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Markets, Institutions, and Transaction Costs: The Endogeneity of Governance

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FOR SOCIAL SCIENCE RESEARCH

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Abstract

Much of the literature contrasts the dynamics of free markets with the 'political' dynamics of governance. The distinction portrays the process of 'economic' competition as separate from the deployment of private political resources to affect the terms of competition in line with agent preferences. This yields a distorted view of the ways in which real-world economic agents compete with each other, and the market-governance/state-market dichotomy creates more confusion than it clarifies, failing to account for the empirical observation that complex market systems and institutions of governance cannot be found apart. Even as an analytical distinction, the dichotomy blinds us to the ways in which states are active constituents of the market place, and the ways in which market actors and their constituencies are part of the wider process of governance shaping the terms of competition. This paper will extend the transaction cost approach and the insights of institutional economics to demonstrate in theoretical terms that the emergence of the institutions of governance is endogenous to the utility-maximising behaviour of economic agents. Utility-maximising behaviour and conflict over the terms of competition in the market generate both the formal and informal institutions and processes of governance such as regulation and dispute settlement. The paper then presents a conceptual model for understanding the essential integration of market and governance processes, the 'state-market condominium', in which markets are not just about what firms do in competition with each other, but are conceptualized as an ensemble of regulatory authority operating simultaneously through policy processes and the competitive interaction of firms. Contrasting forms of market correspond to political compromises based on the preferences of interacting agents. The model hypothesises reflexively that conflict over the terms of competition in markets generates changes in actor preferences concerning regulation and governance, and that the outcome of conflict over divergent actor preferences concerning governance and regulation generates changes in market structures. Changes in preferences concerning governance therefore are intimately bound up with preferences concerning market structure. This approach brings the work of economists and political scientists closer together.

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"We cannot solve problems with the same kind of thinking which created them."
(A. Einstein, attributed)

This paper contributes to our theoretical understanding of the relationship between governance and institutions on the one hand, and patterns of market exchange on the other, thus bringing the study of each closer together. Given the clear historical interdependencies between the two, the study of each will arguably be the weaker if such attempts are not regularly undertaken. The starting point is two empirical observations: that systems of market exchange and institutions of some sort are not to be found apart from each other,[1] and that the terms of competition in the market are shaped as much by the political as by the economic strategies and resources of firms and of other economic agents. Market systems thus range in nature from the highly competition-oriented to more collusive and/or regulated systems. These observations should provide an in-built exhortation to theorists to develop concepts which better theorise the relationships between governance and the market, and thus the real world we live in.

Introduction: the Literature and the Argument

The idea that there are important interdependencies between the institutions of governance and the functioning of the market is certainly not new. Classical political economists were well aware of the symbiosis between the two (Smith 1937(1776); Krätke and Underhill

[1]As has been firmly established by the transaction cost literature, among others.

2006). Political economists from political science and economic history traditions[2] have for some considerable time suggested that functioning market systems emerge largely as a result of organised coalitions and political decision-making which alters the nature of rights and the law for a range of economic agents (e.g. Polanyi 1944; Kehr 1977; Cox 1986; Schwarz 2000), and that the institutions of governance in particular economies are closely related to the specific circumstances of their economic development and industrialisation processes (Gerschenkron 1966; Skocpol 1979; Schwarz 2000). Comparative political economists have also long analysed the relationship between different sorts of national economic institutions and corresponding economic outcomes and relative levels of performance (Katzenstein 1978;[3] Zysman 1983; Gourevitch 1986; Hall 1986; Hall and Soskice 2000). They have furthermore looked at the relationship between international level outcomes and political processes at the domestic level, arguing convincingly that the emergence of liberal vs. protectionist cross-border regimes in trade and financial markets is closely related to domestic coalitions and politics (Kehr 1977; Gourevitch 1977, 1978; Milner 1988; Underhill 1991; Keohane and Milner 1996). Finally, successful economic development processes in the emerging market economies have been explained in terms of institutional configurations, specifically the capacity of 'strong' states characterised by institutions which are relatively autonomous from societal interests to circumvent or co-opt incumbent anti-developmental coalitions and to foster new and economically more successful interests who back the process of industrialisation (Skocpol 1979; Johnson 1982; Haggard 1990; Wade 1990; Evans 1995;

[2] An excellent and up to date survey of the range of this political economy literature is provided by Cohen, forthcoming 2008.

[3] Who originated the strong state-weak state hypothesis.

Weiss 1998; Woo-Cummings 1999).[4] Theoretical attempts to explain the relationship of political authority and institutions to economic processes have been likewise abundant (Gilpin 1987; Strange 1988; Gill and Law 1988; Stubbs and Underhill 2006). All have employed a range of approaches and methodologies from rational choice to historical institutionalism to overtly interest-based political economy approaches which take into account history, culture, and institutional constraints to a greater or lesser degree.

In economics, the transaction cost and institutional economics literature has also devoted considerable attention in recent years to this question of the relationship between institutions, governance, and market processes. Analysis began by focussing on the firm (Coase 1937; Williamson 1975) and later began to focus more explicitly on the institutions of governance and their relationship to the relative economic performance of national economies (Olson 1982; North 1990a, 1991), including corporate governance (Morck *et al* 2004; Berglöf and Claessens, 2006). Given the effects which political interventions can have on the functioning of markets, it was a logical step for economists focussing on development issues to argue that the quality of institutions and governance are likely to be crucial to successful economic outcomes (Olson 1982; North 1990a), and to explore the conditions under which successful forms of governance might be fostered so as to improve development prospects over time (Acemoglu 2005). Economic theories of politics have also been developed, such as North's (1990b) theory invoking the notion of transaction costs in relation to the 'political market', though with no apparent reference to earlier but similar efforts by political scientists (e.g. Keohane 1982). Acemoglu *et al* (2005) recently presented a theory of interest-based

[4]Concerning further literature on the developmental state debate, see the literature survey in Underhill and Zhang (2005).

constituencies remarkably resembling much work by political scientists, but again with almost no reference to their long-standing work.

There is here a clear case for bringing the two disciplines together. Had there been greater levels of cross-fertilization, it is unlikely that Williamson (1985, 15) would have been moved to declare: "The study of the economic institutions of capitalism has not...occupied a position of importance on the social science research agenda." More accurately, it had not occupied an important place on the *economics* research agenda, a fact which has impoverished the institutions research agenda in general. The separate efforts of disciplines would have been far more complementary, and progress faster, had the debates in political economy been joined earlier by scholars of institutional economics.

This broad range of literature focussing on institutions and economic exchange has then emerged to address similar, by nature interdisciplinary questions, but there is little dialogue across the disciplinary boundaries. While a division of labour based on specialisation is surely beneficial in many respects, if the same subject is being addressed, better interdisciplinary collaboration should help rather than hinder progress and understanding. The literature cited above, a small part of an enormous accumulation of scholarship, provides a suitable starting point for such an endeavour. One purpose of this paper is therefore to bring the economics and political science literatures out of their splendid isolation and to demonstrate how the tools developed by each are useful for the other.

Furthermore, this effort is also aimed at overcoming some important limitations of the current literature across both disciplines. Both literatures increasingly recognise the importance of institutions and governance for explaining outcomes in market-based economic development processes, and both recognise the mutual interdependence of market processes and processes of governance. However, each also presumes that what happens in the market and the economic domain is fundamentally different, separate in nature, from what happens in the process of governance: what firms do when they compete with each other is fundamentally different in nature – has different motivations and origins – from what political institutions do when they make decisions concerning allocation and distribution.

Disciplinary specialisation has arguably carried this separation furthest in economics: contrary to neoclassical economics, both Arrow and Williamson have argued that market and non-market processes, while fundamentally different, are potential if imperfect substitutes for each other. Arrow (1974, 15-43) argued that organisation and institutions emerge as substitutes for market allocation when the price system fails for a range of reasons: "The functional role of organisations is to take advantage of the superior productivity of joint actions (ibid., 53)." Therefore, "we may take the very existence of an organisation with a need for co-ordination as evidence of the infeasibility or at least the inefficiency of the price system," economising the transmission and handling of information (69). This may involve a range of tradeoffs in terms of efficiency, especially because organisations sometimes prove less than adaptable over time. If transaction costs prove too high, the situation will block the formation of markets in the absence of other forms of institutions. Williamson (1975, 1985) argued that institutions emerge as efficient solutions to the problem of high transaction costs: non-market forms of organisation may emerge to assume the function of allocating scarce resources more efficiently than decentralized exchange. This renders each essentially a substitute for the other ("alternative contracting modes," Williamson 1975, 253), although each remains a very different *kind* of allocative process in and of itself.

