Part I

Conceptual and historical foundations
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ECONOMIC GOVERNANCE AND THE ANALYSIS OF STRUCTURAL CHANGE IN THE AMERICAN ECONOMY

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The institutions that govern economic activity in the United States have changed dramatically since the late nineteenth century and continue to do so as politicians, business leaders, and others scramble to cope with sluggish productivity, rapid technological change, volatile markets, increasing international competition, trade deficits, and a host of other problems that plague the economy. This book explains how and why these transformations in governance, the political and economic processes that coordinate activity among economic actors, occurred in different industries and industrial sectors. Although we seek to understand the dynamics of the U.S. economy, we also address questions about the governance of modern capitalist economies in general by focusing on the emergence and rearrangement of several common institutional forms of governance, or governance mechanisms, which include markets, bureaucratic hierarchies, associations, and informal networks. We add further breadth to the analysis by discussing the unique role that the state plays in the governance transformation process.¹

Of course, social scientists have adopted a wide-ranging set of theoretical positions to explain transformations in governance. Those following Adam Smith, John Stuart Mill, and the neoclassical economic tradition adopted

¹ As a result, this study provides a substantial empirical and theoretical complement to the vast, normatively oriented literature, which suggests that a variety of institutional changes are necessary to solve the U.S. economy’s recent problems. Much of this literature fails to appreciate not only the conditions under which various institutional alternatives are likely to emerge, but also that some institutional arrangements may be better suited than others to rectify different types of economic problems in different types of industries and sectors— an issue to which we give serious attention. For a sampling of this literature, see
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a utilitarian view and suggested that governance transformations occur when rationally calculating economic actors see that alternative forms of governance offer more profitable ways of doing business than those already in place (e.g., Williamson 1975, 1985, 1986). Others followed an organizational approach, reminiscent of Max Weber, and suggested that a broader set of motivations and organizational goals, such as a sense of community and reciprocity, also influence governance transformations (e.g., Granovetter 1985). Borrowing from the evolutionary traditions of Auguste Comte, Emile Durkheim, and Herbert Spencer, some observers maintained that more efficient organizational forms emerged to govern economic activity through a natural selection process, where the institutional forms best suited to prevailing environmental conditions are most likely to survive (e.g., Hannan and Freeman 1977; Nelson and Winter 1982). A fourth group, influenced by Karl Marx as well as Weber, developed a political economy approach that argued that struggles over power transformed governance (e.g., Schmitter and Lehmbuch 1979; Berger 1981; Porrow 1981).

This book is located at the intersection of these debates and strives to move them forward by offering a new approach to the analysis of governance transformations. It does this by pursuing several more specific theoretical objectives. First, it offers a new conceptual scheme that we hope will build bridges in a fragmented and scattered literature about economic governance. Second, it provides an empirical analysis of the causal models that other scholars have offered previously to explain or predict the conditions under which different forms of governance emerge. Third, because we find that many of these models, especially those that are based on explanations about economic efficiency, offer causal predictions that are not always supported by our data, we argue that the search for universal generalizations with which to predict governance transformations is futile and that there are no universal or immutable logics in the governance of capitalist societies. Instead, we embrace the broadly neo-Weberian position that one can only hope to find and explain historically specific patterns and sequences of transformation. Fourth, we theorize the process by which governance transformations occur – something that has not been done in most of the literatures that are dedicated to predicting specific types of transformations with causal models. Through a critical synthesis of these models, we argue that transformations occur as actors select new sets of governance mechanisms in ways that are constrained economically, politically, institutionally, technologically, and culturally in complex ways, and that the choices actors make bear heavily on future constraints and choices.

Analyzing structural change

Fifth, whereas most theoretical traditions neglect or understate the importance of the state as it constitutes the institutional arrangement of economic sectors, we theorize the role of state actors and especially state structures in shaping the selection of new governance regimes. Finally, we believe that this book contributes to the debate about the origins and causes of the productivity problems of the contemporary U.S. economy and the prospects for solving them. Our findings are particularly relevant to those who argue that productivity problems stem from organizational weaknesses in the U.S. production system because our analysis illuminates how these organizational problems developed in the first place.

We begin to address these issues in this chapter by clarifying our assumptions about the nature of governance, particularly insofar as they differ from the prevailing neoclassical economic paradigm. We argue that it is not just the search for economic efficiency, but also struggles over strategic control and power within economic exchange that provide the principal dynamic for governance transformations. Furthermore, drawing on the idea that governance is largely a matter of social control, we provide a typology of governance mechanisms that are commonly found in advanced capitalist economies. We also discuss briefly the state’s role in economic governance and why we consider it to be significantly different than the governance mechanisms we identify and, therefore, worthy of separate consideration. Finally, we offer a brief description of the governance transformation process for heuristic purposes. As such, this chapter provides a conceptual framework within which to analyze specific governance transformations that have occurred in the U.S. economy.  

