On the New Institutionalism of Markets:
The Market as an Organization

Rudolf Richter

Abstract

In the world of positive transaction costs and bounded rationality, not only firms or hybrids but also markets can be seen as modes of organization that have to be established or administered by individuals striving to trade with each other. Thus, potential traders face two problems of institutional choice: First, to choose (or administer) the order (or governance structure) of a market organization. Second, to choose, within that organization, a governance structure of their respective exchange contract. We deal in this paper only with the first problem, focusing our attention on implicit (or tacitly agreed upon) orders of market organizations that grew into an existing formal order. We ask: How does the literature describe typical implicit orders (or informal governance structures) of market organizations? How do such implicit orders affect economic efficiency? We answer on the basis of some empirical examples, viz., price leadership in the American cigarette industry, empirical studies in general price stickiness, case studies of the role of social market structure, the evolution of the near standardization of CPU’s of personal computers. Theories of oligopoly and monopolistic competition appear in a different light. Our paper aims at a better understanding of ongoing debates on transformation economics and antitrust.

1. Introductory Remarks

This paper is motivated by the remark of Coase (1988, 7) that “although economists claim to study the working of the market, in modern economic theory the market itself has an even more shadowy role than the firm.” He goes on to say that “in the modern microeconomic textbook, the analysis deals with the determination of market prices, but discussion of the market itself has entirely disappeared.” Since then, economists are becoming increasingly aware of the problem at issue, though, there is still a long way to go. In the present paper, we’ll reflect on Coase’s complaint using analytical concepts of the new institutional economics, i.e., by assuming positive transaction costs, bounded rationality and imperfect
foresight. We further assume that the elementary constitutional rules of the liberal state prevail (property rights, law of contracts, liability law) and that the operational rules of the economy (common language, measures and weights, means of exchange etc.) are given and fully accepted. In such a world, potential traders of some good face two (interrelated) problems of institutional choice: First, to concur with other potential traders on the type and financing of the institutional framework of the market (on the “market order”, “market design” or “governance structure of the market” - a collective good) within which they wish to trade that good; second, given this market order, to agree with their trading partner on a specific governance structure of their exchange contract. The first problem is a problem of non-market coordination of individual plans (a problem of common interest, i.e., of collective choice), the second one is part of the problems of market coordination (a problem of individual interest, i.e., of individual choice – it is subject of transaction cost economics).

Thus, the new institutional economic perspective of pure exchange reminds us that market allocation and non-market allocation are closely related to each other. Their separation is merely an analytical trick of neoclassical economists who wish to distill the pure case of economic exchange. For that purpose they disregard the establishment and running of a market and assume that the institutional framework of markets is given a priori, inclusive some “standard” set of exchange contracts to be automatically applied by a plurality of anonymous, perfectly rational traders. In other words, neoclassical economists think of markets in terms of a given formal (or explicit) governance structure (a set of rules) that steers demand and supply of perfectly rational trading automatons at no costs toward market equilibrium. Traders are condemned to anonymity - unable to develop social relationships.

The new institutional economics of markets, in contrast, allows traders to develop social ties and thus, i.a., to conclude non-standard contracts (i.e., relational contracts). It further allows traders to set up or change their market order, their “cage”, within which they wish to do business with each other. Thus, the NIE of markets is a much wider concept than that of the ideal type of neoclassical perfect competition. It allows traders to pursue their common interest (their choice of market order – a collective good) and their individual interests (the

---

3 The market, “…in a primitive as well as in a developed society, is understood as a social arrangement to facilitate repeated exchange among a plurality of parties (as opposed to occasional exchange between individuals).” (Furubotn and Richter, 2005, 314).

4 As described, e.g., by Furubotn and Richter (2005, 294 f.); lawlessness and economics is analyzed by Dixit (2004).

5 McMillan (2002, 9) “The term market design refers to the methods of transacting and the devices that serve to allow transacting to proceed smoothly.”

6 By law on the basis of the three fundamental laws of nature “…that of the stability of possession, of its transference by consent, and of the performance of promises.” (Hume [1739/40] 1969, 578).

7 Relating to complete (or classical) contracts, i.e., contracts whose terms are completely stated and verifiable for all possible contingencies. Complete contracts meet the ‘discrete-transaction paradigm’: “Sharp in by clear agreement, sharp out by clear performance.” (Macneil 1974, 738). Their emphasis is on legal rules, formal documents and self-liquidating transactions (Williamson 1981, 43).

8 For simplification, we use in this paper the terms „formal“ and „explicit“, respectively “informal” and “implicit,” as synonyms.

9 Inclusive their enforcement mechanism.

10 Macneil (1978).

11 Olson (1965, 15) The “achievement of any common good or the satisfaction of any common interest means that a public or collective good has been provided for that group.” In our case, the common interest is to cut down transaction costs of exchange.
choice of exchange contracts). As for the former – collective action – a market may be interpreted as a mode of organization in the sense of Arrow (1974 33). Following Arrow, Furubotn and Richter (2005, 314) write:

In the real world of incomplete information and bounded rationality, the market can be conceived as an organization (or “business”) that, similarly to the firm, is founded and managed by individuals. Of course, the organization “market” is differently structured than the organization “firm.” The two are parallel, though, in the sense that individual actions are coordinated by a series of contracts between actors and all relationships unfold within the framework of an implicitly or explicitly agreed-upon order (based on written or unwritten agreements rather than through instructions by superiors). Under this arrangement, enduring exchange relations of traders matter. Thus, contrary to the much-quoted remark by Adam Smith, it may be socially useful that marketers know each other and tend their contacts (Podolny and Page 1998, 59; Granovetter 1973).

In other words, markets are not simply “there”, given by nature. Like firms or other organizations they have to be established, operated and financed by collective action of some players. In the institutional environment of a capitalist economy founders of new markets, or operators of old ones, are in the first instance market actors themselves besides law makers or administrative authorities. Traders agree to compete with each other for buyers or sellers within an organization “market”, which they set up and administer – to a degree – by themselves.

Certainly, not all individuals, who wish to buy or sell some good, have to establish or operate a market by themselves. Most of them will be able to participate in one of various already existing market organizations that may or may not compete with each other for participants. Thus, in our paper the term “choice of market order” means either “establishment of a new market” or “choice of an already existing market order”. Be that as it may, all markets require the input of resources to be established and run (fix and variable transaction costs), which generally have to be contributed by buyers and sellers themselves.

In this paper we concentrate ourselves on the problem of choice of a market order (a collective action) which by itself is a rather wide topic that surpasses the limits of a conference paper. We therefore restrict ourselves further, viz., to cases of “implicit collective actions”, viz, the formation and operation of the rules of the organization “market” (informal “governance structures” based solely on the formation of implicit collective agreements – such as ethical codes, customs, conventions the latter with respect to

---

12 Formal organizations like firms, labor unions, universities, or government are not the only kind of organizations. “Ethical codes and the market system itself are to be interpreted as organizations; the market system, indeed, has elaborate methods for communication and joint decision making.” (Arrow 1974, 33; italics added)

13 Smith ([1776] 1976, chap. 10, pt. 2, marginal note): “Meetings of people in the same trade ought not to be facilitated.”

14 In general, organizations „markets” are competing with each other as do organizations „firms”. That is true, without doubt, for the organization of “organized markets” like stock exchanges. We claim, however, that this applies also to all other types of the organization “market”.