There nonetheless remains in the economics literature a strong presumption that governance (in the form of regulation or other forms of 'external' intervention by political institutions in the market), interferes with the market, resulting in costs in terms of inefficiencies and welfare losses, and this sits uneasily with the clear realisation that the two appear so closely intertwined. Anne Krueger's classic article (1974) on rent-seeking behaviour in relation to import licensing is representative of this ambivalence: "government *restrictions* upon economic activity are pervasive facts of life," (291, italics added) she states in her first sentence, implying that if the market were left to its own devices, these restrictions would be less in evidence.[5] She goes on to recognise that some producer groups may well *benefit* from the rents associated with this same state intervention, which logically implies that such rent-seeking is competitive in important ways; her focus is on the costs which this interference with the market mechanism implies.[6] Thus these very economic agents deploy resources and compete (Krueger 1974, 292-3) to establish forms of intervention which interfere in the market mechanism in which they are involved,[7] and there will of course be transaction costs attached to this behaviour which will need to be overcome.

Behaviour which is part of what economic agents do is somehow, implicitly, not part of the market and how it is understood. The link between the process of market exchange and the institutions of governance is therefore recognised but not yet fully explained by the literature in theoretical terms. It remains a paradox as to how competitive rent-seeking is part of the economic game, yet interferes with the market of which it is part. Explaining this paradox, the governance-market link, is what this paper sets out to do. It does so by arguing that the differences between markets and governance are more apparent than real, and that the two processes are fundamentally part of the same phenomenon of economic competition.

[5]Although the argument in this article is that this is an unlikely real-world outcome.

[6]And, furthermore, these costs represent a higher 'deadweight loss' in the presence of competitive rent-seeking for import licenses than when import restrictions are applied in the absence of this rent-seeking behaviour, with considerable implications for the development process (299; 302).

[7]Krueger argues convincingly that this rent-seeking activity is not carried out by separate economic entities, and sees rent-seeking as one part of economic behaviour along with production and distribution. She

This paper thus not only claims that governance is endogenous to market processes in the sense of being interdependent with/inseparable from them. Using the tools of the transaction cost and institutional economics approaches which Williamson did so much to develop, the paper argues that they are at root part of the same process and behaviour of economic agents. This requires taking a significant new step, demonstrating that governance emerges from and is rooted in the very process of market-based rivalry among economic agents themselves, embedded in the rivalry among competing economic agents and factor-based constituencies. Conflict over the terms of competition in the market and the permeation of the institutions of governance by these same economic agents means that both market interaction and processes of governance are part of the ongoing conflict over the terms of competition among agents and factors of production. Rent-seeking is indeed competitive, endemic, in economic interaction, and (not necessarily good) governance is part of this process, helping set the terms of competition in favour of some and to the detriment of others.

The argument here is that conflict over the *terms* of competition is a direct extension of the profit/utility-maximising behaviour of firms or other economic agents and their attempts to realise competitive and distributional advantages over their rivals of various kinds. The principal determinant of market structure in either domestic or cross-border context is therefore the capacity of producer agents themselves to organise institutionally in order to determine the terms on which competition within and across borders will take place, suggesting rivalry not just among firms but with agents in producer groups such as labour. In this way, the awkward political economy of liberalisation becomes easier to comprehend. Preferences for fully competitive versus highly restrictive market contexts are situated along

also draws attention (302-03) to the potential political and social costs of widespread policy-based rent-seeking as the primary route to gain.

a continuum where neither pole is ever reached. Policy preferences are seen in relation to potential outcomes in terms of the breadth of the market, the intensity of competition, and the subsequent distribution of benefits relative to realisable growth in output/wages etc. In view of this analysis, the paper will also explore how one might devise strategies to move up or down the protection-liberalisation continuum to optimise the benefits for particular constituencies which, on normative grounds, one might argue deserve a better outcome. The paper proceeds by employing a transaction cost approach[8] and consists of a conceptual discussion of the political economy of liberalization, emphasising the range and essential unity of various means employed by economic agents of various constituencies to gain competitive advantages, in turn generating more open or closed market structures. In this sense, the paper demonstrates theoretically how and why the institutions of governance are necessarily *endogenous* to the functioning of the market.

The argument in brief proceeds as follows:

1. Rivalries among economic agents principally concern the terms upon which each will compete with the other, with interests focussed on maximising respective utility functions. This concerns both rivalries among sets of like economic agents (e.g. sets of firms or workers in competition with each other) and rivalries across the land-labour-capital-consumer constituency divides.

2. Rivalry among economic agents involves as much collusive as competitive behaviour, with rent-seeking both endemic and, for particular agents, often more utility-maximising than open competition. In this sense, rivalry among agents does not always lead to competitive behaviour, and collusion-based co-operative processes are one way to resolve a range of transaction cost problems ranging from continuity of

[8]The question arises as to what is meant by transaction costs in the context of this paper. Williamson's discussion (1985,18-23) provides a suitable definition. Transaction costs are for the process of economic interaction the equivalent of friction in physical processes: *ex ante* costs involve negotiating, drafting and safeguarding agreements (20). *Ex post* costs (21) involve the cost of adjusting to changing context or other misalignments, of securing commitment to contracts (enforcement; dealing with opportunism) and of setting up the institutions of governance. These costs are interdependent with each other and relate especially but not exclusively to maintaining the continuity of transactions in the market over time. A further aspect on which this paper will also place considerable emphasis concerns the costs of collective action dilemmas and free-rider problems (Olson 1971), of uncertainty (Williamson 1985, 56-61; e.g. uncertainty related to informational deficiencies, see Arrow 1974, 33-59) and the costs of dealing with calculable risks.

exchange in the market, to the provision of the collective and public goods which resolve collective action problems, and controlling free rider behaviour.

3. Forms of organisation and institutionalised behaviours emerge as a result, which both resolve conflicts and facilitate co-operation, though they may involve aggregate-level costs. The utility-maximising behaviour of economic agents in competition with each other is therefore directly linked to the emergence of both the institutions of governance and of the organised social constituencies which compete for/within them. These institutions may be classified as first, second, and third order institutions. Contrasting forms of market and institutional development correspond to political-institutional compromises based on the preferences of interacting agents.

4. Logically, this means that the terms of competition are affected not only by the competitive deployment of 'economic' resources in the market, but also (and sometimes principally) through the (institutionalised) deployment of political resources in line with agent preferences. This provides a further incentive for ongoing investment in the institutions of governance in a situation of economic competition. Economic agents are involved in the simultaneous deployment of both political and economic resources, which means that there is a fundamental unity between political and economic aspects of rivalry among agents.

5. (Perceived) preferences depend upon the sort of agent, their resulting perceived utility function, and their real economic and political resources and position in the broader system of production and distribution. These preferences are relative to the self-interest of agents in the market and to their (institutionalised) position in relation to the range of social constituencies, to their corresponding capacities simultaneously to deploy a range of economic and institutional power resources, and (eventually) to institutionalised patterns of behaviour by vested interests.

6. What is efficient for some is not always for others, and preferences for protection versus open markets coexist on a continuum between open competition and collusion, with neither pole ever being reached in the real-world. Each point on the competition/free trade–regulation/protection continuum represents a governance solution for particular constituent interests in specific circumstances. The institutionalisation of first-mover preferences and the phenomenon of path dependency makes it highly likely that a 'bad equilibrium' producing poor economic outcomes may persist for some time.

7. This model hypothesises reflexively that conflict over the terms of competition in the market generates changes in actor preferences concerning regulation and governance, and that the outcome of conflict over divergent actor preferences concerning governance and regulation generates changes in market structures. Changes in preferences concerning governance therefore are intimately bound up with preferences concerning market structure. The long-standing distinction between the economic domain of 'markets' and the domain of governance inhabited by the state and government breaks down, and should be replaced by the notion of a *state-market condominium*.

8. In practical terms, real-world preferences and outcomes should not be understood against criteria of economic efficiency, but against the perceived utility functions of agents in their broader social context. While real-world outcomes may well be measured as more or less efficient in relation to theoretical norms, 'efficiency' in this sense is no less abstract than the ideal of perfect competition. Following Acemoglu *et al* (2005, 451) but taking the point both further and more seriously, issues of efficiency and distribution are "inseparable": if what is efficient for some may not be for others, then efficiency should be understood in *relative* terms. "*Où en est la rente?*"[9] remains the central focus of enquiry, and policy-makers will need to engage in normative choices as to whose version of efficiency should prevail. This is a central task of governance. Establishing open systems of competition-based rivalry may be one solution to the problem.

Markets, governance, and competitive behaviour: the conceptual dilemma

The economics literature has long been concerned with explaining markets as a spontaneous extension of human propensities and freedoms (Leube and Zlabinger 1985; Hayek 1949, 1960). Adam Smith's often misunderstood work (1937 (1776)) is at least partially responsible for this. Thus, in the literature, the benefits of 'free' trade and competitive markets are typically contrasted with the negative effects of their polar opposites: regulation, protectionism, or monopoly. Free competition arises spontaneously from the interaction of market agents, and restrictions to competition are typically exogenous, imposed by arbitrary political authorities. Free competition represents the smooth and self-regulatory functioning of the market, despite the possibility of private restraints to competition through monopoly or oligopoly. State intervention at the domestic level and protectionism at the border represent the dysfunctional role played by political intervention. The struggle for the free market as a system of allocation is a struggle against politics.

