also represent a myopic tendency, which, in turn, would lead to a much more serious form of opportunism: against one's own long-term advantages, to give in to the temptation to breach the contract because of short-term advantages, and to be willing to deceive the other about this breach. In this light, it is entirely possible that two people could have a mutually profitable long-term transaction were it not for both of their opportunistic tendencies. Farsightedness is now the ability to predict temptations in the future and to arrange appropriate measures against falling for these temptations. This is the story of Ulysses and the sirens. Clearly, farsightedness in this sense is not the opposite of myopia but rather its recognition. Farsighted contracting then is contracting with a clear eye to myopic tendencies.

If the foregoing is correct then there are three important points to consider:

First, by far the most important instrument for dealing with myopia is not contracting but training to deal with it in such a way that it will allow the achievement of long-term rewards (see Ainslie, 1992). The result of this training has been called self-discipline or self-command capital (Lindenberg, 1993), and the most important part of this training, if it occurs at all, happens during childhood in the household. For this very reason, what happens in the household is of vital interest to what happens in organizations. Skills in dealing with myopia (i.e., self-command capital) are clearly important for the extent to which opportunism will play a role in contracting, especially for the employment relation which in turn is vital for organizational analysis.

Second, given myopic tendencies, the prevalence of short-term aspects asks for the consideration of those features of governance structures that deal with short-term rewards. Note that since we are dealing with discounting, short-term is really short, i.e., hours or at best days.

Third, in transaction cost economics, most features of the governance structure that are considered are medium or long-term. This leaves out all those features that deal with myopic tendencies; and this is particularly

damaging for the analysis of contractual relation in organizations (employment relations). In what follows I will concentrate on these relations.

Which short-term rewards should be considered? I would like to argue that the most important short-term reward is social approval, so that the operational part of any governance structure in which many people frequently interact is the product of social approval. For this very reason, the substantive part of this chapter has to begin with a theory of social approval. After that, I will discuss the relation of social approval to the governance of the employment relation. The last part of the chapter will deal with changes in the household which greatly reduce the likelihood that self-command capital is formed and which thus put pressure on governance structures in organizations to deal with myopic tendencies even more effectively than hitherto.

A Theory of Social Approval

Next to physical well-being, social approval is a good valued in every society and through the course of history. It is probably safe to say that next to physical well-being, social approval is the major good any person wants, anywhere, anytime (Lindenberg, 1990).

There are basically two situations in which a person gives social approval. In order to describe these situations, it is handy to distinguish two fictitious persons, Ego and Alter. First, Ego is willing to give social approval to Alter, if Alter commands resources that are potentially useful or dangerous for Ego, such as money, influence, knowledge. Although it may not be entirely an instrumental act, as we know from Smith's Theory of Moral Sentiments, giving social approval to Alter who commands scarce resources is rational if Alter remains within Ego's social system. In return Alter may use the resources to Ego's advantage or at least not to Ego's disadvantage, and the giving of social approval is relatively easy on resources. The common term for this kind of social approval is "status."

Second, Ego gives social approval if Alter behaves cooperatively. Commonly this kind of social approval is referred to as confirmation¹. What is taken to be cooperative behavior may differ for different situations, people, and cultures, but the distinguishing feature in all the situations is that Alter could have legitimately chosen a course of action that would have been better for Alter and worse for Ego but did not in fact choose this course of action. Here "better" and "worse" refer to interpersonally comparable

evaluations of outcomes at that moment, not including the payoff from social approval. Social approval can thus be seen as a side payment in an ongoing game. For example, somebody helps you get into the train with your suitcase, giving his time and effort and you thank him. Had you failed to thank him, he would presumably have felt cheated. It is rational to give social approval for Alter's cooperative behavior if Alter remains within Ego's social system. For the same reason, it is rational to give social disapproval for noncooperative behavior.

The other side of the coin is *getting* social approval. If one is interested in getting social approval and avoiding social disapproval (and as we said, most people belong to this category), it is often rational to behave cooperatively, especially if one has no alternative for the production of social approval (like status). If Ego and Alter are both in a situation in which they could behave cooperatively vis-à-vis the other, social approval might seemingly play no role because the super game aspect of, say, TIT for TAT stabilizes the cooperative relationship. However, in most real-life cases, TAT is removed in time from TIT, and the actual exchange is TIT for social approval and TAT for social approval. This means that it is social approval and *not* the super game that stabilizes the exchange. Due to the prevalence of short-term aspects, long-term rewards from cooperation will often be weaker than short-term temptations to defect if there is no support for long-term effects by (virtually immediate) social approval or disapproval.

