

## CONFERENCE REPORT

### EVOLUTION OF INSTITUTIONS AND THE KNOWLEDGE ECONOMY

#### How Do Institutions Evolve?

The Faculty of Economics and Business Administration of the University of Debrecen in collaboration with the Regional Committee of the Hungarian Academy of Sciences (HAS) and the Information Economy and Identity Scientific School of the Hungarian Scientific Research Fund (OTKA) held an international conference on the *Evolution of Institutions and the Knowledge Economy* on 4–5 October 2002 in Debrecen, Hungary. The primary goal of the conference was to contribute to the spread of the ideas of the New Institutional Economics (NIE)<sup>1</sup> in Hungary. In this spirit, the conference gave a platform to Hungarian and foreign researchers to discuss the processes and phenomena of the knowledge economy from the perspective of the NIE.

Three keynote lectures were given at the plenary session, and 35 presentations came out of three sessions. Most of the 28 Hungarian researchers and all of the 10 foreign participants came from the academic sector. Besides the lecturers, many other representatives of the Hungarian academic world and persons from the written media in the area of economics showed interest in the conference.

This report is not an overview of the conference presentations. Because of a lack of space it is impossible to analyse all session presentations or make a selection among them.<sup>2</sup> Instead, after a short résumé of the sessions' subject-matter I will focus only on the keynote lectures; I also intend to make some comments on them and give a subjective interpretation of them.

The session *Institutions of the Knowledge Economy* concerned itself with the question of a firm's evolution. A large part of the presentations focused on one special problem of a firm – such as learning, problems of getting information,

<sup>1</sup> NIE is one of the most important branches of economics that differs largely from mainstream economics. It borrows liberally from various social-science disciplines, though its primary language is economics. Its goal is to explain what institutions are, how they arise, what purposes they serve, how they change, and how – if at all – they should be reformed.

<sup>2</sup> For details see the web site of the conference: <http://www.econ.klte.hu/conference>.

knowledge management, competitiveness, strategy – from the perspective of the knowledge economy. Another part of the presentations gave a contribution to a theoretical understanding of the hybrid forms (joint venture, franchising), in some cases using empirical investigations.

Papers presented in the session *Policy Issues in the Knowledge Economy* looked at questions pertaining to the institutional environment and public policy. Some topics, like the challenges of EU accession, the role of foreign capital and that of venture capital, dealt with the transitional economies. Other researchers talked about were theoretical understandings of transition, the regulation of B2B commerce, and growth fluctuations.

The issues of the third session *Behaviour, Identity and Institutions* perfectly complemented those of the first two because it gave explanations for the actors' behaviours, especially in an analysis of rationality and cognitive aspects penetrating the NIE.<sup>3</sup> The researchers dealt (among other concerns) with the behavioural aspects of institutions – that is, with issues of creativity, altruism, the role of the culture and attitudes.

Another goal of the conference was – besides allowing researchers to report their research results – to get Hungarian new institutionalists acquainted with some prominent NIE researchers. The keynote lecturers, namely R. N. Langlois (University of Connecticut), C. Ménard (University of Paris 1; president of ISNIE<sup>4</sup>), L. Benham (Washington University, St. Louis; Ronald Coase Institute), are all world-renowned, and they are respected representatives of the NIE.

Langlois gave an outstanding lecture on *The Vanishing Hand: the Changing Dynamics of Industrial Capitalism*. His vanishing hand hypothesis is about a process that came at the beginning of the 1990s, i.e. the time when the term 'knowledge economy' was established. What was the process Langlois was referring to?

In order to interpret Langlois' discourse, a good starting point would seem to be if we look at the processes moving towards hybridisation – in the sense of Zenger and Hesterley (1997). According to them, we are witnessing two underlying trends. On the one hand, market-like elements are penetrating a firm – i.e. the hierarchically-centralised, vertically-integrated firm is disappearing; and, on

<sup>3</sup> More and more attention is being given behavioral and cognitive issues in economics. This has been proved by the fact that, in 2001, one of the Nobel prizes in economics was given to Daniel Kahneman for his research in psychological economics.

<sup>4</sup> ISNIE (International Society for New Institutional Economics) was founded in 1996. Its first two presidents, Ronald Coase and Douglass North, are Nobel-prize economists. Nowadays, ISNIE is one of the most important international economic societies. For further information see: <http://www.isnie.org>.

the other hand, the market is becoming infused with firm-like characteristics. Richard Langlois' concerns deal with the first tendency.<sup>5</sup> He refers to this process as the vanishing hand. This means that co-ordination by management (visible hand) is replaced by market co-ordination (invisible hand).

Professor Langlois explains this process as follows. Environmental uncertainty requires some form of buffering. The types of buffers to be used depend on space and time. Langlois showed us, through the history of the US economy, that the managerial revolution of the 19th century was an appropriate buffer for its time – like the market is in today's knowledge economy. Yet why is this so?

An increasingly fine division of labour, due to standardisation and a focus on core competencies, will lead to greater modularity in the knowledge economy. Modularity diminishes the need for management and integration as buffers. The reason for this is that the need for co-ordination among components is not so intense here – and, indeed, it is not characteristic of non-modular systems, such as the firm (Langlois 2002). Among economic systems, it is the market that is most modular. Accordingly, the market is the most effective mechanism in transferring information and knowledge – as Hayek (1945) argued.

