

**Contingency, Validity, and Consent:  
A Critique of Power in Williamson's  
Transaction Cost Economics**

David V. Sanchez  
Senior Thesis in Sociology  
Advisor: Mark Gould

April 21<sup>st</sup>, 2010

**Table of Contents**

I. Introduction ..... 3

II. Imperfect Information and Transaction Cost Economics..... 7

III. Parsons' Characterization of Neoclassical Theory..... 11

IV. Imperfect-Information, Order, and the Necessity of Conceptualizing Power and Governance..... 16

V. Power in Transaction Cost Economics..... 21

VI. Imperfect Information and the Principal-Agent Problem..... 24

VII. Williamson and the Principal-Agent Problem..... 27

VIII. The Problem with Williamson Part I: Normative Consent..... 28

IX. Problem II: Authority, Generalization, and Valid Power..... 33

X. Problem III: Cultural Intelligibility and the Contingency of Action..... 37

XI. Some Implications of Treating Power as a Generalized Medium..... 43

XII. Implications for Economics and Sociology..... 48

XIII. Conclusion..... 52

## **I. Introduction**

This thesis critiques the conception of power in Oliver Williamson's Transaction Cost Economics. Williamson articulates imperfect-information models within neoclassical economic theory, and the neoclassical nature of his theory means he cannot conceptualize social or cultural norms, social systems, or actors who conform to normative orientations besides that of instrumental rationality. Williamson conceptualizes power as hierarchical fiat that is obeyed by agents out of self-interest. Williamson cannot understand the motivation of consummate performance in the workplace (and hence the solution to the principal-agent problem), the constitution of valid power that is obeyed by an agent even when it is not in her self-interest, or the importance of reduced complexity for the successful operation of power. Williamson therefore cannot understand the operation of power within the firm. Understanding the operation of power within the firm requires a theory that not only transcends neoclassical assumptions, but also recognizes the importance of social and cultural systems and understands power as a generalized medium whose generalizability and success are constituted at the structural level.

Williamson follows Ronald Coase's argument that firms exist in order to economize on transaction costs. Williamson's unique contribution is his analysis of ex post transaction costs (which arise after contracting), which are made especially relevant because of a situation of bilateral dependence between contracting parties. Williamson argues that firms reduce transaction costs by governing disputes between bilaterally dependent parties, and that hierarchy is most effective for

dealing with these disputes. Governance within the firm is carried out through hierarchical authority that relies on power conceived of as fiat.

Williamson articulates imperfect-information neoclassical economic models. The neoclassical theory within which Williamson constructs his models is illuminated by Talcott Parsons, who analyzes the underlying assumptions of neoclassical theory. To Parsons, the four fundamental attributes of neoclassical theory are atomism (methodological individualism), a sole positively-stated normative orientation of instrumental rationality, treatment of ends as exogenous, and empiricism. These assumptions limit the kinds of arguments that can be made consistently within neoclassical theory, and they profoundly influence Williamson's conception of power.

When imperfect-information is acknowledged, many conclusions that are robust within perfect-information models do not hold. Opportunism and bounded rationality are manifest, and Williamson argues that firms must economize on the consequences of these behavioral assumptions. A problem of order is manifest, and power and governance must therefore be postulated.

For Williamson, hierarchical governance resolves the problem of order. Hierarchy involves the operation of power conceived of as fiat. Fiat operates according to sanctions that are designed to align incentives within the firms; fiat structures incentives so as to make the costs of malfeasance prohibitively high. Fiat is obeyed by agents out of self-interest, and order is an outcome of rational self-interest. This conception of power is consistent with the logic of neoclassical economic theory.

Williamson's reduction of power to fiat means that he cannot understand normative aspects of consent, the interplay of authority and generalization in the constitution of valid power, or the importance of reduced complexity in the operation of power. Therefore, Williamson cannot understand the extraction of rents from workers in competitive capitalism, the obedience of workers to valid orders that contradict their self-interest, or the importance of cultural intelligibility to the operation of power. Williamson is unable to understand the operation of power within the firm.

The principal-agent problem refers to the problem of a principal (i.e. boss) motivating an agent (i.e. worker) to work in the principal's interest. This problem arises within imperfect information models. Information costs make knowing the worker's marginal product difficult or impossible, the principal and agent may have different interests, and performing work is costly to the agent. Principal-agent problems are crucial to the logic of the employment relationship in imperfect-information economic models, as well in understanding the extraction of rents from workers within competitive capitalism.

The principal-agent problem is manifest in Williamson's distinction between consummate and perfunctory cooperation. Perfunctory cooperation results in work that is minimally satisfactory, whereas consummate cooperation is operative when workers have an affirmative job attitude and willingly take initiative. Williamson notes that motivating consummate cooperation is crucial to the boss-worker relationship. Williamson believes that he can explain the motivation of consummate cooperation based on his ex post mechanisms of governance. In this

perspective, agents are induced to cooperate consummately because incentives are structured so as to award compliance to the interests of the principal.

Williamson's solution to the principal-agent problem fails. Instrumentally-rational workers will not work hard beyond what is required by the rules and beyond that for which they are compensated. Behaving in a consummate manner entails conforming to a normative orientation besides instrumental rationality. To understand consummate performance, neoclassical theory must be transcended.

Consummate performance can be explained through a notion of consent, in which agents voluntarily accept authority. Consent is constituted through legitimation and justification—in which both the process for exercising power and the content of the obligation created by power are viewed as consistent with social values—and through the feelings of moral commitment that result from the internal atmosphere of a firm.

Williamson also cannot understand the constitution of valid power, and why valid power will be obeyed by an agent even if it is not in his self-interest to do so. Understanding this requires conceptualizing authority and the generalization of power, two crucial aspects of treating power as a generalized medium of communication. In this conception, power is valid if is consistent with the authority of a principal and when it is generalized (applicable not in one situation or social relationship, but in many). Conceptualizing power as a generalized medium also requires transcending neoclassical economic theory.

Williamson further cannot understand the intelligibility of power within social relationships. Due to the vast complexity of the world and the contingency of

action, power relies on reduced complexity in order to operate. Williamson acknowledges complexity, but does not understand the reduction of complexity in the social world. Reduced complexity can be explained through the positing of shared cultural and social systems, or through the treatment of power as a generalized medium. Each of these explanations requires the conceptualization of social systems, something that cannot be done within neoclassical theory.

Treating power as a generalized medium has other implications, both for the understanding of power and for both sociology and economics as disciplines. Treating power as a generalized medium highlights the way that power is generated at the structural level, and also that the operation of power depends on an interplay of coercion and consent.

If one accepts the arguments that conceiving power as a generalized medium can solve problems that cannot be solved from within neoclassical theory, then it means that imperfect-information models introduce into the theories anomalies that cannot be resolved successfully without transcending neoclassical economics. Likewise, if one views power as a generalized medium, this means that one must adopt a social theory that endorses the autonomous effects of cultural and social systems and that views power as constituted on the macro-structural, rather than micro-interactional level.

## **II. Imperfect Information and Transaction Cost Economics**

In order to understand Williamson's treatment of power, it is necessary to understand Williamson's relationship to economic theory and the fact that

Williamson articulates imperfect-information neoclassical models. Likewise, it is important to understand the centrality of transaction costs in Williamson's conception of the firm, his differentiation between ex ante and ex post transaction costs, his understanding of asset specificity and bilateral dependence, and his argument that intra-firm hierarchical governance structures reduce transaction costs by invoking fiat.

New Institutional Economics (NIE) and Transaction Costs Economics (TCE) (the branch of NIE that focuses on contractual relations) articulate imperfect information models within neoclassical theory. Both approaches emphasize the importance of transaction costs. Transaction costs, in contrast to production costs (the cost of producing a good or service), are the costs of transacting on the market—Williamson refers to transaction costs as “the costs of running the economic system” and “the economic equivalent of friction in physical systems” (Williamson 1985: 19). The insight that transaction costs matter results from the acknowledgment of information asymmetries and the corresponding behavioral assumptions of bounded rationality and opportunism<sup>1</sup>.

Transaction costs derive from, and are a form of, information costs. Information asymmetry, bounded rationality, and opportunism result in numerous costs during the negotiation of economic agreements. For example, during negotiation of an agreement, a party will not instantly and costlessly know exactly the terms of contract it can obtain, nor will the party know the demands and

---

<sup>1</sup> Bounded rationality and opportunism are the natural consequences of postulating instrumentally-rational actors within situations of imperfect information. This is elaborated in section IV.

negotiation strategies of the other party. Likewise, contracts must be negotiated to safeguard against opportunism. Furthermore, since all information is not knowable, contracts will not be perfect. There may be transaction costs incurred during the performance of the contract; similarly, performance of contractual obligations will not always be automatic, so disputes will arise. These disputes must be mediated, which contributes to the costs of governing the firm.

In formulating Transaction Cost Economics, Williamson elaborates on the insights of Ronald Coase, an intellectual predecessor of TCE and NIE who elaborated the consequences of transaction costs. Coase used transaction costs to explain the emergence of the firm. Coase argued that firms exist because, in light of transaction costs, it can be cheaper to contract within a firm than to simply organize every transaction on the market. However, when it becomes more expensive to organize production within a firm than on the market, production will be organized on the market. In this argument, entrepreneurs direct resources and coordinate production internally within an organization to economize on transaction costs (Coase 1937: 392). To Coase, firms consist of the "system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur," and the size of the firm (measured by Coase as how many contractual relations are internal vs. external to the firm) is the result of finding the optimal price-maximizing balance (Coase 1937: 393).

