

Public and Private Bureaucracies: A Transaction Cost Economics Perspective

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The public bureaucracy is a puzzle. How is it that an organizational form that is so widely used is also believed to be inefficient—both in relation to a hypothetical ideal and in comparison with private bureaucracies? This article examines public bureaucracy through the lens of transaction cost economics, according to which the public bureaucracy, like other alternative modes of governance, is well suited to some transactions and poorly suited to others. Rather than proceed in a completely general way, I focus on what James Q. Wilson describes as “sovereign transactions,” of which foreign affairs is an example. I ask what it is that distinguishes sovereign transactions, after which I compare the efficacy of public and private bureaucracies for managing such transactions. I conclude that there is an efficiency place for public bureaucracy, but that all modes of governance (markets, hybrids, firms, regulation), of which public bureaucracy is one, need to be kept in their place. I further observe that public bureaucracies are not all of a kind and that differences between them need to be distinguished.

The public bureau has had a mixed reputation within economics. At the one extreme is the older and resilient (but increasingly discredited) public finance tradition, where public agencies (and the government to which they report) are treated as “omnipotent, omniscient, and benevolent” instruments (Dixit, 1996:8).¹ The property rights view—that the public agency is a haven for inef-

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1. Although it is widely believed that these are yesterday’s misconceptions, benevolent government has a lasting appeal, as the recent summary of the conference volume on *Confucian Traditions on East Asian Modernity* discloses (Wei-Ming, 1996:12–39). Thus Tu Wei-Ming reports that in the

efficiency, relief from which will be realized only if property rights are correctly assigned and the activity in question privatized—stands at the opposite extreme.

Things, however, have been changing as new developments in incentive theory (Tirole, 1994), transaction cost politics (North, 1990; Dixit, 1996), and incomplete contracting (Hart, Shleifer, and Vishny, 1997) have been brought to bear. This article works out of the transaction cost economics perspective.

Transaction cost economics views the public agency as a candidate mode of governance that is well-suited for some purposes, poorly suited for others. For which transactions is the public agency well-suited and why? Where does the public agency fit into the overall scheme of economic organization?

Several moves are needed to answer these questions, the first of which is to supplant the idea of the public agency as a benign, technical entity (in which production costs are featured) with the concept of the public agency as a flawed, organizational entity (in which transaction costs are featured). Just as the study of business organization benefited from recognizing “the inadequacy of the neoclassical view of the firm and [developing] richer paradigms and models based on the concepts of various kinds of transaction costs. . . , [so does] policy analysis . . . stand to benefit from . . . opening up the black box and examining the actual working of the mechanism inside” (Dixit, 1996:9). Because all feasible modes of organization are flawed, the strengths and weaknesses of each candidate mode need to be assessed comparatively. The discrete structural attributes that define and distinguish the public bureau and are responsible for its powers and limitations thus need to be identified and explicated. Relatedly, the puzzle of why a private firm is unable to replicate the public agency needs to be addressed.

The third move is to ascertain the attributes of transactions to which the public agency affords a (comparatively) efficacious governance response. The attributes that distinguish public sector transactions thus need to be identified and explicated. Such an effort quickly encounters another problem: public sector transactions are not all of a kind. Among the different classes of public sector transactions that are herein distinguished, I focus especially on what James Q. Wilson (1989) refers to as sovereign transactions, of which foreign affairs is an example. This fourth move is motivated by the prospect that the “study of extreme instances . . . [will provide] important leads to the essentials of the situation” (Behavioral Sciences Subpanel, 1962:5). Thus although almost no one recommends that the foreign affairs transaction be privatized, what is it

East Asian [Japan and the Four Mini-Dragons (South Korea, Taiwan, Hong Kong and Singapore)] cultural context “government leadership is deemed indispensable for a smooth functioning of the domestic market economy and vital for enhancing national comparative advantage in international competition. The central government is expected to have a holistic vision of the nation and a long-term plan to help people maintain an adequate livelihood so they can attain their aspirations of human flourishing” (1996:25). He further ascribes strong moral authority to the government and observes that “in self-understanding or in public image, the political leader ought to be a teacher as well as an example and a public servant” (Wei-Ming, 1996:25–26). The idea of duty is prominent: “Duty consciousness prompts East Asian moral and political leaders to act so as to enhance the public good” (Wei-Ming, 1996:27).

about foreign affairs that makes this an “obvious” candidate for governance by a public bureaucracy? Why is privatization comparatively unsuited?

Section 1 examines contrasting views about the relevance and lessons of transaction cost economics for the study of public bureaucracies. The rudiments of the transaction cost economics setup out of which this article works are sketched in Section 2. The remediableness criterion for assessing efficiency is advanced in Section 3. Different classes of transactions for which public bureaucracy is a candidate mode of organization are discussed in Section 4. Attention is thereafter focused on sovereign transactions. The added “probity hazards” that are posed by sovereign transactions/foreign affairs and the manner in which a public bureaucracy effects hazard mitigation are examined in Section 5. The impossibility of replicating a public foreign affairs bureaucracy by a private bureaucracy or by regulation are treated in Section 6, after which the comparative attributes of private bureaucracy, regulation, and public bureaucracy are displayed. An overview is sketched in Section 7. Conclusions follow.

1. Transaction Cost Politics?

As with prior applications of transaction cost economics to politics, I focus on the federal level. Earlier treatments that relate closely to the issues addressed here include Wilson (1989), Moe (1990, 1997), North (1990), and Dixit (1996).