The vanishing hand hypothesis is not about the end of management as such because we will always need management as human's cognitive capabilities. What was emphasised by Langlois, though, was the changing comparative advantage with regard to the buffering of uncertainties in connection with market and human cognitive capabilities. Today's trends simply favour the market; and the vanishing hand refers to this.

To put it another way, while market and management exist in parallel, in different given situations, one of them predominates, i.e. has a comparative advantage. The last decade should be considered a turning point in this balance of comparative advantage.

The topic of the second keynote lecture *The Governance of Hybrid Forms* by Ménard was closely related to Langlois' theme. He also dealt with the problems of hybridisation, but from a different perspective. The fact that there is no agreement among researchers on the nature of the firm and of the market can be highlighted here. While Langlois defines the market in a broad sense, Ménard, following the Williamsonian tradition (Williamson 1991), sharply distinguishes hybrids both from the market and the firm. What is called a hybrid (a network,

<sup>5</sup> For him, the market has a broad meaning: it encompasses not only spot contracts but, in addition, a wide range of forms with firm-like characteristics – for instance networks, alliances, supplier chains. Note that these forms are seen by some other authors (Hodgson 2002; Powell 1990; Williamson 1991) as a third distinctive form existing besides the market and firms.

franchise, etc) by Ménard is regarded as the market by Langlois. Yet Ménard went on to look at the distinctive features of hybrid forms.

The lecture gave a detailed analysis of the role of authority and the question of how to distribute quasi rents in hybrid forms. After identifying the attributes that make hybrid forms specific structures, Ménard examined the issue of the variety of hybrid forms. On the basis of a previous empirical investigation (Ménard 1996) – according to which there exist a large number of different hybrid forms within an industry – the question of why there are so many efficient hybrid forms was put on this occasion. Clearly, the form parties choose cannot be accidental. According to Ménard, the given form depends on the characteristics of given transactions. It was not said explicitly, but our speaker might have assumed that for a given transaction, on the basis of its features, one of the hybrid forms would have a comparative advantage vis-à-vis the others – which would explain the variety of such hybrids.

There is no doubt that hybrid structures are gaining ground in the knowledge economy, which makes their study especially interesting and important.

I think that the works of the two professors here have served to complement each other. Both have been concerned with the same process, namely the process of hybridisation, though from different perspectives: Langlois discussed the issue of the penetration of market-like elements into a firm, while Ménard examined the problem of why the market is becoming more firm-like.

L. Benham's lecture on *Heterogeneity in Market Outcomes: an Approach from New Institutional Economics* as well as Ménard's belong to the field of transaction cost economics. The notion of transaction cost is central to NIE yet, surprisingly, its concept is rather vague, not having been clearly defined anywhere.<sup>6</sup> The original Coasean transaction cost concept as "marketing cost" (Coase 1937) has been widened – and diluted – to a significant degree.<sup>7</sup> Professor Benham's concern was not to discuss the definitional problem as regards transaction costs, although he did mention it. He introduced a new notion, namely the "cost of exchange". For him, this is the opportunity costs faced by an individual in obtaining a specified good, using a given form of exchange, within a given institutional

<sup>6</sup> Note that the definitional problem as regards the transaction cost is not the only one in NIE. Similarly, the notions of the firm and the market are also not clear-cut. However, an understanding of economic processes requires unambiguous concepts. It seems that one of the methodological problems of the NIE lies in the use of non-clearly defined concepts. More intensive efforts – following the work of Hodgson (2001; 2002) – are needed to thus define these notions in a clear-cut way.

<sup>7</sup> For instance, the first speaker, Langlois (1992), introduced the concept of dynamic transaction costs that arise in real time in the process of acquiring and coordinating productive knowledge.

setting. As Benham pointed out, the cost of exchange includes the price of the good itself plus the transaction cost of obtaining the good. Thus, the notion of transaction cost is being used with a Williamsonian meaning.

Benham focused on the differences in the costs of exchange. The professor thinks that costs of exchange can differ among individuals, groups and countries – that is, they are specific with regard to individuals, the form of exchange and to institutional setting. This has been proved by Benham's empirical research.

The importance of these ideas lies in their capacity to enlarge the domain in which the traditional theoretical price model can be applied. The cost of exchange has to be seen as the relevant price that individuals face. The individual- and institution-specific character of prices provides an explanation for price differences in a competitive market.

Perhaps we do not exaggerate when saying that the international conference on *Evolution of Institutions and the Knowledge Economy* held in Debrecen has to be ranked among the most prominent of the economic conferences held in the region in 2002. We hope that this conference will give a push to Hungarian research work in the NIE and will contribute to the further development of this branch of economics. Certainly, the work of the *Hungarian Society of New Institutional Economists* (HUSNIE) will help in this process, the foundation of which was announced in the course of this conference. The primary aim of HUSNIE is to promote and co-ordinate research projects in the field of NIE as well as to encourage co-operation with foreign research groups and to organise workshops.

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