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## **ABSTRACT**

### **Consistency in Organization**

Recent thinking has emphasized the importance of consistency in a firm's compensation policy. By starting from Williamson's ideas about idiosyncratic exchange, this view can be supplied with some theoretical foundation. At the same time, the consistency view can be applied to a number of organizational issues. It sheds new light on some Williamsonian themes, like the boundaries of the firm or the attenuation of incentives within firms.

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# Consistency in Organization

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Internal organization assumes and effectively  
discharges certain *quasijudical functions*.

Oliver Williamson (1975, 30)

Oliver Williamson has followed Alfred Marshall in emphasizing that organization is an important factor of production. Inspired by Coase he went beyond Marshall, however, and insisted on the importance of internal organization within firms as distinct from market processes.

In the following I shall point out that internal organization relies heavily on psychological consistency requirements. This perspective has been emphasized in modern compensation theory, but has not, to my knowledge, been extended to organization theory. I shall develop this idea, starting from Williamson's discussion of idiosyncratic exchange. The view will shed new light on several Williamsonian topics, like "Williamson's puzzle," or the attenuation of incentives within firms.

## *Small Numbers*

Co-ordination in a well-matched team is typically characterized by specialization of the team members and the absence of relevant competition for each of these specialists. In such a setting, market coordination seems less useful. It would invite strategic behavior, and would necessitate protective measures to shield against such tactics. Each team member could threaten to block the gains from co-operation unless paid a larger share of the surplus. The potential conflicts and concomitant safeguards involve sunk costs, to be counted as transaction costs. Such transaction costs are quite different from – and more important than –the costs “of discovering what the relevant prices are,” as there are many ways of splitting any surplus, and there is no clear-cut way for “discovering” any set of relevant prices.<sup>1</sup> The costs for settling disputes may be considerable in any small number setting unless organizational features and firm-specific norms are implemented that reduce the costs of haggling and haggle-

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<sup>1</sup> There are game-theoretic solutions to such issues, but these solutions leave the problem basically unsettled. The „folk theorem” would state that any distribution could be sustained in an infinite co-operative setting, whereas the core of such a splitting game will always be empty, implying that any successful co-operation would require a reduction of possibilities for bargaining. Both lines of thought would suggest the formation of a normative system to overcome those bargaining problems, as has been suggested by Williamson (1975, 30) early on. The quotation is taken from Coase (1937, 88).

As a consequence, co-ordination within firms relies on non-market organization. Prices are rarely used within firms to coordinate the division of labor. At best, payments serve as incentives, but even then they do not perform any market clearing function.<sup>2</sup>

### *Markets, Hierarchies, and Custom*

In the following I shall follow Williamson in assuming that behavior within an organization is motivated and controlled differently from what occurs in the market, and I shall emphasize the importance of psychological *consistency* for internal organization. But before doing that, let me just discuss briefly a position which denies the theoretical usefulness of distinguishing between different modes of control in markets and firms. All behavior, it is said, is governed by incentives, and a firm is to be interpreted as a specialized market, rather than a categorically different organizational form.<sup>3</sup> As Alchian & Demsetz (1972, 777) explain: “Telling an employee to type this letter rather than to file that document is like my telling a grocer to sell me this brand of tuna rather than that brand of bread.” It is maintained that there is no useful analytical distinction to be drawn between command and free choice, even if people in real life happen to make such a distinction. Furthermore, it is asserted that people don’t change their nature when entering a firm. Whether inside or outside a firm,

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<sup>2</sup> Schlicht (1998, 229-31)

<sup>3</sup> Holmstrom (1982)

their behavior is controlled by the same behavioral tendencies. If they behave differently within the firm or in the marketplace, this is to be attributed to the different sets of incentives provided. Human behavior is always to be analyzed in terms of (given) preferences and constraints. This view is what I would like to call the *principal-agent view* of the firm, and which I am going to criticize.