15 An excellent illustration of the extent of this field of research is provided by McMillan (2002).

16 Williamson (1981, 42)

17 Arrow (1974, 33)
transactional activities like the conclusion of contacts, the fulfillment or enforcement of promises (the modes of delivery or payment), and competitive practices such as price policy, R&D or advertising activities. Competitive practices are equivalent to what is called “tacit collusion” in oligopoly theory - a term of ill repute among neoclassical economists, though not necessarily for new institutional economists favoring the “equilibrium-of-a-repeated-game” approach to institutions (or, in our case, the order of an organization).\textsuperscript{20} Indeed, to interpret tacit collusion among competing parties as a collective good is an unusual way to look at an equilibrium of oligopolies or other solutions of imperfect competition. However, as we hope to demonstrate, it is a possible way to do so.

In any case, under the conditions of NIE, the formation and observation of implicit (or tacit) rules of the organization “market” are neither compelling evidence of economically undesirable results (as in the Harvard School view on antitrust) nor need they be efficient governance structures (as in the Chicago School view of antitrust).\textsuperscript{21} They may be hopelessly encrusted organizations that are unable to adapt themselves to unforeseen developments (like the German labor market). Given positive transaction costs, bounded rationality and imperfect foresight we ask the following two questions:

1) How does the economic literature answer the problem of the collective choice of a specific implicit market order?

2) How does the choice of a particular implicit market order affect the economic results of this market?

We shall try to answer these questions by examples in a purely argumentative style of the NIE.

\textbf{A Clarifying Interjection:}

As stated above, we assume given elementary constitutional rules of the economy - property rights, law of contracts, liability law - and given operational rules (common language, measures and weights, means of payment etc.). We leave open, how the choice of market order comes about. Two extreme cases can be imagined: by spontaneous action (bottom up by implicit collective agreements) or by order of a central authority (top down) on the basis of a pre-planned or “constructed” (Hayek) market design. Real market orders are generally located somewhere in between these two extremes - with an amount of spontaneous or implicit ordering everywhere – also in a constructed market design. The in-between cases comprise, i. a., weekly markets like farmers’ markets, industries like the (American) cigarette or automobile industry, formally organized markets like the New York Stock Exchange etc. To illustrate our point – the omnipresence of implicit collective agreements – it is irrelevant which specific cases we use as examples.

\begin{itemize}
\item[18] That is, “conventions” in the sense of Weber (1968, 34). It designates “…that part of the custom followed within a given social group which is recognized as ‘binding’ and protected against violation by sanctions of disapproval.”
\item[19] In the sense of Lewis (1969).
\item[20] According to which an institution is defined as a salient Nash equilibrium of a recurrent “supergame” about the way a given “underlying game” is repeatedly played (cf. e.g., Furubotn and Richter (2005, 8).
\item[21] Schmidtchen (1994) describes the first view as one of ‘market power phobia’… and the second as one of “efficiency euphoria (quoted from Bickenbach, Kunkar, Soltwedel 2000).
It should, finally, be mentioned that institutional oriented economists had already addressed Coase’s critique around the time he brought it forward, among them the later Nobel laureates George Akerlof (“The Market for Lemons: Quality Uncertainty and the Market Mechanism,” 1970), Michael Spence (“Job Market Signaling” 1973), Joseph Stiglitz (“Incentives and Risk Sharing in Sharecropping,” 1974). However, their work typically deals with the problem of individual choice of the governance structure of individual exchange contracts under asymmetric information, not with the problem of collective choice of an institutional framework of markets. Certainly, both are problems interrelated but, still, they are two pairs of shoes.

2. On Terminology and Hypotheses

2.1 Definition “Organization”:

There exist different definitions of the term “organization.” While Arrow (1974, 33), like Olson (1965), views organizations as a “… means of achieving the benefits of collective action in situations in which the price system fails” – with or without a central authority – does Hayek (1973, 37) use the term organization in the sense of "constructed" order (τάξις) as opposed to “spontaneous” order (κόσμος). Others like H. Albert (1967, 393) restrict the word “organizations” to those social structures for which a central authority exists, while Ouchi (1980, 140) defines an organization simply as “any stable pattern of transaction between individuals or aggregations of individuals.” For North (1990, 7f.) institutions are the rules of the game and organizations the players;

Institutions are the constraints that human beings impose on human interaction. Those constraints…define the opportunity set in the economy. Organizations consist of groups of individuals bound together by some common objectives [in our case: to trade efficiently some good(s)].

In this paper, we use the term organization in the sense of an institution (a set of rules including their enforcement mechanism) that is established by certain actors with the purpose to achieve a common goal. It may be established either by order of some actor(s) (the founder(s) of a firm, a university, a stock exchange) or by explicit or implicit agreement between a number of interested parties (the founders of a club, the promoters of a circle of friends, the leading producers of, e.g., cigarettes or automobiles). The subtitle of this paper relates to organizations in the latter sense.

2.2 How do Institutions and Organizations arise?

Among the various approaches to institutional economics, two strands of thought are standing out:

# 1. A line of thought starting from, say, David Hume (1739/40) to Carl Menger (1883), F.A. Hayek (1948, 1967), to A. Schotter (1981), R. Axelrod (1984), A. Greif (1998, 2006). This line is characterized by self-adjusting processes. Transaction costs play no explanatory role. We call this line of thought the "invisible-hand approach to institutional economics".

---

22 Or in Schmoller’s (1900, 61) terms “the personal side of the institution.” --- A fuller description of our opinion see Furubotn and Richter (2005, 296 f.).
23 Sometimes referred to as the “Hayek programme” (see Elster 1989, 250).
Another line of thought leads roughly from Frank Knight (1922) and John R. Commons (1934) to Ronald Coase (1937, 1960), M. Olson (1965), K. J. Arrow (1969), O. E. Williamson (1975, 1985, 2005), D.C. North (1981, 1990, 2005). In this approach, transaction costs (or information costs) are essential as an explanatory element. For want of a better term, we dub this line the "visible-hand approach to institutional economics".

These two approaches describe extreme positions. To apply a mix of both seems obvious. In fact, Hayek (1973, 45) himself concedes: "...people gradually learned to improve those [invisible hand] rules; and it is at least conceivable that the formation of spontaneous order relies entirely on rules that were deliberately made." However, he later qualifies his statement by saying that "...the more comprehensive order within which organizations function, rests on the adaptation to the unforeseeable, and that the only possibility of transcending the capacity of the individual minds is to rely on those super-personal ‘self-organizing’ forces which create spontaneous orders" (loc. cit. 54). Certainly, one cannot regulate everything to the last detail. The classical way out is to leave reasonable gaps in the organizational or legal design that can be closed over time. This leads us to the problem of institutional and organizational stability.

2.3 Institutional and Organizational Stability

Economists are largely interested in the existence and stability of equilibria. The invisible-hand approach to institutional economics pursues exactly this problem with respect to institutions or organizations – their ability to adapt to the unforeseeable (Hayek 1973, 54) or their “adaptive efficiency” (North 1990, 80). However, an invisible hand mechanism can be an extremely time consuming process of trial and error. Fortunately, the work of the invisible hand can be accelerated substantially by planned collective action based on well tried rules and insights of economists. At this point enters the visible-hand approach to institutional economics. Yet “constructed” institutions or organizations will function only as expected if they are – in a way – self enforcing, i.e., obey an invisible hand mechanism. Today’s institutional insights of economists are, in some areas at least, quite well developed and able to offer policy makers a helpful hand. As a simple example, compare the fate of the Banque Générale set up in Paris in 1716 on advice by John Law with that of the Deutsche Bundesbank of 1957 which evolved from the Bank deutscher Länder of 1948 that was based on advise of a group of American and German monetary economists.