While Coase was concerned with firms, NIE has used his theories to think about institutions. New Institutional Economics assumes that "institutions are broadly defined as means of reducing ... information and transaction costs"

(Harriss et al. 1997: 3). Williamson focuses both on firms and institutions of contracting and governance, emphasizing the ways in which firms economize on transaction costs and safeguard against opportunism and in which economic institutions affect transaction costs. Williamson argues that transaction costs are economized upon "by assigning transactions (which differ in their attributes) to governance structures (the adaptive capacities and associated costs of which differ) in a discriminating way" (Williamson 1985: 18). To understand this economizing, Williamson takes a comparative institutional approach that examines governance structures within organizations based on their costs.

When examining governance structures, Williamson focuses on both *ex ante* (before the agreement) and *ex post* (after the agreement) transaction costs. *Ex ante* costs include drafting, negotiating, and safeguarding an agreement (Williamson 1985: 20). *Ex post* costs include haggling costs to correct misalignments in the agreement and the setup and running costs of the governance structures that mediate disputes within the firm (Williamson 1985: 21). *Ex post* disputes are made especially salient by the condition of asset specificity, which "locks in" parties to an agreement; the costs parties incur by investing in transaction-specific assets make breaking contractual relationships expensive (Williamson 1985: 62). For example, asset specificity exists when the working for a firm requires learning an uncommon (or at least not universally demanded) set of professional skills: this may include becoming an expert at using a firm's specific contract management software, or acquiring advanced training in fixing firm-specific communications equipment. To Williamson, asset specificity leads to

bilateral dependency between contracting parties, a situation that is best dealt with by hierarchical organization (Williamson 1996: 16).

Governance structures that resolve disputes within the firm are particularly important to Williamson, who argues that most disputes within a firm do not reach the courts but instead are resolved through avoidance, mediation of differences, or appeal to organizational hierarchy (Williamson 1996: 100). Williamson's emphasis on hierarchy leads him to reject the notion that a firm is a "nexus of contracts," as this notion suggests that there is no difference between markets and firms in contractual respects.<sup>2</sup> Williamson argues that hierarchy enjoys an advantage with respect to fiat both because fiat has its origins in the employment contract and because courts do not review the judgment of directors or adjudicate internal disputes (unlike for market transactions, which are governed by different contract law) (Williamson 1996: 98). As a result, "firms can and do exercise fiat that markets cannot" (Williamson 1996: 100). Williamson thus emphasizes that the firm is more than a series of contracts—it is a governance structure that, as a result of hierarchy and fiat, has distinct advantages in organizing production.

### **III. Parsons' Characterization of Neoclassical Theory**

Transaction Cost Economics articulates imperfect-information models within neoclassical economic theory. In order to understand the nature of Williamson's theory, one may use Parsons' characterization of neoclassical

---

<sup>2</sup> This notion holds that, within firms, employers reward hard work using the same financial incentives as the market—they simply employ financial incentives more accurately. Firm is thus nothing more than a "nexus of contracts."

economic theory (to Parsons, "positivist utilitarian theory"). This discussion will draw on Parsons' argument, as modified by Gould (1981), to illuminate the core assumptions of neoclassical theory and the limits that these assumptions place on what can be argued consistently within neoclassical arguments.

In *The Structure of Social Action*, Parsons characterizes what he views as the four fundamental attributes of neoclassical economic theory. To Parsons, these attributes are methodological individualism (atomism), a single positively-stated normative orientation (of instrumental rationality), treatment of ends as exogenous, and empiricism.

Parsons characterizes social theories through his conceptual framework of the unit act. Parsons writes that the unit act has four components: an agent (which may be an individual, a person in a role, or a collectivity), an "end" (a future state towards which the process of action is oriented; Parsons defines ends counter-factually, meaning ends are defined in relation to the situation had the actor not acted), a situation which is made up of means to achieve ends and conditions the agent cannot change, and a normative orientation of action that regulates the selection of means (and sometimes ends) (Parsons [1937]1968: 44).

As, for Parsons, empirical material cannot be seen except for when mediated by concepts, Parsons uses the unit act as a conceptual framework to allow him to distinguish between theories that necessarily produce error and those that do not. Thus, theories are categorized and evaluated according to how they organize the elements of the unit act, as well as how they conceptualize relationships between these elements and unit acts themselves (Gould 1981: 198).

For Parsons, the first attribute of neoclassical theory is methodological individualism (sometimes called atomism), which holds that the system of action is reducible to the attributes of the individual unit acts that make up the system. Likewise, the agent is understood as the aggregate of unit acts it performs, relationships between unit acts are derivable from individual unit acts, and "the potential acts of one may be relevant [only] as means and conditions to the situation of action of another" (Parsons 1937[1968]: 52). This does not mean that only simple systems may be present in neoclassical analysis: Systems may be very complex and contain nontrivial inter-relations, as is true in general equilibrium analysis, but these interrelationships must be "ultimately derivable from the assumptions made about the individual units of the system" (Gould 1981: 200).

Methodological individualism limits one to explaining social and individual phenomena solely in terms of facts about individuals or their actions (see Lukes 1968: 120). This methodological tenet also means that a number of sociological concepts cannot be present within a theory. For example, norms and values cannot be said to be institutionalized in social orders.<sup>3</sup> As norms are autonomous from (and not reducible to) unit acts, and regulate the relationship between unit acts, norms cannot be allowed into the theory, as this would make the system of action irreducible to the attributes of the individual unit acts that make up the system.

Similarly, one cannot argue that a collective value system structures meaning for

---

<sup>3</sup> Parsons distinguishes between values and norms. Values are broad statements about the desirable nature of society. Norms are expectations or principles that one is expected to follow. Values are more general than norms and regulate the content of norms.

individuals.

The second attribute of positivist-utilitarian theory is that it contains a single positively-stated normative orientation of instrumental rationality. This means that, within the theory, actions are assumed to be rational in that actors maximize their goals against constraints; likewise, actors choose the most efficient means to achieve their ends, after evaluating efficiency rationally (or through bounded rationality), and select only achievable ends.

This is not to say that actors may not deviate from the norm of instrumental rationality. Positivist-utilitarian theory allows for deviation from the positively-stated norm of rationality when actors act either out of error or out of ignorance (as in a situation of imperfect information). Yet crucially, when actors deviate from the norm of instrumental rationality they are not understood to be conforming to another normative orientation (Gould 1981: 200). In positivist-utilitarian theory, the restriction of normative orientations to the single orientation of instrumental rationality causes "norms" (when they are invoked within the theory, if at all) to be reduced to individual preferences, which are maximized by instrumentally rational actors, or to sanctions, which partially constitute the actor's situation. In non-utilitarian social science, in contrast, norms can be treated not just as sanctions or preferences, but instead as obligatory and desirable for the actor (see Gould 2001b).

The third attribute of utilitarian-positivist theory is that the actor's ends are treated as exogenous to the theory (Gould 1981: 201). Parsons argues that this means ends are presumed to be random by neoclassical theory (Parsons

[1937]1968: 60). Gould disagrees with this characterization of neoclassical theory. Rather, what is crucial is that ends are treated as given and thus not explained from within the theory. While utilitarian-positivist theory is not silent about desired ends—arguing that they must be consistent, transitively ordered, and obtainable within the situation of the unit act—it does not treat an actor's preferences as regulated by a normative orientation.

The fourth attribute of positivist-utilitarian theory, according to Parsons, is that the theory is empiricist. Parsons' statement about empiricism paints neoclassical theory as denying the legitimacy of theoretical abstraction, instead presenting the task of doing economics as exhausting all scientifically knowable knowledge about extant phenomena. This definition of empiricist is stricter than the understanding of empiricism that underlies most modern economics. For our purposes, empiricist theory is that which only allows the introduction of concepts into theory when the concepts are reducible to directly observable 'phenomena' (Gould 1981: 201). Therefore, concepts such as social structures that are not reducible to the actions of atomistically conceptualized actors do not exist in positivist-utilitarian theory, nor do notions of cultural systems or systems of shared value-orientations and norms. One cannot postulate or invoke categories that are separate from actors, situations, and unit acts, nor can one postulate hypothetical categories that are not directly observable.

Williamson's Transaction Cost Economics is neoclassical. His theory is atomistic, as all social phenomena and systems of relationships are explained solely in terms of facts about individuals and their actions. Likewise, the theory

contains a single-positively stated norm of instrumental rationality: bounded rationality and opportunism are the behavioral consequences of this single normative orientation when conceptualized within imperfect information. Furthermore, ends are treated as exogenous to the theory. Lastly, the theory is empiricist; nothing enters into Williamson's theory that is not reducible to directly observable phenomena. The neoclassical nature of Williamson's theory has two crucial implications. First, Williamson does not transcend neoclassical theory, except for in an ad hoc manner. Second, the neoclassical nature of Williamson's theory has profound influence on his conceptualization of power.