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[9] My thanks to Patrick Messerlin, who many years ago advised me to shape my enquiries into public policy on this basis.

This vision in much of the literature yields a conceptual dichotomy between the market as exchange, and governance as coercion. This dichotomy assumes that the model of the competitive economy "is a reasonably accurate description of reality (Arrow and Debreu 1954, 265)" and that conditions can be specified which correspond to a wide variety of actual situations under which a competitive economy tends towards equilibrium (p. 266), a form of spontaneous order. The standard neo-classical notion is that economic competition operates through the deployment of management skills, product innovation, and relative factor costs in the strategies of firms, and its effect is measured in terms of competing prices relative to quality and tastes/utility functions or income levels in the market. Coase (1992, 714) points out that economics has largely consisted of increasingly abstract formalisation of what is claimed to be Smith's central idea that an economy could operate in an orderly fashion free of government regulation and central planning. "Sometimes, indeed, it seems as though economists conceive of their subject as being concerned only with the pricing system and that anything outside of this is considered no part of their business." The economics literature (along with most of the political economy literature of political scientists) employs both theory and empirical research methods to develop this contrast between market versus non-market or 'political' systems of allocation, basing the distinction on the 'observable' behaviour of economic agents and the nature of market outcomes. Once again, governance and institutions are understood as organisational substitutes for market exchange that emerge when the market has failed (Arrow 1974).

One may challenge the literature in more ways than one: by focussing on the nature and internal consistency of the particular model, or on the *assumptions* employed and the nature of the data and methodology, or one may challenge the notion of the market as spontaneous order itself. The argument here takes the latter route, building in several respects on the critique of neoclassicism offered by transaction cost approaches and institutional economics (e.g. Coase 1937, 1992; Williamson 2005; North 1990a, 1991; Acemoglu *et al* 2005; Acemoglu 2005), which will be discussed below. The question concerns not only the utility of the analytical distinction between markets and governance, but also is it empirically reliable?

There are in fact at least two problems with this 'standard' view.[10] The first relates to the nature of utility-maximising behaviour of economic agents. The classical political economist Adam Smith (1937 (1776), 250) argued persuasively that business has an inherent tendency to seek to "widen the market and narrow the competition." In this sense, and based on his own empirical observations, he contrasted the interests of mercantile and manufacturing classes with those of the broader public, including labour, consumers, and the state. Here he hit upon an important characteristic of markets and the way they work: the agents most intimately associated with market transactions and support for markets as allocative devices are those most likely to interfere with their effective functioning and overall efficiency. *Utility-maximising behaviour under conditions of economic rivalry may prove as collusive as it is competitive*. As Arrow (1974, 42) points out, the "usual" economic analysis argues that collusive agreements are unstable because the there are always preferable allocative deals for at least some of the participants. He goes on to correct that view by paraphrasing Smith: "members of a common trade find it easier to communicate with each other...[thus] it may well be that the exchange of information leading to a collusive agreement among producers of one commodity is much cheaper than that needed to achieve a blocking coalition. Hence, the collective agreement may in fact be stable (ibid., 42)." It is a pity that much

[10]I use 'standard' in the sense employed by Oliver Williamson (2005),by which he essentially refers tto the neoclassical approach; see also Williamson 1985.

contemporary economic theory does not take more notice of the insights which these passages in Smith reveal about the nature of markets, and the relationship of market processes to various forms of political processes, or what is commonly called 'governance.' "...[C]ollective action can extend the domain of individual rationality. Collective action is a means of power, a means by which individuals can more fully realise their individual values (Arrow 1974, 16)."[11] The principal impact of the point is that markets are unnatural institutions which do not tend towards spontaneity, equilibrium or continuity, peopled as they are by rent-seeking agents whose rational utility-maximising motive detects little interest in competing regularly with others if they can help it (Fligstein 2001). If the theoretical benefits of markets as specific forms of allocation and distribution are to be achieved, then the institutions of governance in society must aim to underpin and enforce some form of competitive outcome. In this sense governance is all about the market, and the market is a broad and complex form of governance based on a series of equally complex institutions for regulating conflict amongst the constituent elements of society.

A second problem with the free market spontaneity view is more an empirical one. While models of perfect competition may help us understand the benefits of removing significant barriers to the freedom of transactions and movement of goods, situations of perfect competition are not found 'walking about'. Real-world markets are approximations of this abstract concept (or rather the other way around) and exist on a continuum of more or less restraint to trade, factor mobility, and the like, just as real-world 'free' cross-border trade

[11]In other words, collusive and co-operative behaviour which leads to the substitution of market exchanges by institutional hierarchies (or the reverse) should not be regarded as outside the bounds of utility-maximising behaviour and economic rationality. Just as concepts of bounded rationality introduced context, culture, and other sorts of "constrains" on rationality into the picture, the point here is that given positive transaction costs, uncertainties of various kinds, and the dilemmas of collective action, the competitive, collusive and hierarchical aspects of utility-maximising behaviour in conditions of economic rivalry are rational; see Williamson (1985, 44-6) .

exists on a continuum with protectionism. It is a matter of degree. Furthermore, the many possible states of affairs on the open competition-protectionism continuum share important characteristics in the sense that each is better for some agents than for others, even if one may argue that one or the other is better for all and constitutes the 'public good'. *Each, competition/free trade vs. regulation/protection, represents contrasting preferences of different producer groups in the economy; each is a governance solution peculiar to particular constituent interests in specific circumstances.* They are not contrasting principles but part of a continuum of preferences for greater or lesser degrees of raw competition among agents in the economy. Both governance and the deployment of resources in competition with rival economic agents are all about setting the terms of competition in line with agent preferences.

In this sense, the analytical distinction between markets and governance established by the literature obscures more than it clarifies. Theory should therefore focus more on explaining the relationship as opposed to the dichotomy between the two, yet this is not always the case. Why is the real world so? The traditional understanding of markets in the neo-classical approach is of a natural or spontaneous pattern of production and exchange free of political intervention. This implies a domain of economic interaction which permits the natural human proclivity for utility- and profit-maximising behaviour to flourish. In Smithian terms, the individual pursuit of private interest can under specified conditions serve an important public purpose: developing the division of labour, improving the prospects for growth, allocating more efficiently, and granting access to wealth to a wider range of citizens than closed oligopolies or state-chartered monopolies, which historically used public authority to limit who would gain from the most lucrative economic activities, who would face competition and who would not. It is the specification of the 'conditions' where the controversy lies.

Smith's work implies that a much broader notion of 'economic' interaction is required than that found in the standard economics literature, one which includes forms of governance normally associated with the 'disabilities' of political intervention. Regulation and political intervention providing co-ordinative or collective goods is very much part of creating the 'specific conditions' under which systems of free exchange will accomplish their public purpose. Thus over time the literature has indeed evolved to understand institutions as central to the way in which market-based systems function (e.g. North 1990a, Acemoglu 2005). Likewise, the quality of the institutions of governance is now seen as a central element of successful economic development and growth (World Bank 2002, 2005). Institutional economics contributions attempt to complement and enhance these insights, demonstrating that functioning market systems tend to be accompanied by a range of institutions which appear in empirical terms to be closely related to the issue as to why markets function at all. Despite exceptions (e.g. Acemoglu *et al*. 2005), however crucial institutions are seen in relation to the functioning of market systems of exchange, the institutions of the market are not seen as part of the process of governance itself, and thus governance is seen as exogenous to the market.

First, Second, and Third Order InstitutionsA first step is to recognise the variation in institutions associated with the market. Empirically speaking, the terms of competition are set not only by firms and other agents interacting as rivals in the market, but also by a range of factors external to market exchanges themselves but integrally linked to the preferences of market agents. More or less hierarchical institutions arise through the utility-maximising behaviour of the range of economic agents in the political economy as agents attempt to realise their preferences in relation to the competition-collusion continuum. Institutions associated with the functioning of the market therefore vary in form, function, in terms of the access they permit to client constituencies, and in terms of membership/direct participation. Some (such as firms or forms of labour market organisation) arise in the organisation of production. Others arise to resolve collective action problems or potential/existing market failure, or to share or reduce risk and the collective costs of the same. Still others arise to resolve disputes and enforce outcomes, and some to define directly the terms on which agents may enter the market and/or interact with each other.