There is an interesting addition, due to the prevalence of short-term aspects. In more complex relationships, either TIT or TAT may not happen in the presence of the other actor and there will be a problem because social approval or disapproval will also be removed in time and thus not stabilize the exchange. In such relationships, the behavioral disposition becomes at least as important as the observed behavior. If Ego believes Alter's disposition to be cooperative, Ego also believes that Alter will behave cooperatively, even if Ego is not in a position to sanction Alter immediately. How does Ego know Alter's disposition? Obviously, previous experience plays an important role, but within that experience clear *relational signals* play the most important role (see Lindenberg, 1994). These are situations in which Alter can signal a cooperative disposition by acting especially cooperatively. For example, for an appropriate occasion, Alter can give Ego a gift or can show concern for Ego's welfare, make a clear sacrifice that helps Ego, etc. Relational signals are purposefully recognizable and thus will, in turn, be rewarded by social approval.

In this way, a stabilization of the exchange relation is achieved even if the cooperative acts themselves are not accessible to immediate social approval or disapproval.

Social Approval and the Employment Relation

Deals between firms are subject to this short-term effect of social approval. There is a nice recent example of a financial scandal in Germany. A developer, Schneider, vanished and left 3 billion in debt to 50 banks. How was this possible? How did Schneider get such loans if the projects were not sound? Schneider was even able to get a loan from a major bank for a building located 100 meters from this bank and nobody in the bank noticed that the plans he submitted stated twice the actual size of the office space, although the bill boards at the site stated the space correctly. Newsweek (May 2, 1994, p.46) quotes a German professor of finance (Schmidt) as saying "There's a strong personal network via the golf-club circuit, and that's one of the problems in the case of Schneider." Notice that this is different from outright corruption, where money is paid for a certain favor. What happens in personal networks is that TIT is exchanged for social approval and TAT is exchanged for social approval, so that there is not direct exchange link between TIT and TAT. In this way, people are much less likely to feel devious for bending standards.

Within organizations, there are many structural ways in which social approval can be made to govern the employment relations. Therefore we will focus on these aspects in the remainder of this chapter. If the foregoing is approximately correct, then cooperation in an employment relation will be only very imperfectly achieved by what is generally considered in the literature to be a governance structure. Pay schedules, rules governing ports of entry, job ladders, grievance procedures, length of employment contract: all of these aspects entail mainly medium and long-term features and say virtually nothing about the workings of short-term aspects. There are some clear implications from the theory of social approval for governance structures, broadly conceived. To begin with, quit aspects are relatively long-term, whereas aspects concerning continuous cooperation are relatively short-term. Therefore, *asset specificity* is much less important for influencing day-to-day cooperation than general damage potential of the employee. The latter will raise the employer's interest in cooperative behavior and thereby force the employer to consider the production of social approval. For

example, the possible damage due to small sabotage, sickness, inattentiveness etc., will influence the employer's interest in a good relation with the employee at least as much if not more than the employee's ability to quit.

Second, for the same reason, *efficiency wages* should work most of all if and when they signal a relational interest of the organization in its work force (see Wielers, 1993). The quit-related pay difference to the market wage is a long-term aspect and should therefore have less or no influence on productivity. This has recently been confirmed in a study by Mühlau (1994), in which he compared commitment data on Japan and the U.S. He found that relational signaling as a firm-specific wage increment to individual human capital aspects predicted workers' self perceived cooperativeness much better than the difference between individual and opportunity (market) wage. Quite generally, the ways employees are treated will all be interpreted as relational signals. This also puts considerable restrictions on the long-term aspects of the governance structure. Payment, metering, contract length, promotion, etc., all turn into relational signals.

Third, *measurement* or separability issues are especially important for employment relations because the less measurable the output, the more important the cooperative disposition and thus the stronger the impact of relational signals.