#### **IV. Imperfect-Information, Order, and the Necessity of Conceptualizing Power and Governance**

The shift from perfect-information to imperfect-information economic models raises the problems of governance and order. Perfect-information economic models present a model of social order based on Pareto optimality. In imperfect-information models, many conclusions that are robust within perfect-information models do not hold. There is no natural identity of interests, opportunism must be controlled, and disputes arise within the firm: in short, a problem of order is manifest. Power and governance within the firm must therefore be conceptualized.

In perfect-information models, perfect knowledge is assumed for all actors, uncertainty does not exist, and information costs and transaction costs are zero (Gould 2001b: 8). Individuals do not deviate from the norm of instrumental

rationality, not even in error or ignorance, because of the assumption of perfect knowledge. Likewise, perfect competition prevails and markets clear (Gould 1990: 7).<sup>4</sup> The most efficient form of production (of those available) is always chosen at equilibrium, and market outcomes are dictated by individual preferences, the original allocation of assets, and technology (Gould 2000: 7).

In perfect-information models, there is no power. All groups are protected from one another by competition (Gould 2000: 7). Efficiency alone determines the equilibrium outcome of the economy. Equilibrium outcomes are in the interest of all actors (insofar as all actors accept their original allocation of assets) (Gould, 1990:1) and each factor of production (labor included) receives the value of its marginal product as its price (Gould 1990: 8). Furthermore, there is no principal-agent problem (in which an employer must motivate workers to work effectively), as the performance of workers is monitored perfectly and without cost. As information is perfect, workers are monitored perfectly and without cost, and opportunism and bounded rationality are not manifest, it is not necessary to examine the internal governance structure of a firm.

Perfect-information models assume and present a model of social order; at equilibrium, no actor has any incentive to change (provided she is satisfied with her starting position). In perfect-information models, the competitive economy is always Pareto efficient—that is, no one can be made better off without making

---

<sup>4</sup> Perfect competition prevails as a mathematical consequence of perfect-information models—therefore, competition does not need to be explained as manifest within a situation, as is necessary in imperfect-information models

someone else worse off (Stiglitz 1991: 2).<sup>56</sup> In this situation, surplus is maximized, and the utility of each actor is maximized given the utilities of others. Notions such as power or social norms are not necessary to explain social order. The need to conceptualize power does not arise until one recognizes the omnipresence of imperfect information.

In imperfect-information models, information is imperfect, often asymmetrical, and often costly to obtain, and therefore uncertainty is manifest (Gould 2001b: 10). In these models, many conclusions of perfect-information models fall apart: this includes not only the assumptions about information, but also the assumptions that transaction costs are zero, that markets clear, and that no actor has an incentive to change his position in equilibrium. Likewise, asset specificity is possible (the situation in which investments are worth more in a particular transaction than in the market in general), there is no natural identity of interests, and there may be a disjunction between what is profitable and what is efficient. Furthermore, markets are rarely ever Pareto efficient, and principal-agent problems can, and often do, exist (see section VI).

Neoclassical imperfect-information models still maintain instrumental

---

<sup>5</sup> This was shown by Arrow and Debreu, who articulated the fundamental theorems of welfare economics. The first fundamental theorem of welfare economics states that, under certain conditions, the competitive economy is always Pareto efficient (see Stiglitz 1991: 2).

<sup>6</sup> Stiglitz argues that the questions about Arrow-Debreu general equilibrium should concern not the logic coherence of Arrow and Debreu's propositions, but the relevance of these propositions to empirical reality. The conditions under which the first theorem is true turn out to be crucial. Specifically, when information is perfect and imperfect, and when there are incomplete risk and futures markets, markets are not Pareto optimal (see Stiglitz 1991 for an overview).

rationality as the sole positively-stated normative orientation, but due to their assumption of imperfect information, individuals do not always conform to this normative orientation. (Note, however, that while actors may deviate from norm of instrumental rationality in these models, they cannot be understood to conform to another normative orientation (Gould 1981: 200)). In these models, an individual may deviate from the normative orientation of instrumental rationality out of ignorance or error, as actors do not understand their environment completely. In Transaction Cost Economics, these ideas are manifest in two behavioral assumptions: first, of bounded rationality, which holds that individuals are intendedly rational, but limitedly so (Williamson 1985: 45), and second, of opportunism, which Williamson characterizes as "self-interest seeking with guile" (Williamson 1985: 47).<sup>7</sup> These behavioral assumptions are the necessary consequence of assuming a sole positively-stated normative orientation of instrumental rationality when coupled with imperfect information.

Opportunism "refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse" (Williamson 1985: 47). Opportunism is not a problem in perfect-information models, because information is costless and perfect, but it becomes an omnipresent threat in imperfect-information models. Opportunism means that actors will act opportunistically unless there are sanctions which de-incentivize opportunism or incentives which make recourse to opportunism inefficient (Gould 2001b: 12). Opportunism also makes impossible the natural

---

<sup>7</sup> Bounded rationality was initially elaborated by Herbert Simon (see Simon 1955).

identity of interests assumed in perfect-information models.

Imperfect information and bounded rationality also lead to incomplete contracting: individuals do not have the knowledge or cognitive capacity to contract comprehensively. When contracts are not perfect, disputes inevitably arise within the firm. Individuals in a situation of asset specificity will have an incentive to resolve these problems using the internal governance structures of a firm.

The assumptions of bounded rationality and opportunism in imperfect-information models mean that social order is no longer a solved problem<sup>8</sup>. With the breakdown of the social model manifest in perfect-information models, social order must now be explained: Imperfect-information models raise the problem of order. For Williamson, this leads to a new imperative for organizations: "Organize transactions so as to economize on bounded rationality while simultaneously safeguarding them against the hazards of opportunism" (Williamson 1985: 32). As Freeland writes, with the move to imperfect-information models, governance of the firm is no longer a solved problem (Freeland 2001: 17). Actors must take steps to guard against the possibility of opportunism. Governance structures of the firm must now be taken into account, and power must now be postulated within the model.

---

<sup>8</sup> Williamson himself realizes that both bounded rationality and opportunism must be present in order for problems of governance to be conceptualized (otherwise, comprehensive contracting and costless measurement are feasible) (Williamson 1985: 81)

## V. Power in Transaction Cost Economics

Williamson's view of the firm as a governance structure causes him to conceptualize hierarchy, authority, and power. Williamson treats markets and hierarchies as polar ends on the spectrum of organizational forms, arguing that there are trade-offs that are made when one form is selected over the other: Markets adapt better to rapid changes in circumstances, and are less subject to bureaucratic distortion, while hierarchies are better at adopting to situations where cooperation between men is necessary. For Williamson, hierarchies are especially well-suited to deal with situations of bilateral dependence, which arises due to asset specificity (Williamson 1996: 151).

Hierarchy is best suited for bilateral adaptation because it deals well with maladjustments and other *ex post* transaction costs that arise between contracting parties. Williamson argues that courts do not often interfere with the internal organization of firms, and that differences are resolved internally, often through an appeal to hierarchy. Hierarchy here functions as an organization's "own court of ultimate appeal" (Williamson 1996: 98). Hierarchical organization, then, is based on authority invested in those at the top, who exercise power through binding fiat<sup>9</sup>

<sup>10</sup>

To Williamson, hierarchical governance of the firm not only resolves

---

<sup>9</sup> Williamson sometimes suggests that fiat is simply binding to subordinates: a principal will order an agent to do something, and the agent will simply follow this demand. In his more sophisticated discussions, Williamson recognizes that fiat will only be obeyed if it is in an agent's self-interest. As this second view is consistent with the logic of his theory, it is the one used in this argument.

<sup>10</sup> The bindingness of fiat is why Williamson believes hierarchy is best for motivating conscious cooperation and coordination (Williamson, 1996: 149).

disputes and motivates cooperation and performance, but also solves the problem of order that arises within imperfect-information models. Freeland analyzes the logic of governance and authority in Williamson's argument. Executives govern through authority and fiat that is rooted in sanctions. These sanctions are designed through the gathering of information in an environment where information is imperfect (Freeland 2001: 312). Order and cooperation are the result of incentive alignment that awards compliance to the firm's goal and punishes malfeasance. The sanctions align the interests of individual actor's with those of the firm (Freeland 2001: 6). Order is thus an outcome of rational self-interest; fiat is obeyed by individuals because it is in their interest to do so, opportunism is constrained by fiat and sanctions, and authority rests on mechanisms "that structure incentives so as to make the cost of malfeasance prohibitively high" (Freeland 1996: 538)<sup>11</sup>.

Williamson's conception of power and authority is consistent with neoclassical economic theory. Individuals conform to the normative orientation of instrumental rationality, obeying fiat rooted in sanctions designed to align incentives (as long as these incentives are successful in making obeying fiat in the agent's interest). Likewise, order within the firm is seen as an outcome of self-interest. The theory is also methodologically individualist. As Freeland argues, "fiat and sanctions create order by altering the *situation* in which action takes place (Freeland, 2001: 24). This view of power is consistent with methodological

---

<sup>11</sup> The creation of order through fiat also reduces the cost of running the firm, meaning firms which invoke fiat are more likely to survive in competitive markets (Freeland 2001: 7).

individualism, which argues that the actions of one individual are relevant for another's actions only as the means and conditions that make up the situation of those actions. The theory is also empiricist: social values that structure meaning or constitute what individuals find desirable and obligatory do not enter into the theory, and no conceptualizations exist that are not generalizations from observable actions.