THE NATURE OF GOVERNANCE

Unit of analysis

Governance is a phenomenon that is best conceptualized at the level of industries and industrial sectors. In contrast to neoclassical models that focus on the behavior of discrete market actors, we view each industry as

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2 This chapter is signed by the editors but is in a profound sense a collaborative product of a dialogue with all the authors in this volume and with several other participants in the Workshop on the Governance of the American Economy, which met regularly in Madison at the University of Wisconsin from the Fall of 1984 to the Summer of 1986. Many of these individuals also provided detailed critiques of earlier drafts of this chapter. Memoranda prepared and presented to the workshop by Ken Bickers and Marc Schneiberg proved particularly useful in advancing the conceptual and theoretical work. In addition, special thanks for their comments go to Michael Allen, Howard Aldrich, William Coleman, Gerald Hage, Gerhard Lehmrbruch, Marc Elisher, Philippe Schmitter, Marc Schneiberg, and Graham Wilson.
a matrix of interdependent social exchange relationships, or transactions, that must occur among organizations, either individually or collectively, in order for them to develop, produce, and market goods or services. Thus, governance is an extremely complex phenomenon. Transactions occur within a sector among a wide range of interdependent actors, including producers and suppliers of raw materials, researchers, manufacturers, distributors, and many others, who must routinely solve various problems, such as raising capital, setting wages, standardizing products, and establishing prices in order for economic activity to continue. Complicating matters further, there are several types of governance mechanisms that groups of actors may adopt to help them solve these problems. If we tried to specify all the actors, all their problems, and all the governance mechanisms they employed, analyzing governance in a sector would become an overwhelming task. One need only recognize that a matrix representing the relationships among all possible combinations of actors and problem areas would involve scores of cells. However, because our major concern in this book is with understanding the transformations in governance mechanisms historically, we have simplified matters by focusing only on governance mechanisms when they fail, encounter serious legitimacy problems, and when actors search for and devise alternative means of governing their relationships. By narrowing our attention to these moments when new arrangements of governance mechanisms emerge, the analysis becomes much more manageable.

**Interests and rationality**

Rather than assuming that economic behavior is always self-interested or rational in the sense that people select the most efficient course of action in order to maximize their utilities or wealth, we recognize that people may also be content merely to satisfy their needs. Furthermore, they will do so not just within the limits of bounded rationality, where actors make intendedly rational choices based only on the incomplete information available to them (e.g., Simon 1961), but also within those of contingent rationality, where the political, economic, ideological, and other institutional conditions prevalent at the moment constrain the range of choices available in the first place. Indeed, a variety of values or ideologies, including but not limited to opportunism and avariciousness, motivates economic activity and is conditioned by all of these contingencies, not just markets.³

³ For further discussion of contingent rationality, see Peter Hall (1986: 34–7) who, for example, argues that we cannot derive the rationality of economic actors from the market a priori because the institutional structure of markets and, therefore, market rationality is historically specific.
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Significance of nonmarket forms of governance

Our approach to the study of governance is also different from neoclassical economics because, as noted earlier, rather than focusing almost exclusively on markets, we are concerned with shifts to alternative forms of governance. We agree that autonomous organizational actors often coordinate their transactions through markets, where hard contracts specify the terms of exchange, such as price, quality, wages, and conditions of work. However, market contracting does not always ensure that the interests of all parties to a transaction are sufficiently served. Market uncertainties may be so severe that actors believe that they do not have enough information with which to act. Economic risks may be so difficult to assess that parties to exchange find it very hard to develop acceptable contracts. In short, markets may fail to provide for the kinds of transactions that actors desire, in part because economic reality often differs from neoclassical assumptions about pure competition, uninhibited entry and exit from the market, the availability of accurate information, and the like.

Under these circumstances, actors seek alternative forms of governance rather than permitting exchange relationships to fracture under what Oliver Williamson (1985: 3) called the hammer of unassisted market contracting. Collective action, for instance, a common phenomenon in industries despite the presence of Mancur Olson’s (1965) free-rider problem, emerged in the U.S. textile industry during the early 1900s in an effort to stabilize production levels and prices when manufacturers, relying on markets to coordinate their activities, failed to do so (Galambos 1966). Indeed, alternative forms of governance warrant attention in their own right because it is their presence, as common elements of economic life, that undermines many of the neoclassical assumptions about how markets work in the first place. The presence of huge corporate bureaucracies, which limit some actors’ access to markets and market information, is a common example (e.g., Galbraith 1967).