Fourth, *power*-related instruments, such as downward pay adjustment due to bad market position of the employee, are incompatible with relational signaling and will therefore not be used even when the damage potential of the employee is relatively small (see Lindenberg, 1988). This also holds for the salary negotiations at entry (see Wielers, 1991).

Fifth, emphasis on *status differences* in an organization will cut higher ups off from informal networks and therefore from cooperation and information from below. The reason for this is that positional status elicits social approval from lower employees as an investment for potential advantages, not as a reward for cooperation or as a signal in the willingness to continue to cooperate. Communication will therefore be careful and guarded and relational signals will only be exchanged with those few for whom the higher up is a "sponsor." For them, the relationship to the sponsor creates short-term encouragements and advantages.

Sixth, for the same reason, *tournaments* only attract entrants when the long-term aspects (like status) are complemented with short-term aspects through sponsors. In fact, it seems that it is this short-term aspect that provides the operational motivation to seek status within the organization in the first place. There seems to be no simple internal labor-market status

seeking; sponsors always act as pull. This is confirmed by Burt's (1992) study in a large American corporation. In terms of selection, this fact may work quite differently than the employer's intention because sponsors have their own agendas for sponsoring, which are quite independent of the tournament.

Seventh, the strategic creation and use of *informal networks* have become an important feature for the study of governance structures. For example, since cooperativeness will be signaled in situations where there are mutual gains from cooperation but poor measurability, management can make use of informal networks for the selection of personnel for the leadership positions in that very unit. This will generally yield another person than when management selects on the basis of status attributes (see Krackhardt and Hanson, 1993).

Changes in the Weight of Short-Term Aspects

There are good reasons to assume that the prevalence of short-term aspects is increasing in Western societies and that, as a result, there is a convergence of important features of governance structures everywhere.

In brief, the argument is as follows. The ability to be guided by long-term aspects is composed of a number of other abilities: the ability to actively select short-term influences compatible with long-term benefits, the ability to imagine long-term consequences, and the ability to internalize external approving agents and thus to approve and disapprove of one's own actions. This collection of abilities is a certain kind of human capital, mainly learned in early childhood training and may be called *self-command capital*.

With changing general welfare, child training in families is likely to change in such a way that less self-command capital is produced. How does this happen?

Sharing Groups and Changes in the Home²

Self-command capital is the result of socialization, mainly in early childhood.³ Against former opinions, it has become clear that firmness or permissiveness in child raising is not just a matter of style or fashion or pedagogical beliefs of the day. It is first and foremost a matter of incentives. Permissiveness asks much less effort from the parents than firmness. If you want your child to develop the ability successfully to battle short-term

temptations you need to do two things: a) you have to be consistent, i.e., you have to be a living example of somebody who successfully deals with short-term temptations; and b) you have to get your child to want to be like you (see Rollins and Thomas, 1979). For the first, there should also be no convenience bending of rules. If bedtime is agreed to be at 8.30 pm, then deviation from this rule should not be allowed for reasons of short-term temptations of the parent. Thus if there is a thrilling movie on TV at 8.30 you should not waive bed time because of it. Considering that these kinds of collisions in interest between rules and convenience can happen daily just as often as rules apply, this is a high price to pay for the parents.

For the second requirement, you cannot just be strict or "authoritarian," because if the child fears you it will develop a different set of skills: to conform when observability is unavoidable and to maximize the possibilities in which the parent cannot observe the behavior. When the child is observed, the parental strictness supplies enough short-term advantage against other temptations, but when not observed, the child feels unbound to the parental expectations and there will be no experience of successful dealing with short-term temptations. Thus, the second requirement demands that the child feels comfortable in your presence, and, that when it does not do what it is supposed to do, you as parent have to tread a very thin line between not letting the child get away with it and not making it fear you. This, again, takes time and effort in each case.

When a behavioral pattern requires much effort, then habit formation is not enough to sustain it in the face of declining incentives. Together, the two requirements make it very plausible that parents only put in this kind of effort if there are strong incentives to do so. Any weakening of the incentives for self-command training will result in a proportional reduction in such training. Let us look next at the question why and under what conditions parents would be interested in a high level of self-command capital of their children, and then we will look at the conditions under which this interest sharply declines.