Williamson's conformance to neoclassical theory has further implications for his argument. Williamson sometimes qualifies the effectiveness of fiat, or argues that normative commitments besides instrumental rationality motivate behavior (see, for example, Williamson 1985: 44, footnote 4, which discusses "dignitarian values"). These qualifications, however, are no more than residual categories invoked as ad hoc qualifications; they are not part of the logic of his theory, and in fact openly contradict the basic assumptions of it. The assumptions of methodological individualism, empiricism, and instrumental rationality mean Williamson cannot successfully conceptualize the normative elements of governance or of power. As Freeland argues, Williamson may qualify his theory in an ad hoc manner, but his theory cannot tell us when fiat will fail to function effectively, nor specify how to avoid such failures (Freeland 2001: 317). Neither can his theory predict when non-rational beliefs will be important, what beliefs will motivate actors, or the mechanisms through which these beliefs will affect action (Freeland 2001: 318). Instead, the logic of neoclassical economics requires Williamson to reduce power to fiat.

As Williamson reduces power to fiat, he cannot understand the normative

aspects of consent, the interplay of authority and generalization in the constitution of valid power, or the importance of reduced complexity for the operation of power. Therefore, Williamson cannot understand the extraction of rents from workers, why agents might obey valid orders that contradict their interests, or the importance of cultural intelligibility to the operation of power. In order to understand this first problem (the extraction of rents from workers), one must understand the nature of the principal-agent problem and how it arises in imperfect-information economic models.

## **VI. Imperfect Information and the Principal-Agent Problem**

The shift from perfect-information to imperfect-information economic models not only forces theorists to consider social order, governance, and power. The acknowledgment of imperfect-information also introduces what is known as the principal-agent problem. The principal-agent problem is the problem of motivating a party to act on behalf of another party; it arises when an individual (the principal) compels another individual (the agent) to act in the principal's interests (Stiglitz 1987: 966).<sup>12</sup> To use common-place terms, a principal-agent problem is manifest when an employer (principal) hires a worker (agent) to

---

<sup>12</sup> Principal-agent problems have been important to thinking about capitalism since Marx. This is shown in Marx's distinction between labor and labor-power. Labor is the process of work, the actual activity or process of working. In contrast, labor power is ability to work, which is possessed by the worker. In the capitalist mode of production, the laborer sells his labor-power to capitalists. The fact that laborers sell their ability to work (labor-power) and not their actual work (labor) means that capitalist must motivate workers to actually do work; therefore, principal-agent problems are crucial to understanding the capitalist-worker relation, and are endemic in the capitalist mode of production.

perform work: the work serves the interests of the employer, and the employer must motivate the agent to perform the work. In this situation, the principal and agent may have different interests, the task of working is costly to the agent (who could be pursuing other opportunities), and work must therefore be motivated. Principal-agent problems are omnipresent in imperfect-information models; Stiglitz goes as far as calling the principal-agent problem "the central problem of economic incentives" (Stiglitz 1987: 967).

The principal-agent problem is the result of imperfect-information, which introduces multiple complications in the employer-worker relationship. In perfect-information models, workers (agents) are paid the value of their marginal product at equilibrium. With imperfect information, it is either costly or impossible for a principal to know a worker's marginal product: an employer does not know how much work his worker has really done. The information asymmetry also means that principals may know more about the task he wishes the agent to perform. Likewise, workers are prone to opportunism, and will endeavor to be paid as much as possible for as little work as possible. The principal's problems of inducing effective performance and enforcing a standard of good performance therefore must be considered. Furthermore, principals and agents may have different interests in imperfect-information models. If unaligned, these interests must be aligned through incentives and the motivation of the agent by the principal (in neoclassical analysis, this is done through situational sanctions and incentives).

Traditional, perfect-information neoclassical analysis emphasizes symmetrical power between principals and agents: it argues that it makes no

difference whether an employee hires capital or whether capital hires labor. This symmetry does not hold once the principal-agent problem is acknowledged (Stiglitz 1987: 967). This is so because of the interplay of capital ownership, interest, and profitability within the firm. First, ownership of the means of production (class, to some theorists) enables command over the production process (see Bowles 1985). Second, motivation to perform a certain task is affected by one's interests in it; if an agent has little to gain from carrying out the task she is commanded to do, then her work must be motivated in another way. Third, in imperfect-information models, profitability is not necessarily equivalent to technical efficiency.<sup>13</sup> Firms pursue activity that is profitable, not necessarily technically efficient; even in competitive markets, an activity may be sustained if it is profitable for the owner of the firm. Principals will pursue what is profitable for them, which includes motivating agents to act in a manner they would not otherwise choose (Bowles 1985: 19).

This insight makes the principal-agent problem central to the behavior of firms in competitive capitalism. Competitive constraints within the economy mandate that managers keep their firms profitable. Therefore, there are pressures for principals "to extract as much *rent* (surplus) from the agent as possible" (Stiglitz 1987: 969). Extracting this rent entails motivating agents to work against their interests, and therefore entails finding a solution to the principal-agent problem.

---

<sup>13</sup> The equivalence between profitability and efficiency in perfect-information models was demonstrated by Tjalling Koopmans (1957).

## **VII. Williamson and the Principal-Agent Problem**

The principal-agent problem is manifest in Williamson's distinction between consummate and perfunctory cooperation. Williamson recognizes that an agent's performance of contractual job duties varies. Perfunctory cooperation is "job performance of a minimally acceptable sort" with only "a slight margin [of performance] over the best available inexperienced candidate" (Williamson 1975: 69). Consummate cooperation, in contrast, results when employees do not purposefully withhold effort or knowingly behave at a sub-optimal level (Williamson 1975: 69). Workers have an affirmative job attitude, take initiative, and use judgment. The necessity of motivating consummate, as opposed to perfunctory, cooperation arises from Williamson's acknowledgment of imperfect-information (and thus of opportunism): workers and employers have different interests, and workers do not self-enforce their own behavior.

Williamson notes that the distinction between these two types of employee performance is crucial to the employment relationship: firms want to buy work performed in a quality manner, and not just time on the job (Williamson 1985: 262). Likewise, the fact that workers may cooperate in a consummate manner makes the firm more efficient, thus fulfilling the firm's key role of economizing on transaction costs. In competitive markets, principals must therefore motivate their agents to pursue the interests of the principal in a consummate manner.

In justifying his own approach to the principal-agent problem, Williamson characterizes much principal-agent literature as concerned only with ex ante (pre-contract) incentive alignments, and argues that this literature views all relevant

contracting issues (including the principal-agent problem) as resolved by comprehensive bargaining during contracting (Williamson 1985: 28). Williamson views this as inadequate, given his emphasis on ex post transaction costs; contractual obligations alone cannot explain why an employee might devote his full energy to carrying out tasks to the best of his ability (Williamson 1985: 263). Williamson's approach moves beyond ex ante incentive alignments, instead suggesting the importance of governance, private ordering, and ex post mechanisms for dealing with this problem (Williamson 1985: 29).

Williamson resolves the principal-agent problem through his ex post mechanisms of governance, which are rooted in sanctions and fiat. Principals motivate agents to work hard in the principal's interest by relying on their position of authority. Authority is the result of the ability to impose fiat, which aligns incentives through the manipulation of situational sanctions. Principals may rely on fiat not only to guard against opportunism, but also to exact rents from agents. Fiat is obeyed by agents because it is their interest to do so. Agents perform in a consummate manner as the result of incentive alignment that awards compliance to the interests of the principal. Consummate cooperation by the agent, at least to Williamson, is thus the result of rational self-interest.

### **VIII. The Problem with Williamson Part I: Normative Consent**

Although Williamson believes that he can solve the principal-agent problem within the firm through ex post mechanisms of governance rooted in sanction and fiat, he cannot. Williamson's argument that workers may be

motivated to work in a consummate manner through incentive and fiat is mistaken. Instrumentally rational actors will not work hard beyond what the rules require and beyond that for which they are compensated. Even the best incentive system cannot motivate consummate cooperation in an instrumentally rational actor (for a similar argument, see Freeland 2010). Williamson may qualify his arguments by noting the importance of workplace atmosphere or “respected” authority, but in doing so he introduces ad hoc elements into his theory (Williamson 1985: 239; Freeland 2010). Whether a workplace is pleasant or authority is respected has no bearing on the behavior of an instrumentally rational actor. Behaving in a consummate rather than perfunctory manner entails conforming to a normative orientation besides that of instrumental rationality. This cannot be understood within a theory that postulates instrumental rationality as the sole normative-orientation possible for an actor (where deviance from instrumental rationality is only possible out of ignorance or error). Therefore, to understand consummate performance, we must conceptualize power in a way that transcends neoclassical theory.

