THE FIRM, AS STRUCTURE OF ECONOMIC GOVERNANCE

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Abstract:

The purpose of this paper is to approach the theory of the governance structures, i.e., the firm, the market and the hybrid form of organisation, starting from several conceptual limitations between the terms of governance and the governance proper. Each structure of governance relies on a particular type of contract (institutional component) and varies with the characteristics of the transactions. The basic distinction between the firm and the market is that the firm relies in authority in allocating the resources. Then use of the authority relations gives an advantage to the firm compared to the market, the gain from lower transaction costs. The administrative decision presumes taxation costs that are lower than the costs of negotiation and taxation of each contract of the independent transactions performed on the market.

Key words: governance structures, firm, market, hybrid governance form, transaction cost

JEL classification codes: D23, G34

1. Introduction

The economic governance refers to the processes that support the economic activity and the economic transactions by protecting the property rights, by taxation of the contracts and by use of collective action to develop an adequate organisational infrastructure. These processes are accomplished within formal and informal institutions. As field of research, the economic governance studies and compares the performance of different institutions under different conditions, the evolution of these institutions and the transition from one set of institutions to another.

Governance is an appliance that involves at the same time institutions, relations, rules and behaviours, i.e. much more than the structure represented by the term of governance. Enterprise governance, in the general meaning, can be defined as a coherent aggregation of institutional devices and practices of an entity, which legitimate the functions of authority exerted directly by the leaders and by the hierarchical delegates. If the governance system of an enterprise is inadequate, the enterprise may be inefficient.

Two levels can be distinguished when describing a firm:

a) Its governance, i.e. the mechanisms that legitimate the role of the management and its supervision, as well as the power of the delegated power (seen as an institution – the written or customary constitutional right of the institution);

b) Its management, i.e. the actual exercise of power, taking managerial decisions, with all the consequences bearing on the final performance.

The economic exchanges within the companies are not governed by the price mechanism, like on the market, but rather by governance structures that presume rules and hierarchic supervision. The governance structures are institutional forms or arrangements and they refer to the different ways of allocating incentives and opportunities. They appear as a natural result of saving on the transaction costs. The governance structures are the hierarchies (companies), markets and the hybrid forms. Each of them presumes a transaction cost, and the selection and survival of one form or another depends on the efficiency of reducing the cost depending on the attributes of the transactions.

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2. Analysis of the alternatives of governance of the economic activity

After analysing the governance structures, it is important to present their characteristics. The essential features of each governance structure may allow inferring the operational criteria of the process of choosing between the three unknown forms: company, market and hybrid form.

*The company (hierarchy).*For Ronald Coase, the company and the market are alternative ways of economic coordination. The company is seen by the theoreticians of the neo-institutionalism as a governance structure, seen as a complex combination in which the monetary motivations and impulses remain important, yet not unique. The company remains "a team relying on a connection of contracts, each side aiming to accomplish its specific investment (human or physical) function of the accepted hierarchical structure…" (Ménard, 2005, p.287) Unlike the market, the company has the advantage that the transactions run and are regulated by *orders.*

Ménard says that this advantage comes from: first, the capacity of supervisions to reallocate human resources without negotiations decreases the cost of transactions and is a strong means of curbing in certitude. Second, internalization of transactions provides the necessary framework to expand the area of rationality, to enhance the quality of decisions by the «division of the cognitive work», which the hierarchies make possible. Third, the communication system developed and coordinated by the entrepreneur is a gain compared to the market-provided information, costly and hard to access. The main coordination system of the company is the *hierarchic order*, which involves allocation, monitoring and control. Thus, on the basis of a hierarchic structure, known before hand, each individual carries on the received orders. Transactions are done in the manner and with the duration set by the hierarchic structure pre-set and accepted by the involved parties. Controlling is one of the main instruments used to render the company more efficient, because it aligns the interests of the managers with those of the shareholders, prevents and limits the opportunistic behaviours, prevents or solves disputed with minimal expenditure of time and money, etc.