Quite generally, a regulatory interest in a small interacting group comes from the juxtaposition of positive and negative externalities. Because of the positive externalities, the persons involved prefer dealing with the negative externalities to exit. If the negative externalities cannot be avoided altogether, they can at least be mitigated if every person behaves in a certain way. There may be rules which if followed reduce externalities; there may be other rules which reduce the negative effect after it occurred. For example, if it is agreed that you play your trumpet only during certain hours

then the negative externalities of your play have not vanished but they have been mitigated. And if, for whatever reason, it happened that you did play your trumpet in the "off" hours, there is a range of agreed upon things you can do in order to signal your cooperative disposition, such as apologize, explain, give gifts. There is an interest by everyone involved that people keep to these rules and agreements.

The juxtaposition of positive and negative externalities is regularly created by joint consumption or production in a small interacting group. Such a group has been called "sharing group." A family is such a sharing group, in which space, food, risk, affect, status, and other goods are shared to various degrees. Imagine that a family has enough rooms in the house so that the children are not sent to play in the street, but not enough rooms to avoid having children sleep in the same room and to keep the livingroom and child play areas separate. This creates many negative externalities about bed times, play times, times to have visitors, etc. Clearly, the parents have a regulatory interest in their childrens' behavior (as do the children vis-à-vis their siblings and parents), and there will be rules about cleaning up toys, about bed times, playing times, about who decides what TV program will be watched, etc. There will also be understandings about ranges of relational signals in case of mishaps, such as apologizing and making up. The more being shared inside the home, the stronger the regulatory interest.

There are also externalities from the behavior of children outside the home, such as playing in the neighborhood, being polite, pursuing the right education, choosing the right occupation, choosing the right marriage partner, etc. The more these activities outside the home affect the status of the parents (positively and/or negatively), the stronger the parents' regulatory interest.

Clearly, for inside and outside the home, behaving appropriately when externalities are strong means that you must be able to deal successfully with short-term temptations. Cleaning up toys, keeping to agreed upon bedtimes, putting up the sustained effort for a particular education, choosing occupation and partner with regard to long-term effects, etc., all require self-command capital. Thus, the incentive for parents to put up the extra effort in training self-command capital depends on the strength of the externalities of sharing.

Following the work of Elias (1982) on the process of civilization, we can trace a process over the last centuries in which self-command training in families became stronger mainly through an increasing centralization of power of the state and the accompanying increase in the state's regulatory interest. For families this meant first of all that the behavior of their children

outside the home would exert strong externalities on the parents' status. Increasing codification of forms of etiquette would also affect standards at home, especially with regard to signs of impulsive behavior (lack of cleanliness, lack of keeping to rules of speech and decorum, etc.). With the Victorian age, this kind of pressure on the self-respecting home had reached a high mark, exactly at a time when in many Western countries new economic and bureaucratic organizations were founded. These organizations could build on a general level of self-command capital in crafting their governance structures.

What Elias did not describe is what has happened since then. Whereas rules and rule-following only mitigate negative externalities, economic solutions can eradicate them. Having a separate room for each child, having play and living areas apart, and having various television sets does greatly reduce the negative externalities that can come up in the home. Rising general welfare thus slowly but surely changed in most families the way parents dealt with negative externalities in the home. While the norms were still unchanged (for instance your child is still expected to clean up), the incentives of the parent to enforce the norms declined with the strength of the negative externalities. As a consequence, the relative shadow price for self-command training went up. As we said above, when costs are very high, habit formation is not enough to sustain the "cheaper" behavior. Convenience bending of rules would increase in frequency, and self-command training would decline proportionately.⁴

This effect of welfare has been reinforced by also affecting externalities outside the home. Since there was a general rise in welfare in the Western countries, the decline in self-command training happened in virtually all strata, so that no group could successfully exploit the other group's decline. Not surprisingly, the willingness to sanction other parents for bad behavior of their children outside the home declined to the degree that one's own child would also behave badly outside the home. Whether we are talking about public behavior, or choice of education or occupation or partner, the longer general welfare exists in a society, the lower the negative status-effects of behavior of the children outside the home on the parents (see Simic and Custred, 1982). Again, the relative shadow price of self-command training increased because of it, and the incentive for such training decreased accordingly. Permissiveness in child rearing is thus a general consequence of increasing welfare, not a temporary fashion of people also listened to the wrong guru (say, Dr. Spock). As new generations of parents grow up, themselves with lower self-command training, it becomes increasingly

difficult to be a living example of self-command to the child, which again raises the relative costs of such training. It is difficult to think of a scenario that would change this trend in Western societies except a general and sustained decline in welfare.