In this paper, we think in terms of a mix of the visible and invisible hand approaches. We assume that the “construction” of institutions by individual actors is feasible (to a degree) because – to repeat Hayek (1973, 45), "...people gradually learned to improve those [invisible hand] rules; ..". We are particularly interested in the activities of actors who establish new markets or operate and develop already existing ones, and we opine that the organization

---

24 As North (2005, 51) stresses: “Humans deliberately try to shape their future and indeed have no alternative but to try to structure human interaction – the alternative is anarchy or chaos.”

25 Fligstein (2001, 29) argues similarly: “...people can make choices and attempt to construct social organizational vehicles to attain their ends. This does not mean that people are all successful or have the same opportunities to be actors. It does mean that the entire apparatus of modern economies is, at least partially, an outcome of these social technologies of organization. These have been invented and, upon reflection by the actors who use them, intentionally refined.”
“market” is a plexus of explicit and implicit (tacit) agreements among actors – in general under the leadership of some outstanding figures: the market entrepreneurs in the sense of Schumpeter (1942).

3. Which Market Organization?

Economists are “functionalists” in the sense of Turner and Maryanski (1979, 113): They look for general laws or principles of human organization, i.e., stable mechanisms that underlie the working of economic organizations (correspond with rules that are imaginable to arise spontaneously) such as the concepts of incentive mechanisms, the price mechanism, the law of one price, the economic circular flow, etc. The concept of the price mechanism is based on a complex set of assumptions regarding human behavior and institutional framework by which it is controlled. It presupposes, i.a., the existence of “perfect” competition among actors. Before we continue, it seems appropriate to repeat briefly the basic (“functionalist”) theory of the “price mechanism” under the ideal conditions of perfect competition.

3.1 The Market Mechanism: Theory of Perfectly Competitive Markets

The theory of perfectly competitive markets is concerned with the definition of market equilibrium and the explanation of how the latter may be reached under certain ideal conditions – among them perfect competition, zero transaction costs and the assumptions that the supply of the traded good increases, its demand decreases with market prices. An early graphic description of the theory of competitive market equilibrium provides the Marshallian Cross. An excellent verbal description of how a market equilibrium can be reached is given by Böhm-Bawerk (1888) by his Grundgesetz der Preisbildung (basic law of price formation), which later was corroborated by Vernon Smith (1962) in his experimental study of competitive market behavior. This theory assumes truly discrete exchange between total strangers. Traders compete with each other in the sense that they neither explicitly nor implicitly (tacitly) agree on the price they bid or ask and that competition relates only to prices not to product quality or advertising (homogenous products, no personal preferences). Furthermore, traders are perfectly informed - however, only on the quality of their traded good and its quoted or traded prices. They do not know, in particular, the reservation price of other marketers. Finally, after the bell's gone, all contractual claims are met to the point.

Marshall’s demand and supply curves (or Böhm-Bawerk’s demand and supply schedules) represent the reservation prices of buyers and sellers. Buyers wish to pay less and sellers to receive more than their reservation price. Price formation (= price competition) is organized by way of a double auction. Information on quoted and traded prices of the traded commodity

---

26 Incentive structure, governance structure, market order.
27 The illustration of the equilibrium price of a commodity by the intersection of an upwards sloping supply curve (“law of supply”) and a downward sloping demand curve (“law of demand”) in a system of coordinates whose vertical axis denotes the price and horizontal axis the quantity of the commodity. We are concerned here only with issues of the institutional framework of markets. For that purpose suffice, for the time being at least, the classical plausibility considerations regarding the price dependence of the quantities of demand and supply. The microeconomic foundation of these relationships and of the existence of a market equilibrium is object of neoclassical microeconomics.
28 Böhm-Bawerk (1888/1909, 357 ff.).
29 “...brought together by chance (not any common social structure, since that link constitutes at least the rudiments’ of a relation outside the transaction).” (Macneil 1978, 856)
is immediately available for all marketers at no cost. Vernon Smith demonstrated in his market experiments that under such conditions prices will in fact converge to their competitive equilibrium (the intersection of the Marshallian Cross) – even if the number of traders is small. What matters from an institutional economic viewpoint is the proper design of markets; following McMillan (2002, 9) in particular of
- the mechanism that organizes buying and selling (here: a double auction, given that explicit or implicit price arrangements between competitors are successfully prevented; individual plans can only be coordinated by the price mechanism, i.e., not by product differentiation, advertising or other “qualitative” parameters),
- the channels of the flow of information (here: immediate and costless information on going prices; no information on the other traders’ reservation prices; full information on the quality of the {perfectly homogenous} traded good),
- the rules of property rights and contract law (here: the transfer of ownership of a fictitious commodity and its exchange for money on the basis of a freely concluded and binding contract that is problem free executed).

Vernon Smith’s market experiment demonstrates visibly that the abstract model of the Marshallian Cross is more than a thought-up ideal. It is also suited for practical use provided the conditions of perfect competition are somehow met – with one exception: no large (or infinite) number of buyers and sellers is needed. Instead, in the real world the place of the number of competitors seems to be taken by “the utter dispersion of power” (Stigler 1968, 181) - a condition met in Vernon Smith’s market experiment by his initial condition of equal sized individual turnover quantities.

The model of the Marshallian Cross is not only plausible and corroborated by experiments; its underlying ideal type of a “perfect market order” is also reflected by the design of organized markets like stock or commodity exchanges, auction houses, electronic markets etc.. It is, further, recognizable among old style local markets - held at the same place, same time, for the same goods. Properties of old style local markets, on which people talk with each other on prices and qualities of traded goods, are revived (to a degree) by the internet. Further, the Marshallian Cross can also be used to predict what is going to happen if sellers, buyers or the government suspend the price mechanism by fixing maximum or minimum prices. No question, the hypothetical market organization underlying the theory of the Marshallian Cross is widely applicable. However, why are not all real life markets organized in a manner closer to the ideal type of the perfect market? Why are auction style price mechanisms such rare

---

30 “Each marketer is ignorant of the reservation prices at which other buyers and sellers are willing to trade. …the only way that a real marketer can obtain knowledge of market conditions is to observe the offers and bids that are tendered, and whether or not they are accepted.” (Smith 1962, 115)
32 Telser and Hoginbotham (1977, 997).
33 Thus the anthropologist Fröhlich (1940) on pre World War I African markets. Even though he does not quote economic theory he must have known its doctrines. His paper is written as if he intended to illustrate if not all then most of the elementary assumptions of the ideal type of the perfect market.
events in reality? The answer is contained in the criticisms of the theory of competitive markets.

### 3.2. The Market Mechanism: Three Waves of Attacks

In the early 1930s neoclassical economics came under fire. It was the time when Ronald Coase wrote his famous article on “The Nature of the Firm,”\(^\text{35}\) Joan Robinson her book on “The Economics of Imperfect Competition” (1933), and Edward Hastings Chamberlin his thesis on “The Theory of Monopolistic Competition” (1933). In Germany Heinrich von Stackelberg’s thesis on “Marktform und Gleichgewicht” (Market Form and Equilibrium) appeared in 1934. During the following years the work of Chamberlin, Robinson and Stackelberg – together with the oligopoly theory since Cournot (1838/1927) and Bertrand (1883) – dominated the debate on “price theory,” while Coase’s transaction cost economics remained dormant until the 1960s and the later evolution of the New Institutional Economics (Williamson 1975, 1). In its wake developed the New Economic Sociology with its criticism of the theory of the classical market mechanism and of the NIE (Granovetter 1985).\(^\text{36}\)

In short, these three waves of attacks occurred successively under the banner of, respectively, (1) monopolistic competition, (2) new institutional economics and (3) new economic sociology.