In the context of a market-based economic system, three orders of institutions may be said to be integral to the functioning of markets, ranging from private ordering, via private (self-) regulation and enforcement, to external or 'public' institutions. Some in a first category (category one) are indeed attributed to the private order of the 'market' such as factor prices: cost barriers to entry; energy, land, raw materials and other inputs; the structure and quality of firms and management; product research, innovation and pricing; or private restraints to trade linked to dominant market players. These have been clearly identified by transaction cost scholars in the 'markets and hierarchies' literature (Williamson, 1975). A second category (category two)is situated on the border between private market order and 'external' (political) intervention: overtly organised or officially recognised cartels; systems of self-regulation such as industry-enforced standards; sectoral or other representative associations of firms or labour market constituencies; or complex private organisations such as stock exchanges, operating markets and designing and enforcing their rules. The third order (category three) is often openly associated with institutions external to the pattern of market transactions: political intervention, such as dispute settlement and enforcement by the courts and the definition of the law; environmental regulation;, social welfare and labour market regulation;, health and safety standards and legislation; collective pension and health provision; collective provision of educational; or local land-use laws. Many of this latter category are recognised to enhance the operation of the market and its efficiency even if they constitute external third-party intervention in otherwise free exchanges among economic agents. They are associated with regulatory and often overtly political decision-making, and often involve conflicts of interest among a range of factor-based constituencies. They operate through a range of more or less autonomous state or other agencies of governance, but are at the same time characterised by their interaction with and permeation by constituencies of agents in the market. These active and organised constituents of the market with contrasting preferences along the competition-collusion continuum deploy both informal and institutionalised political resources to influence the extent and nature of intervention by category three institutions.

These three orders of institutions[12] exist in different configurations depending on a range of variables. These might be structural economic or organisational variables related to economic, social and institutional development and path-dependency. Variables include the nature of the different economic sectors or production processes concerned, the national or local context and history, the nature of corporate governance and labour market organisation, the level of internationalisation of the economy, and the nature of the underlying constituencies of agents and their organisation and linkages to state or self-regulatory decision-makers.

[12]Other scholars have attempted similar systems of classification. For example, Berglöf and Claessens (2006, 125-31) employ a four-part classification with respect to enforcement: private ordering (the exception), private law enforcement, public law, and state ownership/control. See also the account by Haggard and Lee (1995, "Introduction: Issues and Findings," by Haggard and Lee) of configurations of state, firms, and market

The most important point is what category three shares with the first two categories: they *all* have a direct impact on the terms under which competition among agents in the market takes place. A closer look yet is necessary: even those at first sight belonging in category one, thought of as having prices set in the 'market' may in fact be highly politicised in important ways. Energy input costs are determined by a combination of competition juxtaposed upon OPEC or other government policy, (sometimes monopoly) utilities regulation, and other 'non-market' factors. Indeed the traditional factors of production (land, labour, and capital) are part of highly politicised market settings integrated into the decision-making structures of states, and in which organised economic agents participate. Land use and environmental policies shape the market for land. The cost of capital is shaped by both market interactions and often highly political decisions concerning interest rates, exchange rates, or the licensing of financial institutions. The cost of labour and its relative skills and efficiency are determined as much by educational policies, minimum wage legislation, pension and healthcare provision, or collective bargaining institutions at peak or sectoral/firm level as they are by 'market' forces.

In this sense the distinction between these three different categories of elements affecting the terms of competition is purely analytical - based on the distinction in the literature between private order domain of the market and public domain of politics. Empirically speaking they all affect for better or for worse the terms of competition and there is a systematic attempt by market agents to deploy resources to determine them. There exists a series of socio-political institutions of governance to resolve conflicts about them, shaping the market as they go. Simultaneous to competition with each other in the market, firms and

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exchange which constitute the institutional setting for capital markets and, when they function well, may contribute to the development process.

other agents in the economy deploy political resources to affect their costs. The measures associated with political intervention and regulation do not have a price in the market as such, but they certainly have a cost through their effects on transactions, and as such also have a direct or indirect impact upon prices and the incentive structures and relative competitiveness of firms. Both this 'political' and the traditional 'economic' aspect of the terms of competition are integral to the strategies of firms and other economic agents, operating singly or in associations, and thus to the way in which markets operate. In this sense, what is referred to as the political and institutional aspects of 'governance' and what is referred to as 'market' are elements of the same phenomenon: 'governance' encompasses the market and its organisational forms, and most of 'governance' is aimed at resolving the social conflicts of interest around issues of production and distribution, facilitating various degrees of market-like forms of allocation and distribution. As Polanyi (1944) argued, the self-regulating market was a myth.

Of course, Category 2 or 3 institutions may also be considered to frustrate competitive processes, rendering the working of the market less efficient, in this sense *adding* to both transaction costs and creating potential welfare losses for a range of actors through the burden of regulation, taxation, or labour market conditions. Thus it is possible to claim along with much of the literature, and in contrast to the argument presented here, that external regulatory intervention constitutes a barrier to successful systems of market-based transactions. Krueger's analysis (1974, 302-3) certainly points to additional 'deadweight costs' in the presence of competitive policy-based rent-seeking behaviour by economic agents. Yet her basic analysis of competitive rent-seeking behaviour as part of what economic agents do reinforces the argument presented in this paper: that the terms of competition are set through the simultaneous deployment of both policy-process based and traditional ‘economic’ resources.

A further response to the argument that institutions frustrate, not facilitate, competitive market processes has several facets. To begin with, the argument here does not claim that any of the three orders of institutions necessarily imply outcomes characterised by perfect or near-perfect competition, and therefore market efficiency. A normative or theoretical claim that competitively-structured markets lead to more optimal outcomes is not at stake in this discussion, though the claim may indeed be correct. The claim here is that different levels of intervention, different forms of regulation or terms of market access, represent the range of actor preferences along the competition-collusion continuum: the prevailing terms of competition are better for some than for others. Depending on the circumstances and structure of the market, insiders should tend to prefer category two or three regulatory arrangements restricting competition, while market outsiders would seek liberalisation across or within sectoral and/or jurisdictional boundaries in order to gain access to lucrative market segments from which they are excluded. Thus category two or three institutional (political) compromises *may* lead to enhanced competition outcomes, but this is rather unlikely because, as observed above, agents most closely associated with market systems of transactions are also those least likely to embrace highly competitive outcomes. State agencies in category three, or possibly category two private institutions, *may* act to enhance competition in the ‘public interest’ or on behalf of constituencies challenging the status quo, but this requires either the presence of strong preferences for competition, or a considerable degree of institutional autonomy from those constituencies tending towards forms of (limited) collusion. Outcomes are usually of necessity a compromise among a range of interests with contrasting preferences. Furthermore, the situation is dynamic, like the market. While the phenomenon of path-dependency ensures a certain institutionalised inertia, vested interests can be unseated and either political manoeuvring or success in market competition may alter the nature of the underlying preferences of agents themselves.

To summarise, market structures approximating the ideal of perfect competition are conspicuously absent in the real world. It is empirically difficult to separate competitive from collusive aspects of agents' behaviour in a market; preferences for one over the other tend to be context-specific. Competitive market outcomes require substantial enforcement mechanisms. They also need either strong supporting constituencies or institutions which are highly independent of specific actor constituencies to do this. As Vogel has pointed out, free market solutions require more, not less, regulation (Vogel 1996). Whereas the public choice and regulatory competition literature emphasises the enforcement of market solutions as an antidote to policy capture and rent-seeking behaviour of agents in relation to category three institutions, the argument here is highly sceptical in this regard. If regulation and other forms of intervention in the process of competition are endogenous to the market, then genuinely free-market solutions most likely belong in the realm of the abstract.

Theoretical Underpinnings

The argument of this paper may be developed in theoretical terms with reference to the transaction cost and institutional economics literature, beginning with Ronald Coase (1960, 1992) and Oliver Williamson (2005). Coase (1937) initially proposed the idea that the neo-classical assumption of zero transaction costs led to a failure to understand the role of firms as organisational entities in the economy, and why some functions in the market are performed via exchange among firms and other agents, and why some functions are internalized within the command bureaucracies of firms themselves. In this sense, the emergence of hierarchical institutions is a direct result of the functioning of the market: adaptations in the market are consciously co-ordinated by management hierarchies. According to Williamson (2005, 4, who in turn cites Hayek and the organisational theorist Barnard), "To the widely celebrated 'marvel of the market' (Hayek) [was] therefore joined the hitherto scorned marvel of hierarchy (Barnard)" wherein adaptation and innovation is a product of both; in this respect the firm emerges as a "governance structure (Williamson 2005, 4)" central to the functioning of markets.

From 'Economic Governance' to Institutions

Yet Williamson's notion of governance remains a limited one which does not appear to include the category three political and/or legal processes which are the focus of much of the study of governance, nor those in category two noted above. He focuses on the 'economics of governance' as spontaneous private ordering in the market (2005, 1). Even though he labels firms as governance structures, he maintains a clear distinction between economic domain of firms as interacting constituents of markets, versus the legal order of the state. Private ordering is the proper focus of attention for economics, and while law and the state clearly shape private ordering, governance in the political sense is seen as exogenous to market economic exchange and distribution.