Organizational Response to Decreasing Self-Command Capital⁵

With less self-command capital there is by definition less ability to align short-term aspects in a way that is compatible with long-term benefits. Organizations have to meet this challenge. How can a governance structure do something about self-command problems? It is easy to see how Williamson's toothless view of opportunism leads him to simply build unquestioningly in the classical Weber—Barnard view of organizations as layered authority structures with intention-controlled obedience. The question of governance inside organizations then turns into the question how intentions can be manipulated by pay schedules, rules governing ports of entry, job ladders, grievance procedures, length of employment contract, and other such medium and long-term instruments.

The view of organizations as a layered authority structure has been taken mainly from Weber, who also believed that modern man had been disciplined into an obedience machine (mainly through the role of the state and the military).⁶ Weber's view of authority structures in organizations is that "each office has a clearly defined sphere of competence in the legal sense" and the office holder "is subject to strict and systematic discipline and control in the conduct of the office." (Weber, 1978, p. 220f). Barnard (1938) modernized this view by stressing a stronger need to induce obedience by positive reward; however he left the basic idea of hierarchy intact. Simon (1951) then codified Barnard's view of hierarchy by taking the employment relation, in which the employee sells the right to be told what to do by the employer, as the basic building block for organizations. The fact that the employee can sell this right implies that he can command him- or herself enough to simply follow the command if he has been adequately paid to do so. In the light of the argument above however, this self-command cannot be taken for granted.

Not everybody followed the Weber-Barnard-Simon line of reasoning. Some authors used Marx as a source of hypotheses about governance and came up with a "labor process theory" (especially based on Braverman's work of 1974). For them the ability of the worker to be obstreperous

remained as unabated as the motivation of management to control. Governance would therefore have to consist of taking away bargaining power from the workforce by deskilling the workforce, which makes workers easily replaceable and easy to monitor. In this view, self-command problems also vanish from the analysis because the organizational response makes self-command superfluous. What about this line of reasoning? There is a growing consensus that the development goes in the opposite direction (see Wood, 1989; Weiler, 1990). Technological development drives an increase in jobs with high autonomy and discretion. In turn, autonomy and discretion offer much opportunity to succumb to short-term temptations. This comes at a time when households turn out people with less self-command capital. Since this capital is created in childhood, there is not much the organization can do to make up for lack of such training.⁷ For this reason, organizations have and will adapt in other ways than training, namely by changing their governance structure.

The upshot of these arguments together with the relational signaling theory of employment relations is that *the larger the self-command problems of the employees, the less a hierarchy will resemble a command structure, i.e., the less the traditional view of organizations holds*. This view clearly has not informed the economic organization studies. Akerlof is an exception when he states that a major function of management is the prevention of procrastination (Akerlof, 1991, p.7). An organization that would insist on a structure in which authority equals command would only create a situation in which people cover up their own "lapses" and fail to allow for such lapses of their subordinates (see Staw, 1981). Giving up hierarchy in favor of a peer group is an option subject to severe size and homogeneity limitations (see Williamson, 1975, p.41ff) and thus not viable in most cases. In addition, as we have argued above, the larger the measurement problem, the more important relational signals. And the more important relational signals, the less likely that a hierarchy based on sheer authority will work.

The alternative is a *functionally legitimated hierarchy* in which commands are justified by the necessities of the operation rather than by the rights to command. I have called this kind of hierarchy "club hierarchy" because the rough edges of the hierarchy are taken away by the functional legitimation. We find a very similar pattern already in the family.

Functional legitimation needs to be supported in three ways. First, the employee must understand the functioning of the organization in order to interpret the commands as functionally legitimated. In order to achieve this, the organization has to become much more transparent than traditional

organizations, with considerably more *context instruction*. Second, functionally legitimated commands need to be related to short-term aspects. An efficient way of doing this is to create very clear, relatively short *deadlines* that are consistently held. This shortens the time horizon and allows the employee to relate the task structure directly to other short-term aspects. Finally, the hierarchy must become *less focused on status*, because status aspects create doubts about the functional nature of the hierarchy, which have negative consequences for the workings of relational signals and thus for cooperation, as we have argued above. Rational managers will implement such measures.