I accept the thesis that people do not change their nature when entering a firm, but I take them as behaving norm-guided within firms to much larger extend than in the market.<sup>4</sup> Firms use normative structures for purposes of internal co-ordination, and this enables them to outperform markets.

Many writers have rejected the principal-agent view of the firm, often implicitly. Ronald Coase (1937, 54) has been outspoken, however. He draws a distinction between a principal-agent relationship and a master-servant relationship and cites Batt (1929, 6) to the effect “that which distinguishes an agent from a servant is not the absence or presence of a fixed wage, or the payment only of commission on business done, but rather the freedom with which an agent may carry out his employment.” From this he concludes that the employment contract differs from a principal-agent relationship. It is a master-servant relationship, involving “control” and “direction.” I

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<sup>4</sup> The view advanced here builds in part on Isaac, Mathieu & Zajac (1991) who emphasize that institutions (and therefore firms) frame fairness perceptions which entail strong behavioral effects. See also Schlicht (1998) for further discussion.

take it that “control” and “direction” refer to normative control of behavior.

Herbert Simon (1951) has re-iterated the point that the employment contract establishes an authority relation, and Oliver Williamson followed the lead. He drew a distinction between markets and hierarchies and pointed out that the market will select that mode of co-ordination which minimizes overall production costs – a view which I am going to accept in this paper.

The dichotomy between markets and hierarchies is to be complemented by taking account of duty and custom. Leibenstein (1960) has highlighted this when talking about the firm as a cluster of jobs. Each job is associated with duties and responsibilities, entitlements and obligations. The organization of work is achieved, in his view, by the way in which appropriate norms, attached to jobs, govern behavior.

A closely related facet has been invoked by Nelson & Winter (1982). They start, like Williamson, with the observation that the market does not work well in settings of idiosyncratic exchange. There may initially be a quarrel among the team members for obtaining larger shares of the surplus, at the expense of the others, but eventually a ‘truce’ will emerge which is maintained and defended by everybody because “each member strives to protect his interests by standing prepared to deliver a firm rebuff not only to actions by others that clearly threaten his interests, but also to actions that might be quite innocuous were it not for their possible interpretation as probes

as probes of his alertness or determination to defend his rights under a truce.<sup>5</sup> Because of this, everybody defends the firm-specific norms and customs even in cases where he is not personally affected.

### *Entitlements, Obligations, and Organizational Equilibrium*

The above discussion can be developed as follows. As a first step, an organization could be interpreted as a set of conventions. But why do people obey these conventions? One answer would be to think of a set of self-sustaining conventions which everybody obeys because it is in everybody's interest to follow these conventions provided everybody else does the same.<sup>6</sup> This view may be adequate for dealing with pure co-ordination problems, like driving on the right-hand side of the road if everybody else does the same. It is the easy case and does not involve any problem. Such a system would work automatically, and there would be no further need for governance.

The small-number problems arising in teams give rise, however, to co-ordination problems of a different kind. They require a splitting of the surplus accruing from co-operation. They involve potential conflict. An organization has to solve these problems. A convention to split a surplus according to a certain rule cannot easily be self-

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<sup>5</sup> Nelson & Winter (1982, 111)

<sup>6</sup> Kreps (1990).

enforcing because some team members may be first movers. They could try to increase their share in the surplus, knowing that it would be rational for the others to accommodate with this step. The threat to cease co-operating would be irrational for the later movers. In other words, the idea of viewing an organization as a set of conventions which are maintained out of self-interest of the participants seems very problematic.

Yet experimental evidence from ultimatum games suggests that people actually do behave irrationally if they feel cheated. They try to defend what they perceive their entitlements, even if this involves substantial costs to them. Effective norms are defended in this manner. Further, effective norms shape compliance. They induce entitlements and obligations.

Entitlements are rights, as perceived by the individuals. They are, however, not abstract legal rights. Rather, they denote the subjectively perceived rights that go along with a motivational disposition to defend them. Obligations are the counterparts of entitlements. They refer to claims that are subjectively accepted, and go along with a motivational disposition to respect these claims.<sup>7</sup> Both entitlements and obligations are brought about by a set of established rules. They derive from regularities perceived in the past and in the group and bring about norms and customs.