Williamson comes to this position by arguing that while resource allocation through "simple" market exchange arguably might require little in terms of governance and contractual enforcement mechanisms, market exchange as a *system* cannot be carried out *without* "ongoing contractual relationships for which continuity of the relationship is a source of value (Williamson 2005, 2)." Adaptation to the market and the organisation of continuity takes place via co-operative behaviour within firms as organisations which stabilise their otherwise uncertain contractual relationships with each other and process necessary information, and there is a normative argument that market and hierarchical firm forms of organisation should be kept in their respective places (6).

Yet Williamson's basic logic can be developed further to denote how the transaction cost principle generates not only this 'economics of governance' but a broader political economy theory of governance demonstrating the essential unity of the political and economic domains, wherein the state, law, and regulation are *endogenous* to the interests of specific constituencies, whose preferences call for it in varying degrees and forms. A similar exercise employing transaction the cost approach was carried out by Keohane (1982) who drew the fairly common analogy between the decentralised international system, which lacks central authority, and the market. He linked the emergence of institutionalised patterns of co-operation known as 'international regimes' to overcoming the high transaction costs of more ad hoc co-operative agreements among sovereign states. Keohane then (1982, 335) made use of the point that in situations of market failure, the absence of institutional hierarchy would lead to inefficient outcomes, and that market failures were likely to occur where transaction costs to decentralised forms of co-ordination proved prohibitive. Institutional innovation was a necessary condition of continued co-ordination, and he went on to argue (p. 339) that the emergence of political entrepreneurs to sponsor new institutions might provide a resolution to the dilemma. If one may see the international level as a weakly institutionalised version of what happens at the domestic level, the logic of the exercise can apply there too, but this has never been done.

A first point is that Williamson's private ordering among firms *is* governance and he accepts it as such, but his account is only one analytical aspect thereof. His focus is essentially on the vertical integration of the firm, yet this does not exclude a broadening of the analysis to include 1) agents other than firms in the market and 2) the notion that other forms of hierarchical organisation may facilitate a competitive market system where transaction costs are greater than zero (Williamson p. 4, taken from Coase), and where uncertainties and collective action problems are an integral part of costs of operating competitive markets. Williamson's logic arguably implies that as markets become more complex, uncertainties and therefore the cost of maintaining the continuity of transactions under conditions of competition increase. If transaction costs are to be reduced, this implies a need for more sophisticated forms of governance over time, governance which cannot be contained within the organisational structures of firms alone but implies levels of co-operation and associational behaviour *among* them. The very reason why transaction costs lead to the emergence of firms is the same reason that complex market systems lead to institutions of governance external to the constituents of the market themselves.

There is, then, a point at which the level of transaction costs associated with complexity, competition and the need for adaptation increases the incentives for co-operative behaviour, above and beyond the typical incentives for collusion in the market. The first stage corresponds to category two above, such as governance through self-regulation. Coase points out (1992, 718) that while economists often characterise securities exchanges as examples of perfect competition, these private institutions "regulate in great detail the activities of traders.... What can be traded, when..., the terms of settlement, are all laid down by the authorities of the exchange...in effect a private law." These quasi-legal institutions underpin the efficiency and operations of the exchange by dramatically lowering the costs of transactions, or they would not exist.[13] Private ordering often has even its own systems of

[13]They may also involve highly exclusionary memberships and collusive forms of market interaction, as did many stock markets prior to 'de-regulation'.

arbitration, even in the international domain with devices such as soft law and arbitration (Dezalay and Garth 1995, 1998).

Category two is therefore an interim stage beyond the ‘economics of governance’ where institutions have emerged that are separate from agents in the market themselves. Co-operative or perhaps collusive behaviour has begun to attenuate or otherwise shape the terms of competition. The transaction cost approach thus implies a potential overlap between the private ordering of economic governance and institutions of governance apart from, but constituted by the associational behaviour of, the range of parties to transactions. The point at which informal category two governance becomes institutionalised ‘public’ authority outside, if not always independent of, the private contractual parties in the market themselves, varies depending on a range of factors. Category three institutional functions are both similar to and arguably an outgrowth of the private realm of category two, but they involve ‘third party’ institutions and enforcement. These ‘third party’ regulatory and legal processes develop in concert and in consultation with economic agents (where some parties and constituencies tend to be included rather more than others).

More independent state-like forms of governance are no longer a major step. A complex market system based on unbridled competition poses substantial and costly uncertainties on the very agents which constitute such a system. Agent preferences will depend upon their resources and capacities relative to rivals. To take argument one step further: the greater the degree of competition, the more likely it is that competition poses unacceptably high costs to incumbents in the market. There is here a clear motivation for mechanisms of governance which shape the terms of competition. The fact that transaction costs are so high pushes agents to co-operative or even collusive behaviour to reduce the costs of adaptation. If the *firm* is not seen by the literature as an alternative to the market, but is part of the very way in which the market is constituted, the same applies to external forms of governance as extensions of the transaction cost and 'economic governance' principle. The uncertainties of open competition may become destructive for the very agents exposed to its cold winds, and this impact on transaction costs affects the strategic choices of firms. One choice may be collective institution building, and this form of governance derives directly from the profit-seeking motivations of firms and other economic agents, and the incentive provided by market interactions to reduce transaction costs.

State Institutions versus the Market: the State as 'Super-Firm

This focuses the analysis squarely on category three institutions such as legal dispute settlement, land-use regulation, or taxation to pay for them. These involve institutions, processes, and forms of intervention which are not only external to the individual market agents themselves (like category two), but are a peculiar kind of politically determined and *third-party* institution involving (more or less open) public policy processes, otherwise known as the state and the law. These involve social bargains and compromises among the factor-based constituencies represented by the circular flow of the economy. There is a basic continuity between Williamson's category one 'economic governance' and categories one and two, exemplify the continuity between the domain of private order and the domain of politics. All serve to reduce uncertainties, deal with complexity, resolve collective action problems, and thereby ensure the continuity of the market if they function adequately. They all provide both economic opportunities and constraints for agents in the same way as 'properly' economic governance. Why should they be thought of separately if they perform analogous functions?

“Most economists seem to have been unaware of this relationship between the legal and the economic system except in the most general way (Coase 1992, 718). Williamson’ argument is an important step. He acknowledges (2005, 7) that markets involve both horizontal market-based forms (exchange) as well as hierarchical forms of organisation (firms), that hierarchy in some circumstances facilitates co-operation better than markets, and that co-operation is often necessary in order for markets to function. Yet Williamson’ primary concern is after all with the firm and vertical integration, which leads him to treat legal enforcement by the courts, a function of sate, as exogenous (p.9). Yet the conjunction of hierarchical state institutions embedded in horizontal and decentralised market relationships is a paradox which *does* require explanation, which in turn requires a refocusing of the enquiry.

North’s institutional economics (1990a, 1991) and Coase (1960, 1992) move a step closer, explicitly acknowledging the role of formal political institutions, law and regulation and the problem of dealing with social costs. Coase (1992, 716-7) draws attention to Smith’s account of money as a means of reducing transaction costs, but does *not* go on to say much about the emergence of state issuance monopolies, about monetary, exchange rate and stabilisation policies (e.g. for example central banking and interest rates), or about regulatory policies, as a further resolution of the transaction cost and collective action dilemmas in the market were there to be competing monetary instruments or the like. The regulatory and legal institutions of the state are still portrayed as external to, intervening in, market processes as opposed to fundamentally constituting and providing their underpinnings. But Coase clearly accepts that the firm is not the only answer to the problem of transaction costs and the continuity and stability of market relationships. The alternative is some form of state-based regulation which sets incentives and affects costs of using factors of production administratively, making the state a sort of 'super-firm' of a special kind whose decisions should not be considered costless and may or may not lead to lower transaction costs and higher levels of efficiency (1960, 9). The market as a form of governance requires the establishment and enforcement of specific types of relationships amongst agents (capital, consumers, labour). Its incentive structure, contractual stability, and outcomes are also enforced by category three legal and regulatory institutions of the state. Yet as North (1991, 98) points out, "the literature simply takes those as a given."

The proposition here is that just as agents in the market invest in category two institutions, they also invest in co-operative and often collusive institutions of the state, vesting them with authority, as the costs of uncertainties, collective action problems, and the complexity of maintaining continuous interaction in the market, rises. If empirically speaking it can be demonstrated that the hierarchical institutions of state are as closely associated as the hierarchy of the firm with Hayek's "marvel of the market" by facilitating and providing incentives for conscious if autonomous co-ordination, an adequate theoretical explanation of the phenomenon is required.