Above three attacks were directed against the assumptions of the classical theory of the market process. To our understanding, the essential point of the NIE is that, due to transaction costs - the "costs of using the market" emphasized by Coase (1937)\(^\text{37}\) – a market equilibrium may still be efficient (be socially preferable) if the conditions of perfect competition are violated, in particular,

1. if a producer (supplier) keeps the price of his product temporarily fixed (administers his prices), and uses, instead, his product quality and advertising outlays as parameters of action;\(^\text{38}\)

2. if the parties to a contract do not write complete contracts but trade on the basis of incomplete or “relational” contracts\(^\text{39}\) or “non-standard contracts”;\(^\text{40}\)

3. if marketers are tending their social contacts;\(^\text{41}\)

**The first** insight makes use of Chamberlin’s (1933) theory of monopolistic competition in combination with Coase’s costs of using the market (transaction costs).\(^\text{42}\)

---

\(^{35}\) That was started in 1932, see Coase (JLEO 1988, 3).


\(^{37}\) They comprise (i) the costs of preparing contracts (search and information costs narrowly defined), (ii) the costs of concluding contracts (costs of bargaining and decision making), (iii) the costs of monitoring and enforcing the contractual obligations, (iv) the costs of establishing and tending social relations.

\(^{38}\) NIE reasons for price fixing are given, e.g., by Alchian and Wood ward (1987).

\(^{39}\) Macneil (1978).

\(^{40}\) Like vertical integration; see, e.g., Williamson’s four forms of efficient governance (Williamson 1985, 79).

\(^{41}\) Even in highly organized markets. --- Markets do not function in a social vacuum (Hamilton and Feenstra, 1995, 61).
The second insight is part of Williamson’s transaction cost economics. It is aimed at the governance of bilateral relations (exchange contracts). However, Williamson’s concept of fundamental transformation can be applied also to (informal) multilateral social relationships like a market order.\(^4\)

The third insight makes use of the work of sociologists, who argue that the social structure of markets matters for their economic performance, and (implicitly) the concept of transaction costs. "Social structure" is understood as the “structure of social relationships between marketers”. Burt (1992, 8 ff.) uses in this connection the term of "social capital".\(^4\) Forms of social capital are social properties like trustworthiness, social networks, formal and informal rules or institutions (Ostrom 2003, xiv). As any form of capital, social capital is supposed to generate future benefits for its owners. However, in contrast to financial or human capital, social capital is owned jointly by the parties to a relationship. No actor (of the relationship) has the exclusive ownership right to [the fruits of] "his" social capital (Burt 1992b, 58). Thus, the question of individual investments in social capital is a typical problem of collective action (Olson 1965).

To test the applicability of above three insights, we are going to discuss some empirical cases from the literature.

4. The Choice of Market Organization as Reflected in the Literature

To repeat: Our hypothesis is that under conditions of the NIE and a given explicit (formal, “constructed”) market order, there is still room left for “the work of the invisible hand,” i.e., for the growing in of an implicit order.\(^4\) As a consequence, the actual organization of real world markets diverges more or less from their explicitly “constructed” order based on the neoclassical ideal of perfect competition (the principles of Ordnungspolitik). Given transaction costs, the idea of an efficient market becomes a conditional concept, relating to the kind of “constructed” (formal) market order,\(^4\) to the properties of the traded good, the technical and organizational knowledge of the marketers, their ideological attitude towards trade\(^4\) and other circumstances. In the world of positive transaction costs, deviations from perfect competition may be socially preferable.

---

\(^{42}\) Note: The attack on Chamberlin’s theory by Friedman (1953, 7 ff) and Stigler (1968, 311 ff.) is directed against its predictive power, not its normative conclusions. Nobody doubted the inefficiencies of imperfect competition at this time.

\(^{43}\) As is typical for oligopoly theory or the theory of monopolistic competition,

\(^{44}\) Their social capital offers actors opportunities to use their financial and human capital profitably and, thus, contribute to their individual wealth (Burt, ibid.).

\(^{45}\) As Adler and Adler (1984, 197) put it: “…the formal market structure is supplemented and occasionally subverted by an informal social structure or network of roles, relationships and social organization.” (Emphasis in the original); Williamson (1981, 42): “…informal procedures … also perform important governance functions.”

\(^{46}\) Based, e.g., on the principles of Ordnungspolitik.

\(^{47}\) Such as their inclination towards doux commerce, a term from Montesquieu (quoted by Hirschman 1982, 1464).
4.1 Implicit Market Organization I: Administered Pricing

It is a well-known fact that most prices do not react immediately to demand or supply shocks as neoclassical price theory would predict. Prices of large numbers of goods are "rigid" (Carlton 1983, Blinder et al. 1998). In view of the existence of transaction costs, price fixing is plausible. It would be extremely costly (e.g., require an extensive, strictly monitored and enforced institutional framework) to organize real-life markets in the style of a commodity or stock exchange, where prices adapt to changes of demand or supply in fractions of a second. Instead, most prices are administered. They are announced by one side of the market (in production markets usually the suppliers) and kept constant for some time. A characteristic example are "posted prices" as described, e.g., by Alchian and Woodward (1987). Other examples of rigid prices are wages, apartment rents, restaurant prices, etc. Because of the law of one price, administered prices of similar goods tend to be equal. With price competition out of operation, rivalry among sellers is carried out by other means such as product variation or advertising outlays. That is hardly understandable without speculating on some tacit agreements (tacit collusion) between sellers, as is assumed in the case of price leadership among oligopolists. Yet non-price competition is not restricted to oligopolies, it is a characteristic of all markets with rigid prices (i.e., all kinds of monopolistic competition). Implicit market organizations seem to be a widespread social phenomenon.

In sum, formal (explicit) real-life market mechanisms are more or less "polluted" by implicit collective actions (tacit collusion) of traders with respect to their market order. Given positive transaction costs, some "pollution" of the ideal type of the order of perfect markets is not only unavoidable, it may be even necessary to attain an efficient (socially preferable) allocation of resources. An example supply the rules of price leadership understood as an implicit or tacit market order. One firm, not necessarily the biggest, “…undertakes to announce the price, on the basis of its estimate of the most profitable level of the forthcoming price period, and the remainder of the industry usually follows” (Stigler, 1952, 234).

Tacit collusive behavior of oligopolists is theoretically analyzed, i.e., in a repeated-game framework as reviewed by Jacquemin and Slade (1989). Analytically it is the same as the institution-as-an-equilibrium-of-a-game approach mentioned above. We sympathize with this approach - and leave it at that by simply assuming the existence of some Nash equilibrium – some “tacit meeting of the mind” (Posner 2001, 60). In this sense the rules of price leadership (a form of tacit collusion, a spontaneous order or governance structure) are understood as an institution or, in our language, as an implicit order of the organization “market” (that grew...)

48 For detailed examples see Furubotn and Richter (2005, Ch. 7).
49 By “variation” of product in the broad sense: “…alteration in the quality of the product itself – technical changes, a new design, or better material; it may mean a new package or container; it may mean more prompt or courteous service, a different way of doing business, or perhaps a different location.” (Chamberlin 1948, 71)
50 “Selling costs”, see Chamberlin (1948, Ch. VII).
51 The collective good “price leadership” is the “self-sustaining system of shared beliefs about a salient way [the rules or order] in which the game is repeatedly played” (Aoki 2001), i.e., the order of the organization “market” as understood in this paper.
52 Besanko et al. (2004, 272) interpret an implicitly agreed upon price as a focal equilibrium; it would be more likely in a concentrated market than in a fragmented. Insofar market structure would matter.
into a “constructed” order, i.e., an explicitly laid down legal framework) within which competition takes place by means of R&D or advertising expenditures.  