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<sup>7</sup> Schlicht (1998, 24)

Given a set of norms and customs within a firm, and a preparedness of the members to defend the entailed entitlements and honor to the implied obligations, we may view behavior in analogy to the simple co-ordination problem. Conforming to firm-specific norms may be individually rational if everybody expects everybody else to defend these conventions. However the behavioral impact of such rules can not be reduced to incentives. Rather the rules *generate* incentives because they elicit entitlements and obligations and induce behaviors which will mutually be taken into account. The resulting organizational equilibrium, as governed by entitlements and obligations, may be viewed as a “truce,” as Nelson & Winter have proposed. It seems to me, however, that this parlance wrongly invokes the idea that organizational equilibrium is build on latent conflict.<sup>8</sup> It suggests that mutual entitlements and obligations are only obeyed because they are backed up by threats. This is, I think, a misleading way of looking at organizational equilibrium because truce is usually short-lived, both within organizations and between nations, and prone to transform either into peace or into war after a while. It seems thus more appropriate to describe organizational equilibrium as “peace,” where conflicts have settled down and a possible initial truce has engendered a mutually accepted arrangement.

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<sup>8</sup> This holds true for the radical theory of the firm as well, see Marglin (1974). Oliver Williamson (1980) has commented on that.

An analogy can be found in the way in which pecking orders and territoriality are established among animals. Consider the establishment of a pecking order among hens. There may be initial fights, but after a while a pecking order is established and only rarely put into question. The hens generalize apparently from the outcome of one fight to the outcome of the next and avoid unnecessary fighting. Or consider territoriality. There may be an initial fight, and the stronger individual might occupy a certain territory. He will defend his territory and will chase away potential intruders, but real fights will be rare once the territorial boundaries are established. The “ownership effect” will lead to the phenomenon that the owner of a territory will usually win any fight – even against more powerful intruders.<sup>9</sup> He has obtained, so to speak, an entitlement in the territory, which induces him to defend it more fiercely than he would fight as an intruder. Biologists refer to this as “moralistic aggression.”<sup>10</sup> This tendency is strengthened among social animals by the way in which the members of a group maintain or change alliances, and a similar social amplification must be expected within any social organization.<sup>11</sup>

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<sup>9</sup> See the discussion and references in Schlicht (1998, 111-5, 172-5).

<sup>10</sup> Trivers (1971)

<sup>11</sup> See De Waal (1983) on the importance of forming alliances in groups of chimpanzees.

## *Consistency*

Yet a firm's internal organization is not fully reducible to routines, norms, and firm-specific customs. The element of command – emphasized rightly by Coase and Williamson – is of great importance as well. A firm is neither reducible to custom and norms, nor to hierarchy and command. All elements interact strongly, and monetary incentives play a role as well. In the remaining part of the paper I shall comment on the nature of this interaction.<sup>12</sup>

My main thesis is that the actual working of an organization depends strongly on aspects of psychological consistency. The term refers to an overall match between various organizational features, principles, and tacit understandings. It plays an important part in modern compensation theory, but has much broader significance with regard to organizational matters.<sup>13</sup> It bundles command, incentives, and custom together and implies a strong interaction between command, firm-specific norms and incentives.

Consider the starting point of Coase's (1937, 35) discussion of the employment relationship. He notes correctly: "If a workman moves from department Y to department X, he does not go because of a change in relative prices, but because he is ordered to do so." The foreman is well advised not to issue arbitrary orders, even if they

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<sup>12</sup> See also Schlicht (1998, 227-33).

<sup>13</sup> See Milkovich & Newman (1999) for an exposition.

remain within the limits set by the employment contract. He must be entitled to order the workman to move, and it will be his duty not to issue inappropriate orders. The authority of the foreman and the obedience of the worker will be hurt if the foreman gives incoherent orders. The consistency of his behavior is tied up with his perceived competence which is in turn an important element in eliciting authority. He must, for instance, issue similar orders under similar circumstances.