The 'Coase theorem' developed by Stigler is helpful here (Stigler 1989). As Coase himself puts it (1992, 717-18), the theorem says that under zero transaction costs as in standard neo-classical economic theory, negotiations among partners in a market setting would ensure efficient provision of collective goods to attenuate negative externalities, rendering government solutions and institutions unnecessary. But Coase's point is that in the real world transaction costs are *not* zero, and this means that it is far too costly to negotiate and renegotiate the legal system in a market setting. The legal system not only shapes the way in which the economy operates, but "may in certain respects be said to control it (Coase 1992, 717-18)." Thus the legal system and regulatory provisions of governance are far from exogenous to the economic system, but are *part* of it, helping it to function. They are also highly political, the subject of social conflict precisely because the legal system affects costs and therefore *outcomes* in terms of the distribution of benefits. Resolving these conflicts so as to facilitate continuity leads to the development of institutions external to the parties of transactions in the market.

The Dynamics of Competition: explaining the emergence of category three institutions

The point may be further developed by analysing the nature of competition and the adaptation of firms to competition in the market as a central problem of the transaction cost literature. According to Williamson (2005, 4), hierarchical managements consciously co-ordinate the adaptation of firms to the market as *autonomous* units in the realm of category one 'economic governance'. This assumption of autonomy is empirically questionable in a way which both challenges and suggests a solution to the limitations of Williamson's account. An important part of empirically observable economic governance is the private restraint of trade, restraints which abound and may become institutionalised. These private restraints based on the collusive aspects of utility-maximisation straddle the border between categories one (dominant market position) and two (active collusion among agents). They are at least as 'natural' an aspect of the profit/utility maximisation motivated interaction of agents in the market as is competition. When the costs of competition become high, the adaptation of firms is no longer purely autonomous but may become collusive, operating via co-operative category two institutions, some of which reduce transaction costs by shaping the form, and usually reducing the intensity of, competition.

Williamson's concern with the firm and autonomous adaptation represents a one-sided focus on the *agents* as opposed to the broader *process* of competition. As a process, competition can be fundamentally disturbing and indeed destructive for particular firms.[14] Schumpeter was acutely aware of how "gales of creative destruction" would be resisted by those most likely to suffer their adverse effects (Schumpeter 1983 (1912), ch. 2; 1942, ch. 7).[15] Institutions to shape the terms of competition spontaneously emerge to attenuate the forms of competition, attending to the conflicts of interest in this regard. Without these collective institutions, the high transaction costs of uncertainty and collective action problems in a complex market setting may lead to market failure. These institutions may also belong to category three; in this sense the market is constituted not just by firms and private order, but also by regulatory and legal institutions shaping the terms of competition and reducing transaction costs, including the legal and regulatory institutions of state.

If the *incentives* which might produce category three institutions are now clear, it remains to be explained why firms and other economic agents might cede such important elements of their autonomy by investing in category three institutions *outside* their sphere of strictly 'market' interaction. The argument here is that these institutions are not an external imposition by the state (though in some historical circumstances coercion might play a role, though coercion is in turn likely to affect some more than others), but emerge 'bottom up' from the utility-maximising behaviour of agents.

North of course does focus on category three institutions and how the development of these institutions affect the prospects for growth and economic development (North 1990a, 1991), but he does so in a way which conceptualises them as analytically and empirically distinct from the market itself, the separate political and economic domains. He likewise assumes a dichotomy between the institutional forms of these respective domains. This

[14]Even if ultimately creative according to Schumpeter (1983(1912), ch. 2; 1942, ch. 7).

remains problematic if one accepts that the political and legal institutions of governance are highly interactive, if authoritative, forums to provide collective goods, thereby determining outcomes in terms of who gets what. The different categories of co-ordinating institutions may have different specific forms and functions, but their role in the political economy of governance has common and generalisable features.

North seeks to analyse the comparative positive or negative effects of emergent state institutions in path-dependent economic development processes. He does not focus on the link between the constituent interests in the market, the problem of transaction costs, and the emergence of category three state institutions, except to the extent that category three institutions may reduce transaction costs in the market and facilitate development, or not. Why this oversight in the transaction cost and institutional economics literature? First, category three institutions are external to the market and therefore attract less attention from economists; they are largely seen as an object of analysis for the discipline of policy studies in political science. Secondly, the content of the rules developed by state institutions is for those steeped in market equilibrium and the beauty of decentralised decision-making *arbitrarily* determined. There is something repugnant about them, the disability of politics, beyond he marvel of the market, even though as Coase points out (Coase 1960, 9) they may well or may not contribute to the more efficient functioning of markets, it is an empirical question. The central problem is the long-standing conviction in the literature that the analytical distinction between private economic governance of the market and state institutions means they are also empirically identifiable as separate phenomena in the first place. Under scrutiny, this assumption breaks down.

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[15]He argued on this basis that enforcing the process of competition was a crucial support of successful capitalist adjustment.

Economic governance and category two institutions are directly controlled and organised by parties to the market. Successful category two institutions are therefore seldom likely to be highly inclusive: as Olson (1971) pointed out, narrow and focussed interests are easier to organise than broadly inclusive processes, and collective goods will tend to be consistently under-provided in large-scale group settings even if the self-interest of members to pursue a common goal is both clear and perceived, and they would all be clearly better off by successful pursuit of this goal. Free rider problems will ultimately frustrate collective provision in the absence of some form of coercion, and most large-scale interests will remain latent and unorganised (Olson 1971, chs. 1-2). As market complexity and the dilemmas of collective action increase, category two institutions may prove increasingly ineffective in managing relationships outside their limited membership. Furthermore, enforcement in relation to partners who are also rivals remains an obstacle: the possibility of defection from co-operation remains ever present as the dynamics of associational behaviour and of the market shift preferences along the collusion-competition continuum. Defection and the associated institutional instability mean that transaction costs remain potentially high, and costly uncertainty abounds.

State forms of institutionalised governance may resolve these difficulties if economic agents contract in to'third party' institutions vested with genuine authority. This comes of course at the expense of autonomy (an autonomy which was anyway constrained by category two processes). Institutions of state, just like category two institutions, may develop perceived interests of their own; recourse to third party dispute resolution, or demands that regulation be supplied to reduce transaction costs, carry risks of unpredictability and of external influences from other constituencies. Yet such third party institutions can be vested with sufficient authority to prevent the breakdown of co-operative behaviour and to impose the outcomes of dispute settlement. In addition, these category three institutions are *permeable* (if not perfectly so) to a range of interests, and even (partial) capture is a present possibility. Thus these institutions are unlikely to evolve in isolation from the constituent interests in the market, though some constituencies are likely to prove far more influential than others. The contractual parties will choose private ordering and dispute settlement as long as the conflicts of interest and associated transaction costs of resolving them remain acceptable. They are likely to generate or opt into existing co-operative institutions with authority over and above market agents to the extent that the costs of conflicts of interest, of competition, of uncertainty, of collective action dilemmas where there are many interacting agents, are too great to be resolved among contracting parties alone. This is particularly the case when one admits that the market consists not only of firms, but also of consumers and labour representing different social constituencies. This interaction of diverse constituencies in a setting of market complexity leads spontaneously to the politicisation of conflicts of interest, and a recourse to institutions to reduce the costs of such conflict.

The particular position of labour as a constituency (however fragmented) is important here, and it explains a wide range of category three institutions of governance. Where labour is both plentiful relative to demand and less than mobile, open labour market competition may lead to low wages and unemployment. Only highly skilled (thus scarce) and mobile workers are likely to do well in such a situation. Those who are most likely to do so are those with the education and skills that are essential ingredients of political strategies. Some labour constituencies are therefore likely to favour institutionalised constraints on the labour market and may organise to realise this aim. Firms of course face incentives to keep labour costs down, placing firms in a traditional conflict of interest with labour.

As these conflicts are likely to become politicised, their resolution often depends on either category two labour-capital co-operation, or category three institutions of the state. The impact of the resulting institutional compromises on the terms of competition has implications which are broader than wage levels employer profitability. Abundant low-wage labour provides employers with low incentives to substitute capital for labour, yet this substitution is an essential ingredient of longer-run economic development. Moving up the value chain is also a potential source of competitiveness for firms, but the process also relies on a reasonable state of health and appropriate skill and educational levels in the workforce. State institutions can provide collective goods to resolve these dilemmas, facilitating (or of course repressing) worker representation by providing consultative institutions for the parties, educational funding, and support for health and pension costs. In this way social compromises raising efficiency levels and reducing the conflicts of interest and transaction costs of labour markets can be achieved.

First Comers, Path Dependency, and Economic Efficiency

It remains to be explained why market structures and corresponding institutions of governance (categories one to three) vary so considerably across local, sectoral, and national economies, and why they vary so widely in terms of economic efficiency and potential. How does prevalent utility-maximising behaviour lead to such diverse outcomes? The answer lies in an analysis of the dynamics of path dependency, if such an apparent oxymoron may be permitted.