Power and equilibrium

We view production and exchange as systems of power, manifested through market and nonmarket governance mechanisms, an assumption that implies that economic activity does not necessarily tend toward equilibrium, equal exchange, or efficiency, but often involves institutionally determined, asymmetrical, and shifting exchange advantages. Hence, the institutional

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4 See Alt and Chrystal (1983: 175–83) for a review of the vast literature on market failure. It is interesting that although even the most conservative neoclassical economists acknowledge that the problems of market failure may lead to alternative forms of economic governance, they persist in paying only scant attention to these alternatives (e.g., Friedman 1962: Chap. 2).
distribution of power, not just prices, regulates economic exchange. Furthermore, although governance mechanisms and their arrangement evolve over time, there is nothing natural or inherent about that evolution. Instead, the history of governance transformations is guided by actors searching in cooperative and conflictive ways for what they believe are the best available options. We will argue that governance transformations are likely to occur when actors, who are unable to manage problems of interdependence to their satisfaction within the existing arrangement of governance mechanisms, search for institutional alternatives in contingently rational ways. In sum, our framework forces a basic shift in the analysis of economic exchange processes, particularly away from the neoclassical economic tradition that emphasizes rational economic man, commodities, prices, and perfect or imperfect markets to one that focuses on organizational actors with complex motivations, their interdependencies, and the qualitatively different types of transactions in which they engage – phenomena that vary historically within and across industries.5


Despite the vast literature on nonmarket forms of governance, discussed in what follows, there is often a failure to theorize how economic performance and governance processes cause different governance mechanisms to develop, on the one hand, and how the relative influence of different governance mechanisms is determined historically, on the other. For example, it is not enough to assert that all economic action is embedded in networks of informal social relations (e.g., Granovetter 1985) and that such networks, rather than the largely fictitious pure market, account for whatever observable order exists in an industry. To do so neglects the important tasks of identifying different degrees and qualities of embeddedness, specifying different kinds of networks, explaining how they developed, and determining how effectively they moderate different types of exchanges. Similarly, it is not enough to know how private organizations or the state makes decisions, that work and exchange relations are hierarchically controlled, or that capitalists monitor each other’s behavior through networks. We must also determine the origins and performance capacities of these different forms of governance.

For these reasons, we have been particularly interested in the recent literature on industrial economics, especially those variants that recognize that institutions play important, but often neglected, roles in shaping eco-

5 Our assumptions about the functioning of economic systems are similar to those of institutional rather than neoclassical economics. For an elaboration and comparison of institutionalist and neoclassical assumptions, see Stevenson (1987).
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economic performance within and between industries, sectors, and entire political–economic systems. Specifically, we are drawn to the work of Williamson (1975, 1985, 1986) and Douglass North (1981), who have used transaction-cost theory to develop models that seek to explain transformations in the institutional coordination of economic exchange. This may seem ironic because the transaction-cost approach is steeped in neoclassical assumptions, many of which we do not accept. However, for reasons that follow, this approach provides useful starting points for addressing the issues with which we are concerned.

Williamson argued that corporate hierarchies emerge to coordinate economic transactions when the costs of conducting such exchanges through the market become prohibitive. That is, when actors feel that the financial costs of engaging in and monitoring transactions become too uncertain, because transaction-specific investments are great and it is difficult within the limits of bounded rationality to control an exchange partner’s opportunism, they will develop hierarchically integrated, corporate organizations to supplant the market as the primary forum for exchange. Despite its problems (see note 6 before), transaction-cost theory offers the important insight that when actors can no longer efficiently consummate transactions through either the market or, we would add, another form of governance, at least to their satisfaction, they will try to develop other more efficient governance mechanisms. Furthermore, it suggests the need for a general theory of governance transformation that specifies a dynamic for change, accepts that there are different forms of governance, and recognizes that each may play an important role in coordinating economic activity.

Yet to argue that transaction-cost inefficiencies are the sole cause of governance transformations is an excessively narrow view. First, when institutional arrangements undermine the efficient allocation of resources and information for any reason, not just because transaction costs are high, actors may begin to look for alternative arrangements that will improve efficiency. For example, because labor is too expensive, managers in an


7 Williamson and other transaction-cost theorists generally assume that governance transformations begin with market failures. Although this is one possibility, we will argue for a more general theory of governance failure where transformations may also occur in response to the inability of nonmarket governance mechanisms to satisfactorily coordinate economic activity. To do otherwise requires that we accept the neoclassical assumption that markets are the ever-present starting point for the development of alternative governance arrangements, an assumption that has been rejected based on the historical record (e.g., Polanyi 1944; Lazonick 1986), but which has permeated transaction-cost theory (e.g., Williamson 1986: 143). See Robbins (1987) for an elaboration on the empirical and theoretical problems this presents.