From Coase we also have the essence of the underlying contractual relation: the company contract is one of *subordination*. The internal organisation or hierarchy is, as Williamson considers, a more elastic and adaptable form of organisation than the hybrid form of organisation, when strong disturbances occur due to partner's situation of dependence. Williamson calls this type of contract „forbearance", suggesting that in technical organisational, quality, production or marketing matters, justice cannot be called in because it doesn't have the necessary competences. The company is its "own judge", both in the first and last instance. The intervention of the justice to solve litigations concerning company's policy is meaningless as long as the legal framework is observed. The possible disputes are solved by managerial decision, with no need for external instances. The hierarchy is the court of last appeal when solving the internal company conflicts.

The subordination contract is, and remains, the distinctive mark of the company, as Coase put it. Actually, it is a sum of internal contracts, designed and written under the same philosophy, the hierarchic subordination. Subordination, however, can be subject of *ex ante* negotiation, when deciding on the level of the rights and duties, and the technology of the process which materializes them. Hierarchy, as structure within which the process takes place, is not, however, negotiable.

Market. Market transactions are "controllable" through the *mechanism of prices*. The prices adjust and balance the demand and offer. It is used by the economic actors which want to make good transactions while cutting on the cost of information.

The market displays a large level of autonomy of the economic actors. The relations are impersonal; the actors don't know each other, like in the case of a company. Unlike the company, negotiation is allowed on the market. It is done within the limits set by the objective price revealed by the demand-offer relation. Within the limits set by the market, one can negotiate. Inobservance might end in bankruptcy. However, the freedom of movement on the market is not without limits, because there is a legal framework consisting of a set of norms that stipulate the participants and the nature of the goods to be exchanged, the restrictions imposed by the law of competition and the sanctions for those evading it.

Looking at the market as a self-regulating environment which sanctions swiftly the cheaters, Coase believes in reputation, which constructs and maintains responsible behaviours. A cheater, once uncovered, is not punished just by the offended party, but also by the collective. The social structures acting on the market, the associations of manufacturers or consumers, consolidate a “feeling of justice” (Greif, 2005, p.727-786). On this basis, an individual participates in the sanction decided on someone who didn’t cheat on him, hoping that his gesture will cut down the probability of emergence of a new cheater whose probable victim might actually be him. Sometimes, the collective coercion might be tougher and with higher losses than the one coming from the state authority.

Thus, we may say that the market is a governance structure within which the exchanges are organised, accomplished by consented constraint based on reputation, moral hazard and civic spirit. This constraint is operable via a contract through which the property rights are transferred and which is negotiated based on price information.

The type of the classical commercial contract is associated to the market governance structure and allows coordinating, through the mechanism of prices, the transactions which don’t involve specific assets, rather goods that can be transacted simply, with no ambiguities and indefinable terms. The buyers and the sellers are not in a relation of dependence; each of them can leave the relation at a mere cost. Market is enough to sanction the irresponsible and opportunistic behaviours.

The classical contract is concluded on a short term, and renewed only if the current suppliers have the best offer on the market. The possible disputes are solved in justice, using the existing legal support. Since the sides in conflict are not linked by any specific act and are, therefore, not interested to continue the contractual relation, the classical contract allows solving the litigations.

The hybrid form. Williamson acknowledges the existence of hybrid structures of governance, which take some features from the company or from the market; however, none of these features can be identified. These governance structures have both certain market characteristics (the exchange relies on the mechanism of prices), and certain company characteristics (presence of a coordinating authority). The commercial sector (economic activities), one can distinguish three discrete forms of governance structures: the classical market, the hybrid contractual and the hierarchy.

The most important features characteristic to the hybrid forms are: joint investment, contracting and the competitive environment.

In the case of the hybrid forms, the economic actors consent to make a *joint investment* by summing the efforts, resources and investments with the purpose of accomplishing a common goal. Although the convergence and the common goal gather the partners within a network in which they share the resources, the sides remain legally distinct entities. The common interests determined by the exploitation of these resources produce joint administrative structures: organisms for planning, information collection and processing, accounting, etc. Planning can target the quality, quantity, the staff policy and, within limits, the price policy.