If the worker in department Y is idle each afternoon, but always helpful in department X, the foreman will be bound to send the workman each afternoon to department X. After a while, it will not even be necessary to give the order. The workman will know and go by himself, and he might fear reprisal if he does not help in department X in the afternoon even if not explicitly ordered to do so. He will begin to see it as his duty.

Authority is in this way tied up with job roles and responsibilities. Every order and each decision creates a precedent. It moulds entitlements and obligations and strengthens or weakens authority. As a consequence, *every order and each decision must be seen as both directing resources and shaping firm-specific customs*. While a command given into a computer may be issued without affecting the basic response of the computer to other commands, this does not hold true within a firm. Within a firm, every command creates the expectation that similar future situations will be handled in a similar manner, and weakens behaviors which appear inconsistent with that com-

mand. If the workman is told to stay in department  $Y$  in the afternoon, he will interpret this as meaning that he is expected to stay in department  $Y$  in the near future, even if not explicitly ordered to do so.

### *Williamson's Puzzle*

Oliver Williamson has emphasized the “chronic puzzle” about the limits of the firm.<sup>14</sup> Two firms  $A$  and  $B$  can do together whatever they could do separately - *and more*. There is thus, no inefficiency to be expected if firms  $A$  and  $B$  integrate; we could rather expect some efficiency gains achievable by selective intervention. The puzzle is that we do not find firms getting larger and larger. Sometimes it seems successful to downsize or split. It must, therefore, sometimes be cheaper to organize the set of activities of  $A$  and  $B$  separately rather than jointly. As Williamson (1985, 138) put it, “the integrated firm *cannot* wholly replicate outside procurement in ‘business as usual’ respects. Instead, there are *unavoidable side effects*.”

The aspect of consistency contributes to understanding some of these unavoidable side effects: While firms  $A$  and  $B$  can each develop specialized set of customs which are fine-tuned to its particular needs, firm  $AB$  cannot handle similar things differently in its departments  $A$  and  $B$ . This would hurt consistency. It may still be possible to differentiate between departments, but in many cases (such

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<sup>14</sup> Williamson (1985, Ch. 6) for a recent statement and discussion.

as compensation policies) this is very difficult and costly to sustain. It is a frequent occurrence that certain activities are outsourced for the simple reason of making it possible to pay the outsourced workers differently from what they would receive as regular employees. Janitors are outsourced in order to save on wage payments, computer specialists are outsourced in order to make it possible to pay them more.<sup>15</sup> The consistency requirement works as a constraint, and disintegration is a means of overcoming this constraint. Conversely, integration induces the consistency constraint, along with the side effects mentioned by Williamson.

### *The Perceptual Limits of the Firm*

I have interpreted the firm as an organizational unit which relies on norms and customs for coordination, rather than on market incentives. In order that such a system works, the boundaries of the firm must be recognizable for its members because they must know whether the firm-specific norms are valid or not. This implies a *perceptual* theory of the firm: The firm is what the firm members perceive as a firm. This perception frames and thereby triggers their behavior. Or, in the terminology of Isaac, Mathieu & Zajac (1991), firms and other institutions provide institutional frames which activate certain types of behavior rather than others.

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<sup>15</sup> See Mücke (2002) for some illustration.

From this point of view, the boundaries of the firm relate to perceptual boundaries: A firm is what people identify as a firm. In this sense the notion of the firm is “realistic.” It “closely approximates the firm as it is considered in the real world.” (Coase 1937, 54). The relevance of the perceptual notion of the firm derives from the fact that people form these perceptions and base their actions thereon.

### *Low-Powered Incentives*

Williamson (1985, 140) has contrasted the prevalence of low-powered incentives within firms with the high-powered incentives prevalent in markets. While no a-priori reason can be given for firms not to deviate from markets in the other direction and offer super-powered incentives, several reasons for the attenuation of incentives within firms have been advanced. The consistency view adds some further arguments for attenuation.