Freeland (2001) enables one to understand consummate performance by solving the principal-agent problem through his notion of consent. Freeland criticizes the Transaction Cost Economics view of power and governance for failing to consider normative elements of power and order,<sup>14</sup> and, in contrast to

---

<sup>14</sup> Freeland argues, contra Williamson, that the primary imperative facing governance mechanisms in a firm is to establish and maintain social order. This is not done by using information to devise appropriate policies that are enforced through fiat and sanctions, but rather by creating cooperation and motivating

neoclassical theory, systematically incorporates positively-stated normative orientations besides instrumental rationality into his theory (as well as social and cultural mediation of action: See section XII). This results in a different understanding of power. To Freeland, the successful operation of power within the firm entails more than incentives and fiat as they pertain to an agent's self-interest; rather, the successful operation of power always entails an element of consent, or the voluntary acceptance of authority, on the behalf of agents (Freeland 2001: 7).

Consent encourages agents to pursue organizational goals, even when these goals are against their own interests. The motivation of consent creates order in a different way than sanctions: while sanctions change the situation of action for an actor, consent changes an actor's intentions independent of situational constraints. It does this by constituting behavior as desirable and obligatory, regardless of incentives (Freeland 2001: 24). Consent can thus encourage agents to conform to a normative orientation that is not instrumentally rational.

Freeland views consent as constituted in two ways. First, consent is created through legitimation, in which actors voluntarily accept authority when it is viewed as consistent with social values.<sup>15</sup> Therefore, expectations will be constituted as morally binding when they are consistent with these values (Freeland 2001: 25). Consent is also crafted within the organization. To Freeland, firms operate as mini-societies with their own norms, personal and group relations, informal aspects of organizations, and historical precedent. The feelings of moral subordinates (Freeland 2001: 33).

---

<sup>15</sup> Parsons also insists on the legitimacy of power in his formulation of power as a generalized medium (this will be expanded on in section XI).

commitment that result from these internal aspects of an organization also constitute normative obligations for individuals, who may consent to authority based on these normative obligations (Freeland 2001: 27).

Freeland's focus on legitimation may be made more precise through a distinction between legitimation and justification. Legitimation refers to the subsumption of norms and activities under moral value-commitments; norms and activities must be consistent with these value-commitments to be viewed as legitimate by actors. Justification, on the other hand, refers to the justification of an outcome through procedural due process. A decision or obligation is justified if it is the outcome of a process that is consistent with values (Gould 1990: 34; see also Gould 1993). Legitimation and justification are often conflated, but the recognition that these two processes are distinct illuminates that procedures must themselves be consistent with values, and likewise that decisions may be reached through legitimate procedures, but still be inconsistent with values. An obligation is most likely to be viewed as binding when its content is consistent with values (legitimation), and when it is created in a valid way (justification) through processes that are viewed as consistent with values. Legitimation and justification also apply to power: For power to constitute binding obligations, both the process for creating obligations and the content of the obligation itself must be consistent with social values.

In order for power to operate successfully within the firm, it must be consistent with and appeal to values and norms. Likewise, the process of constituting binding obligations for agents, and the binding obligations

themselves, must be consistent with social values. The operation of power and the resolution of principal-agent problems thus depend on social values and norms. Principals motivate agents to work in the principal's interest not only through structuring incentives and exercising fiat, but also by appealing to values and norms. This argument contradicts Williamson, and this is necessarily so. The logic of neoclassical theory assumes instrumentally rational actors, but this assumption means that neoclassical theory cannot adequately solve principal-agent problems within the firm or understand the extraction of rents from workers within competitive capitalism.

The contention that one must transcend the neoclassical assumption of instrumentally rational actors in order to solve principal-agent problems may be illustrated through an example. Assume a principal-agent relationship between a law firm owner and a secretary who works in the law firm office. The firm owner (principal) has an interest in maximizing profit by minimizing the costs necessary to have the office organized and other secretarial duties performed; the secretary (agent) has little interest in the profitability of the law firm, and there is little motivation for him to perform as effectively as possible, because his principal is unable to know how efficient he is at any given moment. The firm owner may attempt to make him work more efficiently through incentives (a bonus) and sanctions (docked pay). If the secretary is assumed to be instrumentally rational and opportunistic, as imperfect-information economic models state, then he will only perform the minimal required work to receive bonuses and avoid docked pay (this is performing in a perfunctory manner, in Williamson's sense).

For the secretary to perform consummately (by having a positive job attitude, taking initiative, and making up for others' suboptimal performance), he would have to maximize something besides his own material gain. He might be motivated by the fact that he enjoys his workplace environment; likewise, he might have a normative commitment to his job, pride in the law firm, or value 'hard work'. This, however, would entail conceptualizing a normative orientation for the secretary besides that of instrumental rationality, a task that requires articulating a theory that is not neoclassical, but instead can meaningfully conceptualize normative aspects of consent.

### **IX. Problem II: Authority, Generalization, and Valid Power**

Beyond being unable to solve the principal-agent problem, Williamson also cannot understand when power will be valid, and therefore obeyed by an agent when it is not in his self-interest. In order to understand this, one must understand the institutionalized nature of authority and the generalized nature of power. This requires conceptualizing power not only as legitimate and justified, but also as a generalized medium of communication.

As previously noted (section V), Williamson treats power as fiat. Fiat is obeyed by agents out of self-interest. An agent will obey a principal only if it is in his interest to do so. Williamson can conceptualize a principal-agent relationship in which the agent will perform a large number of tasks if ordered to do so, but this would be a result of the contract negotiated between the principal and the agent and the agent's self interest in obeying that contract. A principal cannot rely

on his authority within the workplace to secure conformance to his demands: the authority relationship is the result of contractual mandates and self-interest only.

To understand why Williamson's understanding of authority is problematic, one may return to the earlier example of the principal-agent relationship between a law firm owner and her secretary. Suppose the boss asks her secretary to talk to a co-worker and mediate an intra-office emotional conflict, and he agrees to perform this task. This task is not likely to be part of the secretary's contract, performing the task is costly to the secretary (who could be performing another task that is in his interest), and the boss is not likely to increase compensation for him because he mediated this conflict—thus, the secretary performance of this task was not due to his interest. How might one explain the secretary's conformance to his boss's demand?

A boss of a law firm is expected to run her law firm well, and do what is necessary to accomplish this task. If the boss asks her worker to mediate a conflict that is interfering with workplace productivity, she is operating within her authority. This authority acts as an institutional counterpart of her power, regulating the limits within which her commands must be obeyed. One can clearly conceive of limits to this authority: if the boss requested that her secretary wake up early to come shovel her driveway on a snowy day, the secretary would likely not perform this duty. The boss, whose authority specifies that she may administer an office but not order her employees around before work begins, does not have the authority to order the secretary to do this.

It is also important to note that the boss's authority is not just applicable in

this one situation or with this one employee. The boss has the authority to issue these kinds of dictates to many employees, in many different circumstances. This highlights that the boss's power is generalized, and thus operative in many social relationships.

Authority is crucial to explain when power will be operative within a firm, while the generalized nature of power is crucial to understanding why power is operative in a wide variety of situations, outside of specific contractual or personal relationships. These two aspects may be understood if we conceive of power as a generalized medium of communication, as Parsons and Luhmann have done.

Conceiving power as a generalized medium treats power as a circulating medium that enables communication. Generalized media are operative in particular interactions, but are generated at the structural level.<sup>16</sup> In particular, power is operative between two actors in a social situation (alter, who acts first, and ego) when alter's selected action leading to ego's selected action (Luhmann 1976: 517, 529). When successful, power transmits one actor's selection to another; one partner's selection thus motivates the other's selection.

The conception of power as a generalized medium of communication entails a recognition that power is generalized—that it is useful not only in particular situations or singular interactions, but instead operates free of individual relationships, individual personalities, or particular interactions. This is due to the fact that power, while operative between individuals in particular interactions, is

---

<sup>16</sup> This will be elaborated in section XI, where it is argued that if a system constitutes valid power, it will be generalizable and operative in a wide variety of social relationships.

the result of structural factors. Recognizing power as generalized enables one to understand that the operation of power will not be determined by the characteristics of a particular relationship between one principal and one agent, or by the personal attributes of individual actors, nor by a particular contractual agreement within a firm. Principals may have authority to exercise power in many contexts.

Likewise, the conception of power as a generalized medium treats authority as the institutional counterpart of power. Authority is therefore the institutional code within which power is organized and legitimized. Institutional codes constitute standards of selection for alter and ego and regulate the acceptable limits of pressure which alter may place on ego. Authority serves as the institutional code of power, so authority defines the limits of acceptable pressure alter may place on ego (Gould 2001a: 131).

Authority is also the aspect of status within a social organization that allows incumbents to legitimately create decisions that are binding on the collectivity as a whole (Parsons 1963: 244). Authority confers a set of rights within a collectivity, including the right to acquire and use "power over" another, i.e. to make decisions that take precedence over subordinates' decisions within a collective operation and in the interest of the effectiveness of this collective operation (Parsons 1963: 243). Authority may thus enable hierarchical organization.<sup>17</sup> Furthermore, the fact that authority confers the right to use power within a collectivity means that power

---

<sup>17</sup> This also requires a structure in which power is functioning as an effective symbolic medium.

requires more than just a specific contractual exchange to operate; rather, it requires power to be institutionalized into the set of social relationships in which power will be operative.