We are going to discuss such an implicit order (or informal governance structure) of the organization “market” by examples and start with a particularly well documented case of price leadership, viz, the price policy of the American cigarette industry during the interwar period. Cigarettes are not exactly held in socially high esteem nowadays. Improvements in their quality or in the way they are serviced etc. are more likely regarded as socially undesirable. However, following Nicholls, we believe

…that the policies of the American cigarette industry have much in common with those of other large-scale industries, especially those in which advertising is of paramount significance. As such, the policies of the cigarette industry can serve as the basis for at least tentative generalizations about a much larger sector of all industry…." (Nicholls 1951, 4).

At the risk of being dull we shall retell briefly some characteristic pieces of Nicholls's detailed report on the US Cigarette industry to give the reading a feeling for what we mean by an implicit order of an organization “market”, i.e., the result of implicit (tacit) collective actions of marketers. Of particular interest is, as we see it, the role of the visible hands of certain leading actors (in a sense, of some Schumpeterian “market entrepreneurs”).

4.1.1 An Example of Price Leadership: The American Cigarette Industry During the Interwar Period

During the interwar period (1919 - 1939), the American cigarette industry was dominated by three big firms (Reynolds, American Tobacco, Ligget & Myers). They were created by the dissolution of the American Tobacco Trust in 1911. The "Turkish and Domestic blend" had been introduced by Reynolds who launched its “Camel” cigarette already in 1913 (Nicholls 1951, 36). It was enormously successful. American Tobacco followed the Turkish and domestic blend market with its brand “Lucky Strike” and Ligget & Myers with its “Chesterfield” cigarette in 1917 (loc. cit. 37 ff.). After a period of price competition 1912 - 23 the industry adopted virtually identical prices, discounts and net prices in 1923 (loc. cit. 57). Between 1923 and 1939 there were only seven mutual price changes: four price increases lead by Reynolds (Camel), three price cuts of which one (1928) lead by Reynolds, two by American (1933). Until 1931, “first comer” Reynolds, who had the biggest market share until 1928, became the industry’s undisputed price leader. With prices virtually fixed and equal, competition was shifted almost wholly to a non-price basis, in particular to advertising.
In view of the cut by the Great Depression we discuss the intervals of 1923 - 1931 and 1931 - 1939, separately.

1923 - 1931: Advertising became king and advertising expenditures soared, with American Tobacco (Lucky Strike) soon taking the lead. The most spectacular of its advertising campaigns was inaugurated in 1928. It was based upon the slogan, "Reach for a Lucky instead of a Sweet" as an intensive bid for women smokers. American's president Mr. George Washington Hill defended his shift to non-price competition in an anti trust hearing of 1941 with the argument:

> When the time came for our company to decide whether we would go after business on a quality or a price basis, it was decided to stick to quality. ... We all know how spasmodic, unsatisfactory and short-lived a brand or business is that is built up on price alone (loc. cit 59).

Mr Hill added that advertising is also good for the industry as a whole:

> Of course you benefit yourself more than the other fellow...but you help the whole industry if you do a good job. (loc. cit. 60)

Of course, that argument applies also to a policy of low prices - as problematic as it may be in an oligopoly. American's advertising outlays increased between 1925 and 1931 from near 9 mill. to almost 24 mill. (loc.cit., 61). American exceeded the original market leader's Reynolds advertising expenditures for the first time (by more than 25%) in 1929. At the same time, American (Lucky Strike) overtook Reynolds's (Camel) market share. In its later court hearing, James Gray, president of Reynolds testified:

> The Advertising Department is more of a routine operation than ordinarily would be supposed, because our advertising copy is prepared by an advertising agency....Dissatisfaction with advertising results brought a change of agencies rather than a major assumption of advertising duties by company officials (loc. cit. 60).

Ligget & Myers depended also to a great deal on advertising agencies, and followed a non-aggressive advertising as well as price policy (loc. cit. 60). It lost some 3.5 per cent points of its market share between 1925 and 1931. The original market leader Reynolds was relieved of some 13 per cent points of his market share. American's aggressive advertising campaign had been quite effective in terms of its market share.

All three leading cigarette producers seem to have also considered the growth of total demand of cigarettes vis à vis cheaper tobacco products as an important function of their advertising. Reynolds, e.g., argued in the courts hearings that the firm was committed to a policy of high volume of advertising...(partly) in order to hold the consumption of ... cigarettes, instead of letting drop it back to the less valuable consumption....represented by smoking tobacco or chewing tobacco. (Nicholls 1951, 61).

Still, a competitive price cut was tried out once by Reynolds (Camel), the price leader of the industry, in 1928. The prices of Luckies and Chesterfields followed the same day. The reason

---

56 Keep in mind the dynamic nature of the cigarette market. Total US cigarette consumption increased by 42 per cent during the seven years of 1925 - 31.

57 American's net income grew of all three big companies due to the increase in general cigarette consumption. (loc.cit. 71).
for Reynold's price cut was possibly that the firm lost market share in spite its spent about 60% more on advertising than its challenger American (Lucky Strike).

Mr. James A. Gray, president of Reynolds, explained later this price cut as follows:

In 1927….we had done the largest amount (of advertising) in the history of the company…. (Yet) we were experiencing in the early months of 1928 a considerable decline in the sale of Camels…. (It was therefore decided) that….it was an opportune time for us to compete on a price basis rather than trying to spend (so much) money in advertising from which we apparently were not getting results. 58

However, Reynolds market share continued to decline while American's share increased further (see Figure 1). As a consequence, Reynolds increased its price again in the following year. They did this to be able to do more advertising. 59 The other two followed suit as before.

Mr. Vincent Reggio, president of American, admitted later "…all of us were glad to follow (Reynold's lead) and increase that price." At the higher price both Reynolds and American increased their advertising outlays considerably on 1930 and 1931.

Conclusions 1925 - 31: Price leadership - the rules of an implicit agreement among a few big suppliers of a commodity to compete by advertising expenses instead of price cuts - is an outstanding structural element of the US cigarette market order of the years 1923 - 1931. Price leader (with two exceptions) was the firm that had successfully introduced the new cigarette taste (Reynolds). It was soon imitated by the other two big cigarette producers American Tobacco and Ligget & Myers. The three major cigarette producers became the “makers” of the “cigarette market order” of the period 1923 to 1931. Secret price cuttings were practically impossible. Their expenses on R&D and advertising did benefit their own firms as well as the cigarette market organization as a whole. They were apparently fully recovered by cigarette sales. 60 Individual and common interests of the three major firms seem to have been consistent. 61

Forget about our object of trade (cigarettes) and ask: What is the social gain of the implicit agreement of suppliers to compete by advertising expenses instead of price reductions? A typical new institutional economic answer is: For repeatedly bought experience goods like cigarettes (soft drinks etc.), the social advantage may be that the investments that are sunk in advertising serve as “hostages” in the hands of the firm’s customers (Klein and Leffler 1981, Shapiro 1983). As a consequence, the sellers' promise to offer steady (high) quality products becomes credible. That consumers have to pay a higher market price for brand name products

58 1928: $ 12, 872 000 ; 1927: $ 9,934 000.
59 As President Grey of Reynolds explained, they increased the price, i.a., to "the very definite need of doing more advertising on Camels."
60 Nicholls (loc. cit. 191): "…the three principal successor firms have succeeded in maintaining a level of net earnings well above normal competitive levels throughout the period since the dissolution" (of the Tobacco Trust).
61 As the courts put it: “…the defendants together realized that they had among themselves a ‘profit melon’ which they had the power to maintain intact by avoiding price competition. It was only within this understood framework that they fought – by advertising, selling efforts and packaging – to see who would get the ‘biggest slice.’” --- And, related to the magical world of perfect competition, i.e., zero transaction costs, the courts continued: “By emphasizing the latter, the defendants merely camouflaged the absence of price competition which the Sherman Act was designed to preserve.” (Nicholls 1951, 349; idalics added).
may be justified as the consumers’ contribution to the provision of the public good “market organization” by the three market makers. However, given the predominance of sellers, the price of the goods in question may still be too high or otherwise socially undesirable. Yet we cannot judge from the outward appearance of “price leadership” alone. A per se rule banning “price leadership” as socially undesirable and therefore illegal seems indefensible.