The hybrid forms are the object of a *contract* whose dominant feature is its lastingness. These contracts are incomplete long-term contracts, flexible enough to allow the necessary adaptations and to cut down the contracting costs, but credible enough to protect the value of the specific investments and minimise the risk generated by opportunism. Such contracts apply to the transactions in which the sides maintain their autonomy, but are bilaterally dependent. The contract facilitates the mutual adaptation and continuity in the case of unforeseen consequences which may appear during the process of transaction. The contract provides a general framework of cooperation through mechanisms of coordination, which complete the contract; it allows the partners to join efforts and can solve conflicts, through contractual stipulations. It is an incomplete contract, strongly negotiated *ex ante,* but open to *ex post* adaptations. It is rather close to the contract used to solve disputes between companies. By comparison with the other types of contracts, market or company related, the contract of the hybrid form is a neoclassical one.

The *neoclassic contract* is necessary for the transactions which presume specific investments, while the use of classical contracts within an institutional market arrangement proves inadequate and costly. This is so because, on the one hand, the relation of bilateral dependence between the sides compels them to ensure the continuity of the transactions. On the other hand, the risk of opportunism calls for complete contracts which to foresee all the possible future events and behaviours and requires using more authoritarian and inflexible coordination and control mechanisms, than the classic market contract.

In most cases, the neoclassical contracts characterise the long-lasting, stable relations between companies which have already agreed on a common manner of conducting the relations of cooperation. This aims, first of all, maintaining the cooperation within specific limits, rather than the strict contractual obligations. Competition tensions might arise because of the incomplete contracts concluded between the partners from the hybrid form. The *competition hybrid environment* can be designed internally, when it targets own partners, and externally, when it targets companies or other hybrid forms.

These characteristics, analysed separately, can be found in the composition of other governance structures too. However, if we analyse them together, these characteristics serve as mark by which the hybrid form is outlined.

The companies (organisations) are permanently in the position to decide whether using the market or organising the activities internally; otherwise, they have to decide between "delegating the execution of a work", "doing the work" or finding intermediary arrangements (hybrid forms). The selection of the adequate governance structure for the organisation of the economic activity is given by the characteristics of the transaction, which determine the costs which, in turn, determine seeking the best adapted organisational arrangement.

The variables which determine the selection of the governance structure can be classified in endogenous (internal), i.e. the intrinsic characteristics of any type of institutional arrangement that may influence the level of the transaction costs, and exogenous (external), i.e. characteristics of the transactions and of the institutional environment.

3. The company as source of reducing the transaction costs

Williamson formulates a theory of the economic organisation which correlates transactions (with different attributes) with the governance structures whose costs and benefits are distinct, in a discriminatory manner (i.e. saving transaction costs). The argument of the transaction costs relies, basically, on the efficacy of the competition to select among the more or less efficient manners and to transfer the resources to the first ones.

In his view, *saving transaction costs* presumes the following steps:

- Identification of the micro-analytical factors accounting for the differences in the transactions costs of the different transactions. These factors are generated by the limited rationality and by the opportunism of the agents, by the size of the transaction (frequency, level and type of incertitude and specificity of the investment) and by the characteristics of the transaction process (processuality presence unanticipated consequences);

- Association of the transactions to governance structures;

- Observance of the inter-temporal processual characteristics of the economic organisation.

While the behaviourist hypotheses are universal, the transactions vary within the afore-mentioned dimensions. The transaction process also matters under the aspect of temporality; because opportunism can show up both ex-ante (information asymmetry) and ex-post (distribution of the profits doesn't reflect the initial investment).

If the frequency of transactions between sides is low, the level of incertitude is high and, furthermore, there are conditions of specificity of the investment, given the hypotheses regarding the human behaviour, transactions are institutionalised within the organisation. In this case, the hierarchic integration in organisations is the most efficient alternative of economic organisation.

The advantages of the company (hierarchy) are:

1. The principle of specialisation works within the company, and it allows the individual actors (each one with his limited rationality) to take care of an aspect of the general problem. Through mechanisms of coordination and control, the results of all activities are integrated at the top of the hierarchy, so that the organisation has the capacity to expand the individual limits if rationality.