The institutionalized nature of power (in authority, its institutionalized code) explains the limits of acceptable pressure within which power will be treated as valid; likewise, the generalized nature of power explains why power is operative in a wide variety of social relationships and situations. These components thus enable a principal to invoke power over an agent in a firm. Williamson recognizes the hierarchical nature of power within firms, but reduces power to fiat. Williamson thus cannot understand the successful operation of power when it is not in the agent's self interest to act in accordance with the principal's demand. A conception of power as a generalized medium, in contrast, highlights that an agent will obey a principal's demand as long as this demand is defined as acceptable by the principal's institutionalized authority. Likewise, Williamson cannot understand that power is operative outside of specific contractual relationships, while a conception of power as a generalized medium highlights that power operates outside of particular social relationships and circumstances when structures constitute power as an effective medium.

### **X. Problem III: Cultural Intelligibility and the Contingency of Action**

A third problem with Williamson's conception of power as fiat is that he is unable to understand the intelligibility of power within social relationships. The question of intelligibility (here conceived as the problem of double contingency)

results from the complexity and uncertainly manifest in highly differentiated societies. Williamson acknowledges complexity and uncertainty, but not the problem of intelligibility of power; Williamson thus does not recognize how the operation of power between alter an ego depends on reduced complexity. Likewise, he cannot solve this problem, as he cannot conceptualize the reduction of complexity through social systems due to the nature of his theory.

Williamson acknowledges the complexity of modern society through his notion of bounded rationality, which holds that actors are "intendedly rational, but limitedly so" (Williamson 1985: 45). Bounded rationality exists because there are limits on cognitive competence—there are psychological limits on the computational and predictive ability of humans. Individuals strive to be rational, but this results in, at best, a crude and simplified approximation of actual rationality (Simon 1955: 101). Individuals thus cannot account for the vast complexity of their world. For Williamson, bounded rationality means that individuals cannot contract comprehensively; transactions costs therefore arise, and we must study mechanisms of governance within the firm, including the operation of power through fiat. The question of intelligibility is not considered in Williamson, however. In order to understand the operation of power, we must understand why it is intelligible to actors. Williamson does not give us the tools to do so, as he does not understand the constitution of reduced complexity outside of the actor, through social systems.

The importance of the intelligibility of power may be illustrated through brief recourse to the earlier example. If the boss at the hypothetical law firm were

to order her secretary to dress more presentably at work, this demand would be intelligible to both parties. In contrast, it doesn't make sense for the boss to order her secretary to order 500 boxes of marshmallow candy in order to cater a business lunch, even though it is within a boss's authority to order her secretary to do so. Likewise, it doesn't make sense for a boss to order her secretary flowers on his birthday, but demand sternly on the card that he is to begin offering her clients coffee and tea when they arrive or be fired. The operation of power will not be intelligible in every instance of alter attempting to induce action in ego, and the act of communicating demands may likely fail. One must understand the intelligibility of power in order to understand its successful operation.

Parsons and Luhmann acknowledge the problems of complexity and intelligibility through their discussion of the problem of double contingency. The problem of double contingency arises from classical sociological questions about how social coordination and interaction between strangers are possible, especially in the situation of a highly differentiated society. This problem was especially important for both Parsons and Luhmann, who treat it as a fundamental problem of interaction that is solved through their systems theories.<sup>18</sup> The problem of double contingency (as they call it) results from the fact that all actors act contingently: the contingent action of alter is dependent on the contingent action of ego, and the contingent action of ego is dependent on the contingent action of alter. If alter acts first, his gratification is contingent on ego's reaction, but ego will not know how to

---

<sup>18</sup> The differences in Parsons' and Luhmann's discussions are not properly emphasized in the present discussion.

act without knowing alter's reaction to ego's potential action (see Luhmann 1976: 508). This double contingency makes it improbable that an action will connect with the actions of others. Without some sort of selection criteria which limits the variation in relations or creates a set of expectations for social actors, action is thus indeterminate and unlikely.

The problem of double contingency relates to the enabling of meaningful interaction: Interaction will not likely be successful unless the problem of double contingency is solved. Unless this problem is solved, social interaction and social relationships are unlikely to exist (this includes, for example, the relationship and interaction between principal and agent). Likewise, unless the problem of double contingency is addressed, we cannot understand why the action of an agent may find a connection and conferral of meaning in the action of others; similarly, we cannot understand how creative interaction is possible within a social order. Most importantly, we cannot understand why the operation of power between individuals is intelligible, or successful. To understand the resolution of the problem of double contingency, it is necessary to look to the creation of reduced complexity.

Here, two theoretical solutions to the problem of double contingency are considered: first, the positing of social and cultural systems that regulate shared meaning and expectations, and second, the concept of the generalized media of communication.<sup>19</sup>

---

<sup>19</sup> Other solutions to the problem of double contingency include those of George Herbert Mead and ethnomethodologists, who view interaction as more contingent

This first solution, associated with the work of Parsons, stresses the importance of relatively stable symbolic systems. These systems regulate and enable meaning and intelligibility through shared codes. These systems are both social and cultural—social systems constitute right/wrong distinctions for individuals, or beliefs about morality or immorality, while cultural systems constitute sense/nonsense distinctions, or what is intelligible to actors.<sup>20</sup> These systems solve the problem of double contingency by making action intelligible and limiting the choices of actors: actors can thus enter into interaction with a set of shared expectations.

The second solution to the problem of double contingency results from Luhmann's understanding of the generalized media of communication. To Luhmann, generalized media solve the problem of double contingency through the transmission of reduced complexity from alter to ego (Luhmann 1976: 512).<sup>21</sup> Each medium has a code, or selection pattern, that defines what is acceptable as communication (for power, this is authority). Media thus reorganize possibilities

---

and dependent on the continued negotiation of meaning. This thesis does not adequately attempt the important task of differentiating these theories from the approaches of Parsons or Luhmann, nor of addressing the strengths and weaknesses of these Meadian or ethnomethodologist arguments, even though it explicitly endorses solutions based on reduced complexity due to social systems. Note, however, that this thesis explicitly endorses the importance of autonomous cultural and symbolic logics, logics that are constituted within systems, but mediate practice (see Gould 2009 and section XII). These systems are often absent within theory inspired by Mead or ethnomethodology.

<sup>20</sup> Social systems and cultural systems also differ in other ways. Social codes often restrict action, while cultural codes are often generative, enabling creativity.

<sup>21</sup> The problem of complexity is very important to Luhmann, who views social systems as generating reduced complexity. One way this is particularly important is the generation of behavioral expectations.

of choice; "like social systems, media are mechanisms for narrowing choices which linguistically remain open" (Luhmann 1976: 511). As a result, media enable social interaction and integration "so that people join with others in a narrow world of common understandings, complementary expectation, and determinable issues" (Luhmann 1976: 512).

Power's operation as a generalized medium consists in alter's selected action leading to ego's selected action. When successful, power transmits one actor's selection to another. Reduced complexity is important to the success of power in mediating communication. A system generates power if it generates alternative of actions that are avoided by alter and ego (Luhmann 1976: 517). Likewise, the institutionalized authority structure defines the limits of acceptable pressure alter may place on ego, thus limiting the ways that alter may induce ego to perform a certain action. Viewing power as a generalized medium therefore allows one to understand how the problems of complexity and double contingency are solved in a situation where alter is attempting to exercise power.

Williamson acknowledges complexity in the form of bounded rationality, leading him to conceptualize governance and power. However, Williamson does not recognize the importance of the problem of double contingency, nor can he solve it in either of the ways proposed by Parsons or Luhmann. Williamson cannot see action as regulated by cultural and social systems, nor can he view complexity as reduced by these systems. To do so requires positing symbolic systems that are not reducible to individual acts and actions (contra methodological individualism)

and not generalizable from observables (contra empiricism)<sup>22</sup>. Therefore, Williamson cannot understand how these systems regulate and enable meaning and intelligibility, or how they constitute expectations that resolve the problem of double contingency. Williamson also does not understand the importance of reduced complexity for the operation of power. He does not talk about the institutionalized authority structure that regulates the acceptable modes of pressure alter may place on ego. Instead his discussion of power mistakenly takes for granted that social interaction will be successful and that action will be transmitted through power.

### **XI. Some Implications of Treating Power as a Generalized Medium**

Viewing power as a generalized medium has certain implications for understanding power within the firm. Specifically, treating power as a generalized medium highlights that power's stability and generalizability depend on forces that operate at the structural, and not individual, level. Furthermore, treating power as a generalized medium illuminates that power's operation depends on an interplay of both coercion and consent.

Gould argues that Luhmann illuminates the micro-level operation of the generalized media, while Parsons explains, at the macro-level, how the successful operation of each medium is based on the status of the medium in its social context. Luhmann allows one to understand the operation of power in the circumstances of particular interactions. Luhmann illustrates how "the manner of

---

<sup>22</sup> This will be elaborated in section XII.

one partner's selection serves simultaneously as motivating structure for the other" and therefore serves the function of transmission (Gould 2001a: 143). This is important, but it doesn't explain why power can operate successfully as a medium. Rather, "the primary explanation for the legitimacy of alter's power is found at the structural level" (Gould 2001a: 142). The media, and the micro-interactions in which they are operative, must therefore be situated within their social structural context. Parsons provides the theoretical tools to accomplish this task.