1931 - 1939: This period is characterized by a grave mistake: A mutual price increase of the dominant American cigarette firms at the heights of the Great Depression in 1931. The increase was initiated by Reynolds. At that time, Reynolds had, for a limited time, a de facto monopoly on the use of a new packing machine that made them the only supplier of moisture-proof packed cigarettes. According Mr. S. Clay Williams, Chairman of the Board of Reynolds, the firm raised its price because,

"…we intended to expend a very heavy (advertising) fund" to push the new package during the very limited time available before the other companies were able to adopt it.…

Furthermore, Reynolds officials thought that "the turn had come and that times were going to get better"; that "courage was needed in the United States to stop this downward spiral in wages and prices…and all that was needed to put some stability in the business of the country."

(Nicholls, 1951, 83)

But why did American and Ligget and Myers follow the price increase?

President Hill of American (Lucky Strike) replied:

I naturally saw the opportunity to make some money…I thought the public might absorb the 45-cent increase, and I followed Mr. Reynolds's lead. (loc. cit., 84)

The sales Vice President of American added, the price increase was met because

I felt that if Camels were going to have this extra money….may be they would use more salesmen…more advertising…a great deal of sampling, …and I said, 'Well, if they can raise it, I had better raise it too, because maybe I will need the money. (loc. cit. 85)

President Andrews of Ligget & Meyers (Chesterfield) explained:

If we failed to increase…we felt that that would be too great a disadvantage to attempt to overcome, (so) it was our best judgment that we should meet it.

An attorney of Ligget & Myers argued in the court hearings that following this price increase and other price increases was in conformity with the firm's belief that, "in general, imitation minimizes risk:"

The inertia of custom, plus extensive advertising, tend to assure a well established manufacturer his existing share of the market provided he does not permit his competitors to do anything drastically different from himself.…

---

62 Which helps reduce the otherwise high level of market transaction costs (The costs of search, inspection, contracting, execution, control, and enforcement (Furubotn and Richter 2005, 51 f., 295).

63 As with regard to the legal side, the Sherman Act, Turner (1962, 671) argues that “oligopolists who take into account the probable reactions of competitors in setting their basic prices, without more in the way of an ‘agreement’ than is found in “conscious parallelism,” should not be held unlawful conspirators under the Sherman Act even though, as in American Tobacco, they refrain from competing in price.”
…if a manufacturer once loses his relative position in the market, he may never be able to regain it; the fate of Lorillard shows that (loc. cit. 86).

The three big firms watched apparently their market shares in the first place, not their profits. The result of the policy of high cigarette prices was that "independent" companies challenged the three big American cigarette producers in spite of their counteroffensive in 1933-34. "They were able to slow but (under the depressed economic conditions of the ‘30's) not to reverse the growth of their competitors." (loc. cit., 90, see Figure 2)

The counterattack of the big three came in Jan. and Feb. 1933. It was led by American with two successive slashes in the price of Lucky Strike, immediately followed by Camels and Chesterfield. (A 20% cut in the list price amounting to a 40% cut in the price to manufacturers after tax). The arguments, why Camels and Chesterfield followed are more or less the same as above. In the following year, Reynolds took over again its role as price leader and initiated the two price increases of January 1934 and January 1937. Both were attributed to high costs of leaf prices (Nicholls 1951, 121, 123).

Advertising expenditures of the big three cigarette producers decreased slightly during the period of their counterattack (1933-39) (Nicholls 1951, 129). The firms' shares in advertising expenditures remained more or less the same (Figure 3).

In spite of the counterattack, the economy brands took during the 30's an increasing share of the cigarette market. Nicholls (loc. cit. 126) reports:

During 1938 - in part reflecting the recession of 1937-38 and the entry of Lorillard into the economy-brand field - the position of the economy brands expanded to 14.2 per cent.

Unlike other independents, Philip Morris & Co and Brown & Williamson were able to establish new standard brands to fall back upon as the fortunes of the economy brands began to wane (loc. cit., 136). (Philip Morris became the dominant firm of the American cigarette market since the 1970s).

Conclusions 1931-39: Whatever the true reason was for the ca. 12 per cent price increase in the midst of an unprecedented economic crisis - the market order of price leadership among the three major producers remained intact. They seemed to have made a truce regarding their advertising activities to regain (unsuccessfully though) the terrain lost to the economy brands (Figure 2). In any case, advertising expenses decreased; the shares of advertising expenses remained different but assumed a certain continuity (Figure 3). Their counterattack was limited to two drastic price cuts led by American, the producer with the highest market share at that time. The cuts, however, were soon taken back (in 1934, 1937) under the leadership of the original price leader Reynolds. The quality of their product remained on its high level

---

64 Among them Brown & Williamson and Philip Morris & Co.
65 And Old Gold of Lorillard.
66 Besanko et al. (2004, 281)
67 Adams (1950, 252) comments that the major cigarette producers made large advertising expenditures which they would not have made "… if they were concerned solely to maximize the profits of the industry as a whole." The argument of the hostage character of advertising and its positive effect on product quality was unknown at that time.
throughout that time.\textsuperscript{68} The rational may have been, not to destroy their enormous investments into the credibility of their high quality promises.

The apparent joint effort of the big three cigarette producers to regain their pre 1931 common market share fits pretty well into Fellner’s (1949) or this author’s theory (Richter 1954) of quasi agreements between oligopolists with the purpose to maximize their joint profits or joint returns.\textsuperscript{69} However, both authors left no doubt that oligopolies are “inefficient”, i.e., socially undesirable market organizations.

What is the social gain of the continuation of the implicit agreement of suppliers to stick to their pre 1931 price leadership order? A new institutional economic answer could be: The three leading cigarette producers may have saved transaction costs by not messing around with their well established and proved implicit market order and for keeping up their high product quality. For the rest, the welfare arguments are the same as above. The defense of the higher price for brand name products would consist of the argument that consumers’ have to pay an extra “tax” to the three private market makers for their provision of the conveniences of the public good “market organization” of a high quality product. However, different from a public body (“the state”) private market makers bear the full risk of losing their investments in the provision public good “high quality market.”\textsuperscript{70}

Final remarks on price leadership: As Burns (1936, Ch. III) has shown, some kind of price leadership is present in many of the industries in which production is concentrated in large units. Burns describes the situation in the American steel industry, petroleum industry, agricultural implement industry, anthracite coal industry, can industry and others. He criticizes price leadership in the neoclassical zero-transaction cost style, viz., that leadership tends to increase manufacturing and marketing costs in efforts to control price competition. (Burns 1936, 144). Adams (1950) describes price leadership activities in further American industries like in the glass container, milk, tin plate industry. Kaplan, Dirlam and Lanzillotti (1958) provide an interesting report on price policy and pricing practices in American Big Business based on a series of interviews.

So much on implicit market organization in oligopolies. One may argue, the more actors on both sides of a market the less important implicit arrangements between competitors. However, that hardly corresponds with the facts.

4.1.2 Evidence of General Price Rigidity

There exists a growing empirical literature on the evidence of general price rigidity. Most papers are purely descriptive and have a different purpose, viz., to prove the hypothesis of the non-neutrality of money.\textsuperscript{71} Competitive issues are hardly or not at all taken into account. Findings are of the kind that on average prices remain unchanged for 4.1 or 7.9 months (Barharad and Eden, 2004), that annual price changes are by far the most typical (Blinder et al. 1998, 64), that the degree of price rigidity differs greatly across industries (Carlton 1989, 68 Of the four successor companies, only Lorillard entered the economy-brand field (Nicholls 1951, 92).