2. Each of the organisational units can be confronted with a given aspect of incertitude and complexity of a situation, getting thus to understand a problem which was previously under the sign of total incertitude.

3. The company has mechanisms which limit opportunism; using the bonus, promotion or control systems, and the organisation has the capacity to direct, to a certain extent, the efforts towards the accomplishment of the common goals.

4. Rejecting the very idea of negotiation, the organisational hierarchy has the capacity to limit opportunism even in the situations when there are a low number of partners involved in transactions. The organisation, as governance structure, generates cooperation and reduces the incidence of the opportunistic behaviours both ex-ante, and ex-post.

5. The company discards the information asymmetry in favour of the management, because the communication system developed and coordinated by the entrepreneur is a gain compared to the information coming from the markets, costly and hard to process.

6. The subordination contract specific to the company can be object of ex-ante negotiation; the company can decrease or eliminate the transaction costs in the ex-post phase of the contracts. This type of contract allows adjusting, with costs that are not large, of the contracts concluded inter-company.

7. The company is better than the market in terms of information too. Compared to the market, the companies have the privilege of setting filters for the non-significant or useless information; routines can be used to develop coded (common) languages, thus reducing the cost of information; using staff specialised in tracking market signals, these can be processed swiftly and at low costs.

8. Due to the own mechanism of coordination and control, the company has the advantage of the subordination contract. This contract is the expression of the will of those leading the company; it is incomplete, but adaptable and can be completed by the same authority which initiated it. Because just one side does the writing and adapting, this type of contract seems more flexible than the neoclassical contract, specific to the market. This contract is also more advantageous as incertitude grows (because the assets become more specific and the frequency of transactions increases), the risks of opportunism being much too important and damaging to the contractual relation, to allow being governed by a contract which allows the autonomy of the parties.

9. The company relies on authority in allocating the resources. The use of authority relations gives the company advantage over the market – the gain from lower transaction costs. An administrative decision presumes lower taxation costs than the costs of negotiating and taxation of each independent transaction concluded in the market.

Within this context, a natural question comes up. Is it possible that a national economy works as a single company?

The arguments in support of this hypothesis are shown below. First, a company of such size will have a position of monopoly and will benefit of all advantages running from it. Within this context, the existence of the market, as place where the demand and offer meet, determined by labour division, irrespective of its form, is pointless.

Second, the cost of contracting the production factors (part of the transaction cost) can be decreased within the company, because the company will not have to negotiate and conclude an individual contract for each production factors; rather, it will conclude a single, long-term, contract the relation between the production factors being of collaboration. When the structure of production must be changed, there will be no need of further negotiations between the owners of the production factors. The process of concluding contracts will be thus simplified, because the transactions between companies are replaced by factor-consumer transactions.

Third, a big-size company will eliminate the inclination towards opportunism, because there will be no information asymmetry, which leads to incompleteness, to the fact that same people have information about a particular transaction, while others don't, and the access to information has a cost which some pay and others don't. Within this context, the complete type of contract will be used, with firm and covering clauses, which doesn't have to be adapted and renegotiated to/and according the new circumstances, because the future can be predicted. The ex-post transaction costs determined by the renegotiation of contracts will be zero.

The opportunism, shown every time two or more economic agents are involved in a cooperation endeavour, will no longer be present. The relations within the company will be harmonious and there will be no conflicts of interest between the main and the agent, which might generate agency costs. From this perspective, the transaction costs might trend towards zero, since there are no stakeholders. This approach has, nevertheless, limits:

- The monopoly position of the company is not in agreement with the free market spirit; it will always be necessary to develop a market which to balance the trends of monopolizing the economy;

- In the case of a large company, the management of resources is difficult and wasting can occur; the transactions are concluded and run within a complex and uncertain environment, in which the economic agents don't have the possibility of forecasting accurately the future, in which there is information asymmetry where the is discrepancy of the information which the participants in a transaction hold; the asymmetric information influence the relations and provide the basis for an opportunist behaviour displayed by adverse selection and moral risk;

- Within the complex process of decision-making within the company, aiming to maximize their value, inefficiencies will occur, yielded by the conflicts of interest between the holders of these interests;

- The economic activities of the companies are diverse and complex; the axes of multivalent are attacked, which has adverse effects on the managerial activity, which is hard to do within the context of interdependence between the branches and sub-branches of the national economy.