To Parsons,<sup>23</sup> power is the generalized medium of the polity subsystem, the subsystem that fulfills the functional need of goal attainment, the process of establishing a satisfactory relationship between a collectivity and its environment through the attainment of needs (Parsons 1963: 233). The generalized media mirror the characteristics of money within the economy (Parsons posits money as the medium circulating within the economic subsystem): they are symbolic and generalized, function as means of acquiring the factors necessary to perform the

---

<sup>23</sup> Briefly, Parsons views action as taking place within social systems, which are series of relatively stable interrelationships among actors that are bounded and exist in relationship to an environment. Parsons formulates a set of four functional imperatives (functions that must be fulfilled, or disorder will occur) for any given social system: adaptation (A) (the adaptation of a system to its environment, and the allocation of instruments for goal attainment), goal attainment (G) (the mobilization to attain socially-legitimated goals, or the needs of social units), integration (I) (integration, coordination, and harmonization of societal components), and pattern-maintenance (L) (maintenance or transformation of social values and transmission of these values to individuals). At the societal level, a subsystem performs each of these imperatives: the economy (A), polity (G), societal community (I), and fiduciary system (L). Subsystems do not refer to concrete social structure, but rather to "aspects" of social action. Parsons equates each subsystem with a corresponding generalized symbolic medium of communication, which functions as a means to acquiring the factors necessary to perform the subsystem's functional role.

subsystem's goal, and depend on the stable functioning of their subsystem of reference.<sup>24</sup>

Power is generated at the macro-level within the political subsystem, and the stable functioning of power depends on the stability of the political subsystem. The effectiveness of power is subject to the balance of inputs to the political subsystem from the three other subsystems<sup>25</sup>; the balance of these inputs will determine whether agents have the authority to implement policy but no resources to actually implement them, whether agents will be forced to rely on coercion, or whether power will function smoothly (Gould 2001a: 140). Power is thus subject to inflation and deflation based on the balance between the level of authority granted to power by its subjects and its actual capacity to achieve what it symbolizes.

Viewing power as a generalized medium treats power as generated at the structural level. The effectiveness of power is not based on factors that operate at

---

<sup>24</sup> The media are symbolic because they do not express utility, or value in use, but only value in exchange (Parsons 1963: 236). Power, therefore, does not function as a factor for effectiveness in attaining a goal (just as money is not a factor of production), but rather a means of acquiring control of these factors (Parsons 1963: 234). Power can thus be seen as enabling the functional process of goal attainment to occur.

<sup>25</sup> In Parsons' schema, interchanges occur between the four subsystems, with each subsystem receiving inputs from the other three subsystems and sending an output to these other subsystems. Gould views the scope of power as determined by the balance of the three inputs into the political subsystem: political support, the assumption of operative responsibility for the implementation of politically-constituted goals, and political authorization. The balance of these three inputs determines whether the political subsystem will produce a situation of power inflation (where the level of legitimate power of an office exceeds its ability to implement this power), power deflation (where the level of resources controlled by the state exceeds its legitimate authority), or equilibrium (in which power functions stably) (Gould 2001a: 140).

the level of interaction, but rather by factors that operate above individual interaction and structure this interaction. Power operates between individuals in particular interactions, but the personal attributes of the actors involved in interaction do not determine whether power will be successful. These personal attributes also cannot explain the existence of power. Rather, the action of alter (in trying to cause action in ego) will have different effects based on her authority. This authority is constituted outside of their single interaction, in social role relationships (Gould 2001a: 143). The success or failure of power, therefore, is due to the status of power within the system. Likewise, this success is not limited to a given interaction: if a system constitutes valid power, it will be generalizable and will operate in a wide variety of social relationships.<sup>26</sup>

Furthermore, treating power as a generalized medium has implications for the interplay of coercion and consensus in the operation of power. It was previously argued (section VIII) that legitimation is crucial in understanding the normative aspects of power. Legitimation is also an important aspect of power conceived of as a generalized medium. If power is legitimate, it constitutes binding obligations for individuals, obligations which are obeyed out of a sense of duty. Legitimation of power parallels the confidence in stability and mutual acceptability that makes money function within the economic subsystem (Parsons 1963: 238). Furthermore, the fact that power must be legitimate in order to constitute binding obligations for actors also contributes to generalization, as an operation of power may be legitimate for all of those who share a certain set of

---

<sup>26</sup> The importance of this was specified previously, in section IX.

social values.

Situational sanctions are not irrelevant to power's operation as a generalized medium. If ego does not conform in reciprocal action to a valid dictate, ego will suffer a negative situational sanction (see Gould 2001a: 135). However, the fact that power is generalized means that power is not simply the function of one particular sanctioning act (Parsons 1963: 237). In the situation, the possibility of negative sanctions comes from the institutionalization of power. When power becomes institutionalized, it has the capacity to constitute binding obligations whose bindingness, if the obligation is not fulfilled willingly, will be enforced by threat or imposition of negative sanctions (often carried out by specialized agencies within an organization or a state) (Parsons 1963: 237). A crucial point here is not that negative sanctions will result when ego does not follow alter's command; it is that, when power is institutionalized, negative sanctions are presumed.

Power, like other generalized media, also has a "security base." A security base is what actors fall back on when a medium is threatened, when trust in a medium breaks down. The security base of power is force. To Parsons, true power is legitimate, constituted in reference to shared values. Yet power can be preserved by force to sanction challenges to authority. Force, however, cannot replace legitimate power; over time, it undermines authority, causing the medium of power to be further threatened.

The fact that power is legitimate, institutionalized, and has a security base of force illuminates the interplay of coercion and consent in the operation of

power. The presumption of sanctions and the existence of force as the security base of power constitute the coercive aspects of power, while power's legitimation and institutionalization in authority highlight normative aspects of power.

Sanctions matter, but it is not primarily to structure interests so as to make the costs of malfeasance prohibitively high. Rather, it is because authority (which defines the legitimate limits within which one can use power) becomes institutionalized, and because challenges to authority are sanctioned in order to preserve power as a medium. Contra Williamson, normative aspects of power are crucial: power must be consistent with values to constitute binding obligations, unless one falls back on the security base of force. In the long run, however, force will undermine power, leading to the breakdown of order.

## **XII. Implications for Economics and Sociology**

Williamson's conception of power is crucial for his Transaction Cost Economics, as it explains why hierarchical organization within the firm may exist and why firms can reduce transaction costs. This conception of power, however, is unable to explain solutions to the principal-agent problem by showing how employees are motivated to work in a consummate rather than perfunctory manner. Likewise, Williamson's conception of power cannot explain why a valid demand may be obeyed by an agent even if it is not in the agent's interest to follow the demand. Williamson also cannot solve the problem of intelligibility, and cannot understand the importance of reduced complexity in enabling the successful operation of power.

It is noteworthy that Williamson is not attempting to resolve dilemmas that are unique to his Transaction Cost Economics. Rather, all imperfect-information economic models raise the problem of order, so governance and power within the firm must be understood within any imperfect-information model. Likewise, principal-agent problems are ubiquitous in imperfect-information models.

This thesis has argued that Williamson's inability to solve these problems is related to the nature of neoclassical economic theory. Williamson cannot solve the principal-agent problem because neoclassical theory assumes a single positively-stated normative orientation of instrumental rationality. Likewise, Williamson cannot understand the constitution of valid power or the solution to the problem of intelligibility because he cannot conceptualize social and cultural systems that constitute expectations and regulate action. Doing so would necessitate abandoning the neoclassical assumptions of empiricism and methodological individualism.

If the arguments of this thesis are accepted as correct, one must conclude that imperfect-information neoclassical models introduce anomalies that they cannot resolve. Resolving these anomalies requires transcending the nature of neoclassical theory, and instead articulating theory that is sociologically-grounded.

Viewing power as generalized medium allows one to understand normative consent, the constitution of valid power, and the intelligibility of power between two actors. This is because conceptualizing power as a generalized medium treats power as legitimate (regulated by social norms and values), generalized, institutionalized in authority, and subject to reduced complexity. Likewise,

understanding power in this way also enables one to understand that power is generated at the structural level and relies on an interplay of coercion and consent. But in order to understand power as a generalized medium, one must articulate a social theory in which power operates according to structural factors and in which action is regulated by autonomous social and cultural systems that are not reducible to individual actions. This has implications for social theory's understanding of the relationship between action and systems and of the micro-macro relationship.

Treating power as a generalized medium requires one to postulate shared cultural and social systems that mediate interaction. These systems generate social (right/wrong) and cultural (sense/nonsense) norms within a social system, enable shared meaning, constitute expectations, and reduce complexity. These systems thus enable power to be legitimate to and intelligible for actors.

Such systems cannot be conceptualized within a theory that is empiricist or methodologically individualist. A methodologically individualist theory cannot allow the introduction of relationships that are not reducible to the individual unit acts that make up a system. Therefore, a theory of this nature cannot conceptualize social systems, which introduce relationships that add information not derivable from individual actors or actions, and which are thus not reducible to aggregates of individual actions. Likewise, empiricist theory cannot conceptualize these systems, as they cannot be generalized from individual actions. In order to understand social systems, one must intentionally introduce constructs such as social and cultural norms, regardless of their ontological status. These constructs

allow one to understand power in light of larger structural logics and constraints, and thus understand its operation as a generalized medium of communication.