69 Which this author modified by assuming “maximization of joint returns” (Richter 1954).

70 Note: Private actors (buyers and/or sellers) will only provide the public good “market”, if they have a chance to at least regain their investments into the public good.

To understand price rigidity, Blinder et al. have asked two hundred firms why they don’t change their prices more frequently? The most frequent answer was: “I would antagonize or cause difficulties for our customers.” The next two equally frequent replies were: “Competitive pressures” and “costs of changing prices”. The first reply comes down to the same as the above described case of price leadership: abstention from price competition in favour of quality competition. The second answer corresponds to Coase’s argument of transaction costs or, in macro-economic language, to “menu costs”. Levy et al. (1997) measured menu costs at five multistore supermarket chains, and show that changing prices requires a nontrivial amount of resources. – Not amazingly, Barharad and Eden (2004, Appendix) that there seems to exist also kind of local price leadership among retailers.

In sum: Price rigidity is a widespread phenomenon that appears to be not only restricted to oligopolistic competition but also characteristic of (“neighboring”) monopolistic competitors. The same arguments as in the case of oligopolistic price leadership may apply for price stickiness; and given the conditions of the NIE, sticky prices may be socially preferable. Though there seem to be no detailed studies of price stickiness in relation to interdependent behaviour among competitors, sticky prices are hard to imagine without existence of a suitable implicit market order.

Social interdependence is a typical sociological issue. We therefore look into what economic sociologists have to say on implicit cooperation between marketers.

**4.2 Implicit Market Organization II: The Social Structure of Markets**

Economic sociologists emphasize the importance of the informal social structure of markets for their performance. For illustration two examples:

(1) Abolafia (1984) studied an open auction [double auction] of commodity futures in an American exchange. These auctions are held in “pits” where buyers and sellers stand facing each other in a multi-tired ring.

At the opening bell traders begin making offers to buy or sell. They use hand signals and strong voices to offer and accept trades across the pit. These trades are recorded by each of the parties. Trading does not stop after each transaction. It continues this way …. until the closing bell rings in the afternoon. (loc. cit. 132 f.)

To economists such gatherings of buyers and sellers are the representation of a perfectly competitive market described above. As a sociologist, Abolafia focuses on the social context of the observed actions in the pits and finds that what seemed to be near-anarchy between the noisily gesticulating traders is actually steered by a coordination and control system whose task it is “…to discover problems in the pit (e.g. under-capitalized traders or market concentration) and taking whatever corrective action necessary to protect market efficiency” (loc. cit. 147). Abolafia argues that this paradox is a central feature in the social organization of all markets. Markets are in effect coalitions of economic actors who compete with each other.

---


73 As Hamilton and Feenstra (1995, 61) put it: “Markets do not function in a social vacuum.”
other (as buyers and sellers) subject to an agreed upon system of “…informal norms among traders, formal rules of trade and organizational arrangements to coordinate collective action.” (loc. cit. 132) The implication would be that “competitive markets do not emerge and maintain themselves ‘naturally’ ”.

Abolafia’s insight seems to play an important role in all kinds of markets. The above treated case of price leadership is one example. Other examples offer markets that are characterized by rapid technical progress like in information technology. Thus Saxenian (1994, 46) observes in her Silicon Valley study:

> Even under relentless competitive pressure, an underlying loyalty and shared commitment to technological excellence unified members of the industrial community. Local firms both competed for market share and technical leadership and simultaneously relied on the collaborative practices that distinguished the region. The paradox of Silicon Valley was that competition demanded continuous innovation, which in turn required cooperation among firms. Nothing was prized more than individual initiative and technological advance, and these depended on the information, technology, and experience that resided in the Valley’s social and professional network.

(2) Granovetter (1974/1995) deals in his empirical study Getting a Job with the job search of professional technical and managerial workers. In his sample, personal contact is (social ties are) the predominant method of finding out about jobs. He finds, the relevant factors of finding a job is social. Job finding behavior is "...heavily embedded in other social processes that closely constrain and determine its course and results." (1995, 39). Of those people of his study finding a job through contacts, the majority saw their contact only occasionally or rarely, i.e., were only weakly tied with their contacts. Employers and employees would prefer to make use of personal contacts in securing labor market information. "They reason, correctly, that personal ties mean better information (loc. cit. 97). "Better" meaning, i.a., better filtered information. "Personal contacts narrow the range within this already narrowed group, and so do less cost than other methods." (loc. cit. 98). Social relationships between pairs of actors are interpreted by Burt (1992, 8 ff.) as their "social capital." They offer actors opportunities to use their individually owned financial and human capital more profitable and, thus, contributes to their individual wealth (is capital in its economic sense of the present value of expected net-income streams of the socially related actors).

(3) Burt (1992) deals in his book Structural Holes. The Social Structure of Competition with the transaction activities of "information" and "control" (what we would subsume under "contracting"). He views markets as networks of social contacts between actors and assumes the existence of positive transaction costs. Competition is the struggle of actors for profitable positions within market networks. Competitors profit from "information benefits" and "control benefits." Information benefits result from access to valuable pieces of information and knowing whom to bring it to; from timing in the sense of being informed early; and from

---

74 Teece (1992, 17) “There is no arena in which uncertainty is higher and the need to coordinate greater than in the development and commercialization of new technology.”

75 Including information about new opportunities like “…new institutions and projects that need leadership, new funding initiatives looking for proposals, new jobs for which you know of a good candidate, valuable items entering the market for which you know interested buyers” (loc. cit., 13).
referrals to players "...you do not know personally but are aware of you" (1992, 13 f.). The price you pay for an advantageous positioning within your market (to build ones brand name) is included in your expenses for fair selling practices (like money back guarantees “no questions asked”), research & development (“product differentiation”), advertising, for the establishment and cultivation of personal contacts etc.

In any case, real life markets are more than abstract systems of formal norms. Personal relationships matter economically. They can be understood as networks of informal relational ties between market actors (traders). Traders themselves are more or less heavily embedded in the more general social network of the local, national or global society. Ties between actors may be anything between strong and weak relationships (e.g., historically developed exchange opportunities on the one side, passing acquaintances on the other). To belong to such a network requires collective actions incl. material contributions. Long-term network relationships between economic actors ease local and global trade and thus help lowering transaction costs. Note that exchange networks are both, difficult to build and hard to demolish. To destroy them by plain force (war or revolution) takes more than ten or fifteen years - as is illustrated by the German Wirtschaftswunder of 1948 ff. in comparison with the slow adaptation of the East German economy to the West German situation after German reunification of 1990.76

4.3 Implicit Market Organization III: The Open Standard

Standardization is a way to combine product differentiation with product compatibility – provided the standard is not a proprietary standard or an official standard77 but an open one.78 Open standards emerge in various ways, e.g., spontaneously as in the case of QUERTY (if we follow David 1985) or by strategic managerial decisions as (possibly) in case of the evolution of “IBM compatible” personal computers. Still, they need not become exclusive standards as the IBM compatibility example shows: For personal computers continues to exist a proprietary standard of their central unit, viz., the microprocessor used by Apple Computers.