Those market constituencies which successfully exert influence on the process of institutionalisation, particularly its early stages, are likely to find their interests better represented than others. This leads to the institutional path dependency, wherein it can be demonstrated mathematically that early choices in the formation of institutions exert lasting influence over their longer-run stable equilibria (Crouch and Farrell 2004, 4-8). In other words, first-comer coalitions to institutions have considerable and embedded advantages in terms of exerting influence over the decisions they produce (Underhill 1998, 9-10). This does not mean that institutions do not adapt to change, but it does mean that adaptation is often difficult and is likely to occur with a considerable lag as vested interests are challenged. To put it bluntly, shifting to new institutions involves important transaction costs and perhaps losses for particular constituencies.[16]

The example of stock exchanges is once again useful here. McCahery (1997, 53-60) employs a public choice law and economics approach to examine the emergence of strictly enforced insider trading regulations in relation to the changing market context and the interests of constituents in the market. Although US law had since the Depression contained prohibitions against insider trading, McCahery convincingly argues that serious enforcement, in which the category two stock exchange had front line responsibility, did not occur until new preferences emerged along with the new market segments associated with the late 1970s liberalisation of financial market regulation. These new constituencies of market professionals and institutional investors seeking to benefit from the innovations born of liberalisation began to challenge the rents accruing to corporate insiders in the takeover market. These insiders had long benefited from lax NYSE and SEC insider trading enforcement and thereby sought to exclude the arrivistes from their market turf. As the SEC brokered compromises with the diverse elements of its increasingly heterodox constituency, the result was a far more rigorous doctrine preventing corporate insiders from obtaining rents from the booming market for corporate control at the expense of market intermediaries and

[16] My thanks to Jerry Cohen for this point.

investors not privy to inside information. This development illustrates a successful challenge to the benefits conferred on first-comers by institutional path-dependency. The case also illustrates two further points: a) the way in which category two institutions such as the stock exchange interact with category three in performing the functions of governance; and b) it demonstrates a clear and direct link between constituent interests in the market and outcomes in terms of the law and public policy of category three institutions.

As pointed out by Crouch and Farrell (2004, p. 6) most economics literature assumes that long-run interactions among rational actors will lead to more efficient outcomes. This includes North (1990a), who supports the idea that institutions are subject to increasing returns over time, and who appeals to the idea of path dependency in state legal and other institutions to explain why some state institutions facilitate development successfully, while others do not. Yet he develops no *systematic* link between the emergence of particular forms of institutions and socio-economic constituencies; the link is only implied. North's institutions are not alien to the process of the market, they shape and facilitate it and are associated with it, but they are not derived from it as a social phenomenon in theoretical terms: "The gradual blending of the voluntaristic structure of enforcement of contracts via internal merchant organisations [category two institutions] with enforcement by the state [category three institutions] is an important part of the story of increasing the enforceability of contracts." (North 1991, 107).

Inefficient institutions can thus persist for long periods of time, but why? This is not just because, as North argues, they offer very limited incentives for change, or as Acemoglu *et al* argue (2005, 428-31; 451) there is no one to commit the government to change. There is indeed, but it depends which constituencies lie behind and have permeated the institutions of governance and what their preferences might be. The underlying support for path dependency or its eventual unravelling needs to be brought alive with the conflicting interests of the constituents of the market and their place in institutions. By dissolving the analytical distinction between market and state forms of governance and by focussing on both the economic and policy rent-seeking activities of specific constituencies as an extension of the profit/utility maximisation motive, inefficient outcomes represent compromises which are inefficient in aggregate or general interest terms but represent utility maximisation for the parties to the compromise itself. Multiple equilibria are possible and there is no necessary tendency towards an institutional equilibrium producing economic efficiency as an outcome, especially where increasing returns apply (Crouch and Farrell 2004, p. 4; p. 7), *because what is efficient for some is not always for others*. In other words, persistently inefficient or 'bad' equilibria resulting from initial choices in the emergence of institutions are most likely initiated by first-comers whose (often collusive) preferences become vested or institutionalised in a path-dependent way. Their preferences must either change or these constituencies must be dislodged from the institutions they helped create if change is to be accomplished. Power and effective strategies by opposing interests are likely to play an important role here.

In other words, as Acemoglu et al (2005, 451) have pointed out in explaining why bad institutions might be chosen in the first place and why they might persist, efficiency and distribution are *inseparable*. Yet this point must be taken more seriously than it is in much of the transaction cost literature, where there is often an underlying assumption that the resolution of transaction cost dilemmas through the emergence of co-operative or hierarchical institutions leads to greater efficiency. As institutions replace market forms of organisation, more efficient outcomes are achieved; this is clear in Williamson (1975) and Arrow (1974), though less so in North (1990a), where the persistent *inefficiency* of a range of institutions of governance is part of what he is trying to explain. Persistently inefficient outcomes may become institutionalised in a bad equilibrium precisely because first-comers succeed in institutionalising *their* distributional preferences as opposed to those of others, with serious consequences for aggregate outcomes. Therefore utility-maximising behaviour (both its collusive and competitive aspects), in combination with overcoming transaction cost problems, may lead to the institutionalisation through path-dependency of seriously sub-optimal aggregate outcomes which are only efficient for (compromises among) specific constitutive groups themselves. As will be emphasised below, policy-makers may need to engage in normative choices as to whose version of efficiency should prevail. This is a central task of governance.

This is of particular relevance to the problem of market access. Contrasting degrees of openness are governance solutions peculiar to particular interests in specific circumstances, part of a continuum of preferences for maintaining a market-based system involving varying degrees of raw competition among economic agents. Where not all agents have the same functions and interests, and thus where their preferences conflict sufficiently, contracting in to institutions with enforcement capacities becomes necessary or else market co-ordination breaks down.

Category two private ordering and category three institutional development processes are, even in relatively authoritarian settings, essentially accommodating to and permeated by a range of private interests who compete to define the substance of rules and the law pertaining to competition among firms as well as capital and labour. They represent compromises to resolve conflicts of interest among the constituencies associated with land, labour, capital, *and* state. The state itself in this view is thus a peculiar form of economic institution, a super-firm of a very special kind (Coase 1960, 9) with claims to reserved monopolies which are either economic (taxation, monopoly issuance of money) or are central to economic life, such as the monopoly of law and coercive intervention (Krätke and Underhill, 2006, 33). These monopolies resolve collective action problems among contractual parties in the market, and attenuate uncertainty. In other words, these institutions of governance independent of the market agents themselves reduce transaction costs, performing analogous functions as the organisation of firms as hierarchies which internalise other sorts of transaction costs.

The market should therefore be conceptualised broadly as an organised form of governance integrating the principles of both hierarchy, competition, and collusion and as composed of a range of institutions across the three categories. The market as a system of governance is embedded in society and emerges from society's conflicts or interest, with particular types of agents performing different functions. In this sense, 'governance' and the 'market' are not separate phenomena at all. Political compromises among socio-economic constituencies and operating through different and sometimes competing forms of institutions determine what sort of economic interaction will emerge in the first place, more or less market, or no market at all, and what the distributional outcomes are likely to be.

One last point need be elaborated here. The arguments above may appear then to admit of a potential contradiction. On the one hand the emphasis is on positive transaction costs and incentives for co-operative and indeed collusive behaviour among agents as they seek to reduce uncertainty and provide the collective goods required for successful interaction. It is argued that interactions based on utility maximisation tend to lead to the institutionalisation of restrictive behaviour which attenuates the uncertainties and collective action problems leading to high transaction costs. Markets involving category 1-3 institutions thus take on forms of co-ordination along the protection/perfect competition continuum. Outcomes depend on the interplay of rent-seeking behaviour based in institutional processes which are permeated by various configurations of market based constituencies. On the other hand, if the benefits of market interaction are to prevail in a particular market segment, then some degree of competition must be enforced by these same institutions. Permeation and the potential for capture militates against such an outcome, yet we also know that state institutions may also emerge which *enforce* market openness and competition on the basis of price. In Williamson's terms, they force adaptation to be *autonomous* as opposed to *collusive*. Competition policy, notoriously weak in most jurisdictions, is such an example. Competition policies may also have underpinnings in particular constituencies (e.g. the insider trading issue). How has a competition-oriented market system emerged in the first place?