Likewise, the conception of power as a generalized medium has implications for the micro-macro debate in social theory. Social and cultural systems mediate practice, but they cannot be understood from observation of particular interactions at the micro level. These systems are partially constitutive of each action, but they cannot be observed, and they cannot be understood solely from generalizations from empirically-observable conduct. Understanding interaction thus requires locating this interaction within the structural constraints and social systems that regulate an interaction.

Similarly, power is generated at the macro-level within the political subsystem, and the effectiveness of power is subject to the balance of inputs to the political subsystem from the other subsystems. Theorists are right to argue that individuals hold power, and that power operations within interaction, but power cannot be understood by looking at individual actions, and the effectiveness of power is not based on factors that operate at the level of interaction. Rather, the constitution of power depends on structural factors: if a system constitutes valid power, it will be generalizable and will operate in a wide variety of social relationships within a system. The micro-dynamics of interaction remain important for understanding any given relationship, but they must be located in their social structural context to adequately explain the operation of power.

### **XIII. Conclusion**

Williamson views the primary function of firms as reducing transaction costs. Transaction costs arise due to imperfect-information. Williamson distinguishes between ex ante transaction costs (which occur before a contract is finalized) and ex post transaction costs (which occur after contracting).

Governance structures emerge within a firm in order to mediate disputes that occur between parties that are bilaterally dependent. Likewise, Williamson views bounded rationality and opportunism as arising due to imperfect-information, and the firm must therefore economize on these behavioral traits of individuals. Imperfect-information leads to a breakdown of the model of social order that exists in perfect-information models. As a result of his acknowledgment of imperfect-information, Williamson is therefore forced to consider governance and power.

Williamson articulates imperfect-information models within neoclassical economic theory. His theory is thus constrained by the logic of neoclassical theory. Parsons illuminates the fundamental assumptions of neoclassical theory as methodological individualism (atomism), a sole positively-stated normative orientation (of instrumental rationality), the treatment of ends as exogenous to the theory, and empiricism. To be consistent with neoclassical theory, Williamson must not conceive of social or cultural norms, social systems, or actors who conform to normative orientations besides that of instrumental rationality.

Williamson articulates a notion of power that is consistent with neoclassical theory. Governance is carried out within the firm through hierarchical authority.

Power is conceived of as fiat. Fiat relies on sanctions to align incentives within the firm and to make the costs of malfeasance for agents prohibitively high. Fiat is obeyed by agents out of self-interest. This notion of power does not allow Williamson to understand the operation of power within a firm. Power within the firm is valid due to its generalizability and its institutional counterpart of authority. Likewise, power within the firm relies on normative elements to motivate consummate cooperation, and requires reduced complexity in order to operate successfully.

Power conceived of as fiat cannot solve the principal-agent problem, which is endemic in imperfect-information models and which is crucial in understanding the extraction of rents from agents within competitive capitalism. This is because fiat does not allow one to understand the motivation of consummate cooperation through normative elements. Cooperating consummately entails conforming to a normative orientation besides that of instrumental rationality, which cannot be conceptualized consistently within neoclassical economics.

Fiat also does not allow one to understand why an agent will obey a valid order when it is not in his interest. A principal's power is valid when it is consistent with her authority, and when structural factors constitute power as generalizable. When power is generalizable, this is not due to characteristics of particular interactions, attributes of particular social relationships, or personal attributes of actors. Rather, because structural factors enable power to operate successfully within a system, it functions successfully in many social relationships and circumstances. Conceptualizing power as generalizable and regulated by

authority requires conceptualizing power as a generalized medium of communication.

Williamson also cannot understand the importance of reduced complexity for the successful operation of power. Williamson acknowledges the complexity of modern society through the notion of bounded rationality, but he does not understand the importance of reduced complexity in making the operation of power intelligible within particular situations. Williamson cannot understand reduced complexity because it is enabled by social systems that constitute shared meaning, intelligibility, and expectations for actors. Williamson cannot conceptualize these systems because his theory is both empiricist and methodologically individualist.

Conceptualizing power as a generalized medium also highlights the interplay of coercion and consent in the operation of power. Furthermore, it treats power as generated at the structural level, dependent upon the balance of inputs into the political subsystem. Power's success or failure is thus partially constituted by the status of power within the macro-social setting. The fact that power is generated at the structural level enables its generalizability, making it operative within many particular interactions.

Williamson's failure to understand the operation of power in the firm means that he cannot solve problems that are manifest within his theory. Crucially, however, it means he also cannot solve problems that are generated within all imperfect-information economic models. Williamson's failure to solve these problems results from the neoclassical nature of his theory. This suggests that, in

order to solve the problems inherent in imperfect-information economics, one must articulate models that transcend neoclassical theory, and instead rely on sociology.

The conception of power as a generalized medium has implications for social theory as well. To understand power as a generalized medium, one must understand action as regulated by social and cultural systems. These systems mediate interaction, but are not reducible to interaction, and thus cannot be understood merely from understanding particular interactions. Furthermore, treating power as a generalized medium requires viewing it as generated at the structural level. This means that, in order to understand the operation of power, one must articulate theory in which particular interactions are placed within their structural context. Understanding power in this way enables one to understand the normative aspects of power, the constitution of valid power that is obeyed by an agent regardless of his self-interest, and the importance of reduced complexity in constituting the success of power. Understanding power this way allows one to understand the operation of power within the firm, which Williamson cannot do.

## References

- Bowles, Samuel. 1985. "The Production Process in a Competitive Economy: Walrasian, Neo-Hobbesian, and Marxian Models" *The American Economic Review*, 75: 16-36.
- Coase, Ronald 1937. "The Nature of the Firm." *Economica*, 4:16: 386-405.
- Freeland, Robert F. 1996. "Theoretical Logic and Predictive Specificity: Reply to Shanley" *American Journal of Sociology*, 102: 2: 537-542.
- Freeland, Robert F. 2001 *The Struggle for Control of the Modern Corporation. Organizational Change at General Motors, 1924-1970*.  
Cambridge:Cambridge University Press.
- Freeland, Robert F. 2010. "The Social Nature of the Firm." Draft Manuscript: January 2010.
- Gould, Mark. 1981. "Parsons Versus Marx: An Earnest Warning..." *Sociological Inquiry*, 51: 197-218.
- Gould, Mark. 1990. "The Problem of Order in Perfect and Imperfect Information Theories." Draft Manuscript: December 1990.
- Gould, Mark. 1993. "Legitimation and Justification: The Logic of Moral and Contractual Solidarity in Weber and Durkheim." *Current Perspectives in Social Theory 13*. Edited by Ben Agger. Greenwich: JAI Press.
- Gould, Mark. 2000. "Class, Structured Inequality and Power in a Theory of Competitive Markets." Draft Manuscript: January 2000.
- Gould, Mark 2001a. "The Generalized Media of Communication and the Logic of Cultural Intelligibility: Macro and Micro Analyses in Luhmann,

- Habermas, and Parsons." In *Parsons' The Structure of Social Action and Contemporary Debates*. Edited by Gabriele Pollini and Guiseppe Sciortino. Milan: FrancoAngeli.
- Gould, Mark. 2001b. "Social Norms: A Critique of Law and Economics Formulations and a Guide to their Correct Conceptualization." Draft Manuscript: July 2001.
- Gould, Mark. 2009. "Culture, Personality, and Emotion in George Herbert Mead: A Critique of Empiricism in Cultural Sociology." *Sociological Theory* 27: 4: 435 – 448.
- Harriss, et al. 1997. "Introduction: Development and the Significance of NIE." In *New Institutional Economics and Third World Development*. Edited by John Harris, Jane Hunter, and Colin Lewiss. New York:Routledge.
- Koopmans, Tjalling. 1957. *Three Essays on the State of Economic Science*. New York: McGraw-Hill.
- Luhmann, Niklas. 1976. "Generalized Media and the Problem of Contingency." In *Explorations in General Theory in Social Science. Vol II*. Edited by Jan Loubser, Rainer C. Baum, Andrew Effrat, and Victor Meyer Lidz. New York: Free Press.
- Lukes, Steven. 1968 "Methodological Individualism Reconsidered." *The British Journal of Sociology*, 19: 2: 119-129
- Parsons, Talcott. [1937] 1968. *The Structure of Social Action*. Free Press. New York.
- Parsons, Talcott. 1963. "On the Concept of Political Power." *Proceedings of the*

*American Philosophical Society*, 107: 3: 232-262.

Simon, Herbert. 1955. "A Behavioral Model of Rational Choice." *Quarterly Journal of Economics*. 69: 99-118.

Stiglitz, Joseph. 1987. "Principals and Agents" In *The New Palgrave: A Dictionary of Economics*. Edited by John Eatwell, Milgate M, Newman P. London: Macmillan.

Stiglitz, Joseph. 1991. "The Invisible Hand and Modern Welfare Economics." National Bureau of Economic Research Working Paper No. 3641.

Williamson, Oliver. 1975. *Markets and Hierarchies: Analysis and Antitrust Implications*. New York: Free Press.

Williamson, Oliver. 1985. *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*. New York: Free Press.

Williamson, Oliver. 1996. *The Mechanisms of Governance*. Oxford University Press