8 Efficiency in this sense is a function of a firm, industry, or economy’s input–output ratio,
industry may switch from a union-based, hierarchical system of obtaining labor, where the (transaction) costs of monitoring labor are low, to a market-based system with higher monitoring costs in the belief that a net saving in resources will be achieved through the realization of lower wages. Second, transaction-cost theory and orthodox economics in general ignore the strategic causes of governance transformations. That is, in addition to simply acquiring the resources and information they need at the lowest possible cost, actors may also be concerned with controlling the terms of exchange under which they make these acquisitions – a strategic concern insofar as power, rather than just the ability to procure resources, is at stake. In this sense, the arrangement of governance mechanisms is undesirable and worth changing from an actor’s point of view if it systematically restricts the actor’s control over the terms of exchange relative to that of the exchange partner. Thus, when strategic problems become intolerable for enough actors, the legitimacy of the prevailing set of governance mechanisms suffers, and they may press for governance transformations. If workers, for instance, labor for low wages under dangerous working conditions, they may decide to unionize and establish collective bargaining with management in an effort to control more closely the terms under which they exchange their labor. As a result, an alternative form of governance replaces the traditional labor market. In sum, governance transformations are likely to occur not only when actors are unable to efficiently get the resources and information they want through exchange, but also when they cannot control satisfactorily the terms of exchange under which they attempt to obtain these resources and information in the first place. However, knowing that all sorts of ineffi-

9 Failure to recognize the importance of strategic causes of governance transformations is linked to, and perhaps derived from, other problems with the transaction-cost and neoclassical economic perspectives. First, as Stevenson (1987) suggested, representatives of these schools fail to ask the important normative questions – how and in whose interest are the standards of efficiency judged and established? – questions which, when posed, would force them to recognize that definitions of efficiency are not always universally accepted and, thus, that there may be additional reasons why actors try to change governance arrangements. Second, as Perrow (1981) argued, adherents to these traditions usually fail to accept the fact that power and class conflict often play important roles in the development of nonmarket governance arrangements, phenomena that are often the result of inequalities in strategic control.

10 We have been influenced here by Zald’s (1970) classic discussion of the political and economic aspects of organizational activity, where organizational politics and economics center on problems of the control and exchange of resources, respectively, within and between organizations.
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iciencies and strategic considerations trigger interests in governance transformations tells us very little about how transformations actually occur and why governance assumes particular institutional forms.

Although North (1981) adopts the same transaction-cost perspective that Williamson does and, as others have noted (e.g., Robbins 1987), suffers from many of the same theoretical problems as a result, he makes several additional points. The institutions that coordinate economic activity are, in effect, property rights structures (we would call them governance mechanisms) that are comprised of systems of rules, procedures, and norms that define ownership and control of the means of production, govern transactions, and determine the efficiency with which resources and information are allocated. Furthermore, although property rights structures vary historically and are determined in part by the efforts of transacting parties to increase the efficiency of their exchanges, they are also determined by actors within the state who are trying to maximize their revenues and maintain the support of their constituents.\(^{11}\)

North’s analysis is helpful not only because he unbundles the concept of property rights by identifying three dimensions with which we can differentiate among property rights structures, or governance mechanisms, but also because he recognizes that political forces and, thus, the state play crucial roles in establishing property rights, an idea that implies that governance transformations often involve conflict, rather than a smooth evolution to more efficient exchange processes.\(^{12}\) This also follows from his suggestion that property rights structures are the institutionalized systems of power and control that actors design to reproduce exchange relations so as to help them obtain systematically greater access to resources and information than others. In short, property rights structures are the institutional arrangements that determine not only the efficiency of economic activity, broadly speaking, but the strategic control of this activity as well. Hence, when actors from the state and civil society try to transform property rights, they necessarily engage in struggles over power and control. Furthermore, these struggles determine directly the various institutional forms of property rights structures that emerge and the degree to which they are efficient and strategically acceptable for different actors. As a result, these struggles constitute the central dynamic of governance transformations and largely determine which governance mechanisms emerge.

This is not to ignore the important effects that a variety of other factors has in sparking the search for alternative governance mechanisms. For example, problems may arise among actors due to the changing physical

\(^{11}\) North’s theory of the state is steeped in neoclassical economic assumptions, such as the maximizing interests of state actors. Although we agree that a theory of the state is important in understanding the transformation of economic governance, as will become apparent in what follows, we do not embrace his version of that theory.

\(^{12}\) For an early attempt to develop these ideas, see Commons (1924).