The birth of IBM compatible systems: In September 1980, IBM marketed its “IBM Personal Computer 5150” as a competitive attack of Apple Computers. It purchased for that purpose two non-exclusive licenses: from INTEL the license to use their central unit or CPU as basis of IBM’s Intel x86 architecture,79 and from Bill Gates the license to apply their disc-operating system for INTEL microprocessors - the MS-DOS (“Microsoft Disc Operating System”).80 As a result, IBM had created

76 As for the German Wirtschaftswunder, much of the pre 1933 global personal and business connections still existed or were easily revived in 1948. Big West German corporations like Mercedes, Siemens, Bosch, Leitz etc – and West German small and medium-sized firms and their networks of national and international contacts still existed. On the other hand, East Germany had lost all of its old firms and business contacts by 1990. It had to start virtually from scratch.

77 As a privately or publicly agreed upon de jure standard, e.g., developed by the International Organization for Standardization (ISO) or the Deutsche Institut für Normierung (DIN) and introduced by law or decrees.

78 On the evolution of compatibility standards see David and Greenstein (1990).

79 It went later under names such as Pentium. While IBM computers operate with control units from INTEL, those used by Apple come from Motorola.

80 A story of its own, see Kaplan (1999, 107ff.). He reports also on the short existence of a soon out-competed operating system used by IBM (the CP/M system developed and owned by Gary Kindall; loc. cit. 114).
IBM’s setting of the course, a clear act of visible hands, contributed decisively to the explosive developments of modern information technology. That may have been good for society, though, not for the trailblazer IBM. The big profiteers of IBM’s managerial decision were INTEL and Microsoft - with Microsoft’s operating system coming for a while near a closed standard.  

The evolution of IBM compatible systems, thus, is the (planned or accidental) result of a strategic maneuver - of a competitive attack the market leader IBM against the rising star of Apple Computers and its Macintosh Operating System.

5. The Choice of Market Order in Retrospect

The basic argument of this paper is that markets are not given by nature but have to be set up and managed by individuals like firms or other types of organizations. Our argument comprises a mountain of problems, of which we picked a rather modest one: that of implicit forms of market organizations (“informal governance structures” of markets) and their (possible) social benefits. This had the advantage that we could fall back on, and reinterpret, an existing and well known set of theories of oligopoly and monopolistic competition and its related empirical work. Under the conditions of the NIE, the (Nash) equilibrium of an oligopoly or monopolistic competition may be taken as a socially useful (even preferable) implicit order (governance structure) of the organization “market”, e.g., the American cigarette market. As a result, the violation of the conditions of perfect competition in cases of oligopoly or monopolistic competition may be less than neoclassical economists thought. It may be even nil. Price leadership may be understood as an institution or, in our language, as a collectively agreed upon implicit order (governance structure) of the organization “market” within which competition takes place by means of advertising and R&D expenditures. Its social advantage may consist in the achievement and guarantee of high product quality and the reduction of the costs of using the market.

As for the rest, a market economy may be seen as a persistent network of tacit agreements (meeting of the minds) between marketers. Its order may be understood as a Nash equilibrium whose establishment and administration requires specific investments of real resources that Burt (1992) calls social capital. Thus, the collective good “implicit market order” (informal market governance structure) of a market economy (or single market) can be understood also as the outcome of specific investments in the social capital of a market organization. Market makers (in our examples producers) pay in advance, e.g., by their R&D and marketing expenses for the provision of the collective good “implicit market order” (informal market governance structure). They are interested, of course, to protect their investments into market

---

81 Decisive was probably that IBM did not demand or did not receive an exclusive license.
82 Microsoft kept its source code until recently secret. (A source code is a program that is to be utilized by another program (the translator). The source program is mostly translated into machine language, which can be directly processed by the CPU.)
83 Because neither was exclusive to IBM, and within a year other companies had worked out how to make much cheaper „clones“ of its PC. (The Economist, July 29th – August 4th 2006, 37) Still, IBM had expected to sell 250,000 unites in five years. In the event, it had sold nearly 1m by 1985. (ibid.)
specific social capital (a collective good) against ex post opportunism (= free riding) of competitors.\textsuperscript{84} Consumers, on the other hand, contribute to the collective good “implicit market order” only later on the condition that they actually “go to that market” and buy its product. The financiers of the market entrepreneurs (“market makers”), who supply the collective good “implicit market order,” carry the financial risk of its provision.

We claim that implicit orders (informal governance structures) characterize all markets – the organized (like stock exchanges) as well as the non-organized ones (like the cigarette industry). The latter have to be established, financed and managed in a way similar to formal market organizations or firms. Leadership “by example” – as in the case of price or quality leadership - or shrewd managerial strategies (as in the case of the evolution of “IBM compatibility”) can play an important role.

We justified our decision to deal only with problems of implicit market organization by the fact that a full treatment of the choice of the market order or organization (or governance structure) by traders would surpass the limits of a conference paper. In actual fact, it surpasses the limits of our own research work up till now. For a German economist, used to persistent national debates on 	extit{Soziale Marktwirtschaft} or 	extit{Soziale Gerechtigkeit}, the addition of theories of and empirical work on special interest politics would be of primary concern for a new institutional economics of the market. It is hard to believe that under real world conditions (as those of the NIE) traders will always choose the economically best (most “efficient”) order of their aimed at market order. Politicians are no saints either. North rightly argues against the view: “…that institutions are created only to reduce transaction costs and increase economic efficiency.” The reason for inefficient institutions are inefficiencies of political markets, “…democracy in polity is not to be equated with competitive markets in the economy.” (North, 1990, 8, 52 f). There exist many ways to influence the determination of equilibrium prices round the back, e.g., through activities of interest groups, political parties, powerful individuals etc. As for antitrust policy, the impression of an outsider (like this author) is that its advocates think of the economy as of a world separated from the polity. Antitrust arguments are at most applied to economic coordination mechanisms, not to political ones. It is as if society would be neatly separated into two halves: commerce and politics. But real world markets do not work in a political vacuum. Look at German labor market policy. An equilibrium price or wage may be better understood as being part of a more general political-economic (bad) Nash equilibrium. If we wish to understand economic policy issues, not only transformation or development economics, we need to be able to better explain the complex system of political-economic relations under condition of the NIE – both with regard to its positive and its normative aspects.

\textsuperscript{84} The regulation of barriers to entry depends on the role model of competition, see, e.g., C.C. v. Weizsäcker (2005 58 f).

\textsuperscript{85} Reynolds was not only a price leader but also a “quality leader” of the American cigarette market of the early 20th century. Similarly, IBM turned out to be a quality leader of the market for personal computers by the introduction of the open standard “IBM compatibility”.

Figure 1
Data from Nicholls (1951), p. 61 Table 16, p. 91, Table 24.

Year: 1925 – 1939

Reihe 1: American (Lucky Strike)
Reihe 2: Ligget & Myers (Chesterfield)
Reihe 3: Reynold (Camel)
Reihe 4: Lorillard (Old Gold)
Cigarette Production: Four Successors & Five Independents

Data from Nicholls (1951), p. 61 Table 16, p. 91, Table 24.

Year: 1925 – 1939

Reihe 1: Successors (American, Ligget & Myers, Reynolds, Lorillard)
Figure 3
Advising expenses: magazines, newspapers, chain radio time
Data from Nicholls (1951), p. 131, Table 37.
year: 1931 - 1939

Reihe 1: Reynold (Camel)
Reihe 2: American (Lucky Strike)
Reihe 3: Ligget & Myers (Chesterfield)
References


Arrow, K.J. (1953), ,,Généralization des theories de l’equilibre économique général et du rendement social au cas du risque,“ Econométrie, Paris, Centre National de la Recherche Scientifique, 81 – 120.


Arrow, K. J. (1970), Essays in the Theory of Riskbearing, Amsterdam: North Holland


http://www.coll.mpg.de


Levine, D., Locke, Chr., Searle, D., Weinberger, D. (2000), the cluetrain manifesto. the end of