The apparent contradiction is resolved if one accepts that perfect competition remains only an abstract possibility, assuming an unlikely pattern of perfectly convergent behaviour among constituents. If perfect competition as a state of affairs is thereby discounted, it is equally arguable that situations approximating monopoly fit the preferences of commensurately few. In this sense, the institutional compromises underpinning the terms of competition are likely to enforce at least a degree of competition in any event, to avoid defection from the market altogether and the overwhelming predominance of collusion. Furthermore, and despite the fulfilment of enforcement and dispute settlement functions, 'third party' institutions are not neutral arbiters but also players in the game with their own interests, and these interests may also vary depending on their relationships and alliances with market constituents. While they reserve certain monopolies for themselves and may encourage still others in the private sector, they derive benefits from economic efficiency and the resulting growth such as revenue enhancement if they encourage at least some degree of competition. Their legitimacy is also dependent on the overall functioning of the economy and its distributional impact on the society in which they are embedded. In a functioning system, they are likely to be supported by potential market entrants or those who seek to expand from one activity to another but face category two institutional barriers, as the insider trading example illustrated above. The preferences of these constituencies in favour of enhancing market access and therefore openness is likely also to favour a higher degree of competition. In addition, consumers of various kinds, including the state as a consumer of goods and services, will have at least some interest in controlling the rents accruing to agents involved in collusive oligopolies. Producers are also consumers of intermediary goods and services, so the preferences of all are likely to be at least ambivalent on this front.

In other words, with the extreme and highly authoritarian exception of a command economy or a situation of rigid path-dependency which proves impossible to unravel, competition among interests will lead to regular movement along the protection-free trade preference continuum given the dynamics of the market and the consequent shifting nature of preferences. The co-operation required to enforce either horizontal market-like organisation of the process of allocation, or less competition-oriented forms, will be underpinned by hierarchical state and category two institutions more or less permeable to the different constituents of the market. Markets and hierarchies are contrasting types of organisation, and the transaction cost approach tells us that both are integral to systems of exchange-based allocation, that both types are part of the broader pattern of market-based governance. The historical move towards market economy was part and parcel of Smith's very political project of limiting both state and private monopolies to encourage a greater degree of competition and thus facilitate both different outcomes in terms of market entry and more optimal outcomes in terms of output, distribution, and growth. The invisible hand does not operate spontaneously, it must be *made* to work. It emerges in symbiosis with the governance mechanisms of Williamson's 'external' state.

The three most relevant concluding points here are a) *that a shift from private ordering and the firm to state-based governance is an extension of the transaction cost problem*, which emerges from utility-maximising behaviour and b) that private ordering *includes a range of competitive and co-operative, even collusive, behaviours*, which give rise to category two and three institutions of governance external to the agents market; and c) *that this administrative decision-making process can be and is influenced by a range of constituent economic interests themselves*, most often to unequal degrees. This means that the economy is also about political resources, sometimes denoted as 'power'.

Conclusion: the State-Market Condominium

For far too long, the study economics and of governance have developed on separate paths while dealing with many of the same phenomena. Both contrasting and shared methodologies and theoretical assumptions have been applied to delineate separate disciplines focusing on the economic and political domains respectively. Political logic is held to pull one way, and economic logic another in a sort of state-market dichotomy or tug-of-war. It is possible to employ the transaction cost literature to demonstrate that institutions of governance are not only essential *supports* for market-based systems of exchange, but that the political processes of these institutions are part of the behaviour of market actors, of the way in which markets function. This implies that the market is not a domain apart from the dysfunctional politics of governance, but that it is one way, and in most contemporary economies the primary way, in which governance among competing socio-economic constituencies takes place. Politics is part and parcel of how the market emerges and operates. In this sense enquiry needs to be refocused away from the uniqueness of 'economic governance' in contrast to political processes, and towards the essential unity of the political and economic domains.[17] While the state and the market are analytically distinguishable elements of the process, this analytical separation is not empirically grounded, as Krueger's (1974) assertion that economic agents compete for policy-based and other rents just as they engage in transactions with each other testifies. State and market agents exist symbiotically in practice, and more often than not the analytical distinction contributes more confusion than it clarifies. If the institutions of state and those of the market are not empirically distinguishable, not discreet things as such, then it would be better not so to conceptualise them(Underhill and Zhang 2005, 4-5; 8).

The analysis of the transaction cost literature above and its application to the institutions of governance encourages a 'last step' in institutional economics concerning the relationship between legal and policy-making institutions and the 'market'. This last conceptual step involves thinking of the state and the market as an integrated ensemble of governance, as a state-market 'condominium' as opposed to competing domains with separate dynamics. The uncertainties and collective action problems to which positive transaction costs are attributable generate not just firms as organisational hierarchies but also category two and three institutions of regulation and state as the conflicts of interest of a functioning market system with greater or lesser degrees of competition are resolved.

This should not at all undermine the historical 'main business' of economics. The 'main business' focus on the dynamics of the market in a competitive setting remains crucial to understanding the potential benefits and distributional impact of more competitive or

[17]This point has been argued elsewhere in the political science literature; see Underhill (2003); Underhill and Zhang (2005).

restrictive market orders, “uncovering the conditions necessary if Adam Smith’s results are to be achieved and where, in the real world, such conditions do not appear to be found, ...[proposing] changes which are designed to bring them about.” (Coase 1992, 2). But if it can be established both theoretically and empirically that institutions of governance are endogenous to the market, it would also be sensible to understand the real world in which proposals for reform needs must be developed and applied, the real obstacles which will be encountered. These are encountered in settings populated by hierarchical institutions permeated by rent-seeking interests rather more than settings characterised by perfect competition. If the state and the market are found together as an ensemble of governance, then that is the world we should analyse.

If the aim is to develop more optimal patterns of market interaction, the model tells us we should focus first and foremost on the preferences of *firms* and other agents, and how they become embedded in the institutions which underpin the form of market which emerges in a particular sector or country. If “ the efficiency of the economic system depends to a very considerable extent on how these organizations conduct their affairs, particularly of course the modern corporation”(Coase 1992, 2) then let us investigate realistically how they conduct *all* of their affairs, from pricing to the organization of production to influencing the terms of competition against various rival interests, be these firms or other agents active in the economy. This influence on the terms of competition includes the ways in which firms are integrated into legal and regulatory institutions through which the market operates, including the decision-making processes which set the terms on which law and regulation works. Their influence in these processes is precisely what Smith most feared would prevent market forms of exchange from functioning properly. Political resources are part of the game wherein producers seek to “widen the market and narrow the competition” by the various means at their disposal, including their use of factors and the other ingredients for pricing their products.

If we combine this point with the notion of path dependency and how 'sub-optimal' institutional equilibria can persist for a long period of time and how change might subsequently take place (Crouch and Farrell, 2004), we have a model which tells us that preferences for limited competition will regularly become embedded in the very institutions of governance to which we look to ensure the continuity of market processes. *This is essentially the explanation for sub-optimal market regimes. They are anchored in domestic patterns of institutionalised rent-seeking which underpin the institutions and outcomes of the market; they can extend into the international domain.* This explains how even international protectionism is an *extension* of market behaviour, and why real-world markets always exist on a continuum along which the terms of competition are set. Through the path dependency phenomenon the interests of some private interests come to be institutionalised and enshrined in particular policy regimes. These may represent the bad equilibrium among multiple possibilities, yet prove very stable over time. In other words, the ability of private interests to win political games at the early stages of institutionalisation locks their preferences in and this equilibrium is difficult to change, even if it has negative effects on the broader public interest. These interests become institutionalised *precisely because they were there in the earlier stages of industrialisation when path-dependency was being generated*. Thus a bewildering variety of capitalisms has become an enduring feature of the global market economy.

The theory of competitive markets *does* tell us that we should not simply listen to the loudest voices with the best deployment of institutionalised political resources. They (*viz*. path-dependency) are more than likely to have had their share of privilege, yet perfectly competitive outcomes remain only an abstract possibility. In short, the crucial question is *whose* rent-seeking will be privileged, and can we find ways to facilitate the longer run benefits which economic theory tells us are there? If negotiations are about the benefits of different policy options to particular coalitions of interests and if the general interest is to prevail, there is a need to construct coalitions to realise the broader benefits of open markets, *assuming* that the outcome is as desirable as the theory says it is. In such a situation, the benefits of freer trade are anyway far from self-evident, because notions of the 'general interest' will differ from one constituency to another.

In this sense the benefits of restricting competition are usually easier to see and thereby represent rational preferences for the producer groups with access to the ensuing rents. The state-market condominium model tells us that producer constituencies are likely to pursue these rents with considerable energy. This behaviour is, as the transaction cost analysis revealed, part and parcel of the way in which the institutions of the market emerge, an extension of utility-maximising behaviour, and we should not be surprised to see the difficulty of achieving market outcomes at domestic or at the multilateral level. Something other than the liberal thesis is clearly going on here.

Yet economic theory should most definitely encourage us to avoid the "deadweight loss" (Krueger 1974, 302) associated with the worst forms of restrictive markets, whatever the preferences of a range of constituencies. The problem is a political one of path-dependent institutions of governance which confer political resource advantages on first-comer constituencies. Private power too often assumes the mantle of governance in the public interest. If the political blockage is to be removed, then negotiating strategies need to focus on either dismantling these constituencies and/or re-organising the way in which the category three institutions are configured.

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