The counterarguments mentioned here show that there will never be a single company covering the entire national economy, and that there will never be just companies, with no market. The two forms of coordinating transactions, the company and the market, coexist. The company doesn't appear as a reaction to the market, but in order to reproduce the market conditions within the conditions of lower transaction costs. If this condition is not met, the company doesn't appear, and the mechanism of prices is the one coordinating the activities. It may happen that the company itself, is not always successful to manage the transactions at costs below the prices

The coexistence of the two governance structures makes sense just within the competitive economy, because planning within the company works when the resources of the same company have the freedom of moving and finding the most efficient users. Thus, the competition between companies is present concomitantly with planning within the companies, the competitive market being the one that provides the framework for activity.

We may say that the company is a component of the normal competitive environment, which takes advantage of the free competition advantages.

4. Conclusions

The economic governance refers to the processes undergoing within the institutions, which support the economic activity and the economic transactions by protecting the property rights, by levying the contracts and by invoking the collective action with the purpose of providing an adequate organisational structure. As field of research, the economic governance studies and compares the performance of different institutions, within different conditions, the evolution of these institutions and the shift from one type of institution to another.

In the neoclassical economy, the company is considered, somehow, as a given thing, being thus considered as something natural. Important is the maximizing behaviour of the company on the market and its impact on the general balance, not the internal processes (organisation of the company, its structure and behaviour). The neoclassical pattern is a theoretic one, which preserves the managerial and institutional variables in order to simplify the working conditions of the economic system. The market pattern is simplified by reducing company activities to a single, problem-free, production function, and by disregarding the transaction costs.

Through the transaction costs, the economic organisation is explained by the relative superiority in terms of efficiency (minimizing the transaction costs) of one form of organisation (the company) in relation with the other (the market). In the neo-institutional economy, the company represents an alternative, to the market, of allocating the resources, or an alternative organisation of the transaction costs on the market.

The basic distinction between the company and the market is the fact that the company relies on authority in allocating the resources. The use of authority relations provides advantage, compared to the market, the gain of reducing the transaction costs. An administrative decision presumes lower levying costs than the costs of negotiating and levying each individual contract of transaction done on the market.

The existence of transaction costs for the coordination of the market activities determines the companies to internalise these costs. Internalisation, in turn, is accompanied by higher organisational costs. The process of internalisation is valid up to a point defined by the level of the costs needed to organise the activities within the company.

The organisations (companies) are permanently making arbitrages between using the market or internalising some activities, otherwise said, between “delegating the execution of a job”, “doing the job” or finding intermediary arrangements (hybrid forms). The selection of the adequate governance structure for the organisation of the economic activity is given by the characteristics of the transactions. They determine the costs which, in turn, determine the selection of the best adapted organisational arrangement. Everything takes place under the umbrella of the behavioural hypotheses (limited rationality and opportunism).

Each governance structure has its specific properties, which define the capacity of that structure to coordinate a transaction or another. The selection of the *institutional component* aims to reduce the transaction costs. Selection is the result of a cost-benefit analysis. For instance, when the attributes of the transaction (frequency, level of incertitude, specificity of the investment) presume high costs in the situation of unpredictable events, the hierarchical integration in the organisations will be better (win terms of economic yield) than the hybrid form of organisation which, in turn, will be better than the classical contract. Thus, the governance structures (institutions) are the natural outcome of the efforts of minimising the transaction costs. In a real world, the transaction costs are not null, and the existence of inadequate rules may lead to inefficiency. The transaction costs, in turn, depend on the institutions, being the result of a particular institutional configuration, of defining the property rights, the ways of organisation and availability of information and of levying the contracts.

The main conclusion regarding the quantification and measurement of the transaction costs is that they can be measured within the financial-banking institutions, but not quite exactly. Thus, after analysing the concept of transaction costs and it defining elements, the conclusion is that these costs are hard to identify, while their impact on the increase of the profit, although being real, is hard to describe.

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