According to the consistency view, firms rely on norm-guided behavior. The set of entitlements and obligations which regulates cooperation cannot be mixed easily with incentives, because the provision of incentives changes entitlements and obligations. Once a worker receives performance pay, this removes his obligation to work fast on order. The presence of performance pay creates the entitlement on the part of the worker to choose his own pace of work,

and weakens or removes his obligation to work as being told.<sup>16</sup> The theoretical argument relates to the theory of self-attribution.<sup>17</sup> The argument suggests, for instance, that incentives may reduce cooperation, and this has been confirmed experimentally.<sup>18</sup> As firms must rely on norm-guided co-operation, wage compression and an attenuation of incentives is to be expected.

### *Change*

The emphasis on routines in the evolutionary theory of the firm hides the fact that the routines are tied together by consistency requirements. Similar cases must be treated similarly. Otherwise, entitlements and obligations will not be coordinated smoothly. Further, the evolutionary view tends to conceive change as brought about by blind trial and error. This is misleading. Coase (1978, 244) has pointed this out nicely: "The firm, the market, the legal system are all

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<sup>16</sup> This thought may help to understand the difference between incentives and command and may contribute to resolve Clark's (1984) puzzle that incentives have been replaced by authority in many capital-intensive factories in the late nineteenth century. Clark sees his findings as vindicating the view of a number of radical economists who have argued that discipline has been used to speed up work beyond what the workers themselves would have chosen, and that firms had the latitude to do that in imperfect labor markets. The counter-argument from the principal-agent point of view would be that firms should have used optimal incentives in imperfect labor markets as well, which would leave the puzzle unsolved. Only if authority works differently from incentives, these findings make sense.

<sup>17</sup> See Schlicht (1998, Ch. 9) for an introduction.

<sup>18</sup> Falk & Fehr (1998), Fehr & Gächter (2002).

social institutions and are the result of purposeful human activity. .... natural selection has an IQ of zero. The IQ of businessmen and politicians may not be high, but it is not zero. Natural selection produces its results by trial and error over long periods of time. Economic systems, such as the structure of an industry, may be transformed within a single generation.” Economic change is neither blind nor fully rational.

It seems to me that this “intermediate” character of economic change – neither blind nor prescient – can be analyzed fruitfully from a consistency perspective. Firms respond to changing conditions by changing or enlarging their repertoire of action, and they seek improvements by building on their competencies. All this must be done in a piecemeal way, and using the means at hand. The firm is not reshaped optimally in response to each and every change in the environment; rather the existing routines are kept or modified, and new routines are developed as variations of the old in order to cope with changing conditions or to introduce improvements.<sup>19</sup> Organizational change is channeled by consistency requirements, just as biological change is channeled by physical and genetic conditions.<sup>20</sup> The exist-

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<sup>19</sup> Alchian (1984, 47) takes the principal-agent view to the extreme and concludes: “It is *not* silly to consider the entry of a new stockholder to be the creation of a new firm.” This neglects the costs of setting up a system of rules which co-ordinate interaction. Once this is taken into account, any change (like the entry of a new stockholder) must be integrated into the existing set of routines, customs, and firm-specific norms.

<sup>20</sup> See Schlicht (1997).

ing system of routines in a firm forms the stock of “organizational capital” and serves as the starting-point for every kind of change.<sup>21</sup> Strategic choices largely reflect the impact of alternative sets of firm-specific customs with regard to change. It would not be “rational” to start anew at each point in time; rather it is reasonable to respond to new exigencies, or find new solutions, by starting from the prevailing set of routines, and by extending and changing the previous routines in a consistent way.

### *Concluding Remarks*

The consistency view of organizations seems to highlight some important aspects of how organizations function. It requires transcending the standard assumptions on human behavior used in economics, epitomized by the principal-agent view. The above discussion was intended to sketch the view and to relate it to some Williamsonian topics. What has been left out here is a more systematic discussion of the underlying model of man. Such a discussion may be found in Schlicht (1998).

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