

Peter Murrell on Oliver Williamson's "The Lens of Contract"

Professor Williamson's paper is about the lens of contract, or thinking contractually. By thinking "contractually", Williamson points us to thinking about agreements, negotiations, and so on. Contracts, as we usually think about them, are certainly often the result of these processes. But the target we have in mind here is the entire process of bargaining, negotiating, and coming to agreement—transactions, at large.

This corpus of theory, as Professor Williamson's paper makes clear, is a mode of thought rather than a specific set of conclusions, much like the germ theory of disease. Here, we have a way of seeing this set of phenomena, and with this new way of seeing comes a research agenda that delineates various analyses, solutions, and modes of behavior. Germ theory does not lead immediately to antibiotics. But it does suggest that hygiene and related behaviors may in fact save lives—perhaps more than some of the more technical innovations that result from germ theory. Using that analogy, I would like to argue that Professor Williamson's suggestion that a few masters of the New Institutional Economics (NIE) enter bureaucracies and bring its lens to bear there, while important, is not the only approach. Additionally, it is just as important to get people in general to think of some of the concepts of NIE in their daily activities. I am asking, then, for a much broader spread of the ideas. This, of course, is harder to implement, but will have much more profound consequences in the long run.

So what are these ideas? I provide a list below, deemphasizing ones that Professor Williamson has already articulated quite well, and emphasizing others that he has devoted less attention to.

Foremost in this set of ideas is **transactions costs**—the costs of simply doing business. These include the costs of setting up organizations, the costs of negotiating agreements, and so on. Fundamental to the NIE way of thinking is examining how the institutional framework affects these transactions costs. A beautiful example of this can be found in Paul Collier's paper, "Making aid smart". There he suggests that aid agencies should allocate to the poorest countries. The very institution of allocating aid according to poverty benchmarks would change the nature of the associated transactions costs by putting the burden of proof on the government officials who were trying to intervene. By doing so, the nature of the outcome of these interventions themselves is necessarily implicated. This is a simple, yet powerful, example of how the NIE framework can be helpful.

Second in the set of ideas is the notion of **differential information** and **incomplete information**. This of course tells us how lower levels of the bureaucracy are able to achieve their objects, which are at times at variance with the objectives of the organization higher up. The notion of differential/incomplete information also leads to my skepticism of Collier's suggestion that allocating aid to countries with good policies

will be helpful. The information asymmetries between local and foreign agents with respect to the policy environment and commitment to reform invariable taint the ability of foreigners to get an accurate read on these without much cost. This approach may, in fact, turn out to be the best approach after all, because any policy indicators will fall short of perfect information. This is simply the ubiquitous nature of differential and incomplete information. Nevertheless, we need to be cognizant of the limitations of our indicators as we use them.

This tells us something about the nature of informational cascades. The example Collier gave of these involved focus groups that asked whether the poor were getting poorer. Given differential information, we could predict *ex ante* that these had a good chance of resulting in an informational cascade. For when we ask about the general state of things, it is actually rational for individuals to rely on group opinion rather than on one's own experience. Once we take differential information into account, instead of asking whether the poor (in general) are getting poorer, we would ask an individual whether he himself is getting poorer. Once we collect and analyze the answers to this more directed question, we can analyze the facts more objectively and avoid the information cascade.

The next NIE concept I want to highlight involves **selection processes**. When there is differential information and inability to monitor a situation perfectly, then the way we set up transactional processes will favor some entities over other entities. Therefore, although I like the idea of demonstration projects, once we think about selection processes we realize that we need to be very careful to take into account the various effects that the selection processes themselves will have on the outcomes of the processes.

We also have to think about ways to moderate these selection processes. There are two important concepts here, the first being **signaling**—how an entity can signal to others its own private, unobservable information. My favorite example of that involves IRIS itself. Why would IRIS choose to be within a university where it has to put up with all sorts of inefficient accounting mechanisms and bureaucratic constraints? IRIS is signaling that it is interested in ideas and in thinking through problems, which is why it is prepared to put up with those inconveniences.

The second conceptual node of selection processes involves **screening**—setting up contractual mechanisms in order to exclude those entities which one wants to exclude. For example, some of USAID's procurements might be open only to nonprofits, who are better aligned to some objectives.

Another fundamental concept involves **asset specificity**. When one party makes a commitment, it alters the bargaining power of other parties. This tells us a lot about why repeated games between specific contractors and entities, such as USAID, are so important to minimize the bargaining results that come about from asset specificity.

Asset specificity also tells us why there might be some problems with conditionality, which rewards countries according to their policy outcomes. Those who monitor and evaluate these outcomes, of course, will likely have clouded judgment as to whether or not the outcomes have obtained. It is easy to justify a variety of claims regarding the quality of governance, and for political reasons, the monitors will often opt for a politically efficacious judgment—at least, they will be more able to do so the less precisely specified the outcomes are. Asset specificity, of course, leads to ex post bargaining. The inability to specify assets completely leads invariably and unavoidably to incomplete contracts that allow rents to be collected during the implementation of a contract. For example, one should be aware of academics collecting data during the implementation of a contract because they are, no doubt, purloining some of the rents that come from the lack of asset specificity.

Lastly, I want to emphasize the **remediableness criterion**. It is easy to misinterpret this criterion as implying that whatever exists—or has existed for a sufficiently long period of time—must work efficiently. But this is not so. The remediable criterion simply suggests that we should be wary of ideas that are not cast in an implementable way. We must conduct experiments, and put our ideas before the tribunal of experience. Things that do exist, though, tend to do so because institutional forces remain in an equilibrium that is favorable to their existence. When we want to replace one institution with another, we must first investigate the forces that are conducive to the current state of affairs. Otherwise, we risk expending wasted effort.