For all these measures, culture and the management of meaning can play an important role. There are subtle codes that make a hierarchy that does not issue commando work (cf. Casson, 1991). Relational signals function much more efficiently if there is a common code. People have to be socialized into this kind of culture. In addition, the common culture facilitates lateral control, especially if informal networks among those who potentially exert negative externalities on each other, are encouraged (by physical proximity, joint cafeterias, joint events etc.). Lateral control helps to neutralize myopic behavior because it combines social approval (and disapproval) with conformity to organizational expectations. Again, it is likely that a rational management will strategically encourage such informal networks.

In sum, relational contracting within organizations becomes more prevalent with increasing welfare and pushes features of governance structures to the fore that are at least as important if not more important than the "traditional" features considered by transaction cost economics so far. A theory more appropriate than transaction cost economics for teasing out the important aspects to be considered in a governance structure within organization is a theory based on relational signaling.

Conclusion

If we take "human nature as we know it," to use Williamson's quote from Knight, then we cannot follow Williamson's half-hearted attempt at introducing human frailty as information impactedness and the ability to lie (opportunism). Williamson wants it both ways. In order to make transaction costs count, he wants to deviate from neo-classical economics, but in order to be able to use the neo-classical toolkit, he has to hold on to unbridled "farsightedness." In this way, transaction cost economics of organizations

misses too many important features of governance structures. Instead, we have to accommodate the fact that human beings are mainly governed by short-term aspects. The most important short-term reward in the interaction among people who can benefit from continuous mutual cooperation is social approval in the form of confirmation. Any model of a governance structure that does not consider the ways in which the production of confirmation is organized is seriously incomplete. Most importantly, virtually all actual and potential governance instruments also act as relational signals, thereby affecting behavior in ways which can only be traced if the production of social approval is explicitly incorporated into the theory.

If there ever was a point to the transaction cost economics view of farsighted contracting and a resulting authority structure, it has been dwarfed by the increasing prevalence of short-term aspects with the rising welfare level of a society, because childhood training for dealing with short-term temptations declines with increasing general prosperity. The consequence of this trend is a convergence of important features of governance structures: we are likely to find increasing relational concerns even in lower echelons; hierarchies will remain strong but they will be more and more functionally legitimated rather than legitimated by authority. For this to work, members of an organization will have to be much better informed than in traditional organizations about the workings of the entire organization (transparency), and there will be less emphasis on status and more emphasis on deadlines (strategic time pressure). In addition, there will be more emphasis on certain kinds of informal networks. None of these features of governance structures could have been analyzed with the traditional tools of transaction cost economics, although these tools themselves are not incompatible with the analysis offered here.

Notes

1. In other publications on this topic (for example, Lindenberg, 1990), I have distinguished two kinds of confirmation: behavioral confirmation for having done "the right thing" and confirmation as person ("positive affect"). Here, I will not distinguish between the two because they are likely to mix in intra-organizational relations. For purposes of identifying different kinds of informal networks within organizations (say, friendship versus acquaintance networks), it would probably be useful to separate the two again.

2. The following arguments have been worked out in some more detail in Lindenberg, (1986).

3. Thaler and Shefrin (1981, p.401) also observe that "the family is the most likely place for the individual to learn (or not learn) the rules and norms necessary to overcome the self-control problems."

4. The obvious alternative for avoiding the blatant accumulation of convenience bending of rules is to do away with rules and stress the own responsibility of the child. This, however, will not work because, the standards against which irresponsible behavior could clearly be identified have not been set. For this reason the child has few opportunities to experience a successful battle against short-term temptations. Without such experiences, there is no learning of skills for dealing with such temptations.

5. The following arguments have been worked out in some more detail in Lindenberg, (1993).

6. Elias' theory, mentioned above, takes off from here.

7. There are at present courses with manipulated traumatic experiences (such as daring to confront danger in the outdoors) for managers who are supposed to make up for learning that was not acquired during childhood. The popularity of these courses points more to the ubiquity of the problem than the possibility of solving it via adult training.

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