1.1 The Politics of Inefficiency

Terry Moe was among the first political scientists to encourage the application of the “new economics of organization” to politics (Moe, 1984) and has been a continuing supporter of this project ever since (Moe, 1997). Because of significant differences between the public and private sectors, however, Moe holds that the “new economics of organization will have to be modified in essential ways” to deal effectively with public bureaucracy (Moe, 1990:119).²

For one thing, the salient attributes of American democracy—separation of powers, periodic elections, majority rule—auger against efficiency: “the most cherished structural features of American government pose obstacles to good administration” (Derthick, 1990:4). This is compounded by the insecurity of property rights that is inherent in democratic politics. Insecure property rights in combination with the American separation of powers “makes new laws exceedingly hard to enact” and yields a bureaucracy that is “vastly overformalized and disabled by its own organization” (Moe, 1997:472). Evidently politics is inimical to efficiency.

2. Applications of “new economics of organization” to public agencies come in several forms. Tirole (1994) applies incentive theory to study public agencies. Hart, Shleifer, and Vishny (1997) have more recently employed the property rights approach (Hart, 1995). Dixit (1996) and I work out of the transaction cost economics setup. Of these three approaches, Tirole works at a high level of abstraction and makes the greatest provision for the influence of politics. The Hart, Shleifer, and Vishny article is more explicit about public/private mechanisms and focuses on services (prisons, schools, refuse collection) for which privatization is frequently urged. This article goes further into the microanalytics, with special emphasis on sovereign transactions.

Also, Moe questions whether agency theory or transaction cost economics carry over from the private to the public sector. Consequential differences between the economics and politics of organization to which Moe refers include the following: (1) the basic comparison between markets and hierarchies in private sector transactions does not apply, it being the case that “there are no markets” for most goods and services supplied by the government (Moe, 1990:119); (2) although private sector actors can be presumed to structure their relationships efficiently, that presumption does not apply to politics because (a) political actors are unable to sell their rights to exercise public authority (Moe, 1990:121) and (b) the needs for compromise in politics give rise to expediency rather than efficiency in the design of public bureaus (Moe, 1990:125–127);³ (3) whereas mutual gains from trade accrue to voluntary private sector agreements, public authority is involuntary (coercive), so the presumption of efficiency gains is further jeopardized; and (4) whereas asset specificity has been the big locomotive for studying many private sector transactions, such is not the case in the public sector.⁴

Douglass North’s paper, “A Transaction Cost Theory of Politics” (1990), is less concerned with the public bureaucracy as an organizational form than it is with the efficiency of the public choice process. According to North (1990:360), the efficiency of politics is to be judged by examining how closely an actual political market “approximates a zero transaction cost result.” On that criterion, actual “political markets [are] inherently very imperfect” (North, 1990:361). Indeed, North contends that political markets are not merely imperfect with respect to a hypothetical ideal, but they also compare unfavorably with economic markets: “Political markets are far more prone to inefficiency” (North, 1990:362), there being a “tendency of politics to produce inefficient property rights” (North, 1990:365). Like Moe, North (1990:360–361) contends that “Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with bargaining power to create new rules.” The idea that politics is a haven for inefficiency is supported by the fact that “high transaction cost issues gravitate to the polity” (North, 1990:372).

As developed below, I agree with Moe that politics is different, yet argue that efficiency reasoning can and does apply to politics. As against North, I argue that a zero transaction cost criterion should be supplanted by the remediable-ness criterion. Also, whereas North’s assessment of public and private is an “apples and oranges” comparison, efficiency needs to be assessed with respect

3. There is a long literature, much of it originating in Chicago, that politics is efficient (Stigler, 1971, 1992; Peltzman, 1976; Becker, 1983, 1989; Wittman, 1989). This literature works at a high level of generality and deals neither with the design of public bureaus nor with comparative institutional analysis. [As Moe (1990:129) describes it, this literature “proudly ignores institutions altogether”.] The main contribution from the stream of research to which the present article relates is that of Stigler (1992).

4. Moe questions that either transaction costs in general or asset specificity in particular are “the keys to choice” in the world of politics (1990:123).

to a common transaction. Finally, high transaction issues “gravitate” to the polity because public bureaucracy, for some transactions, is the best feasible response—its apparent inanities notwithstanding.⁵

1.2 Rival Perspectives

Wilson (1989) and Dixit (1996) are more sanguine about the applicability of transaction cost economics. Thus although Wilson (1989:347) laments that economic theory “gives us little guidance to how government should carry out its responsibilities,” he entertains the possibility that a comparative contractual approach could help to unpack the puzzles (1989:358).⁶ Wilson’s view that “The best way to think about [the efficiency of a government agency] is to ask whether we would be willing to have the same product or service delivered by a private firm” (Wilson, 1989:331) is wholly congruent with transaction cost practice. But while Wilson invites the application of transaction cost economics to politics, he also cautions that “Careful attention to transaction costs will not alone determine where [the] line should be drawn” (1989:359). Not only is the output of government “complex and often controversial” (Wilson, 1989:348), but agencies often have “multiple objectives, government programs have distributional effects, and considerations of equity and accountability are often important” (Wilson, 1989:348).

Dixit’s examination of *The Making of Economic Policy: A Transaction-Cost Politics Perspective* (1996) expressly undertakes to study economic policy making through the lens of transaction cost economics (1996:xiv, 31–36, 45–62). Dixit thus works out of an incomplete contracting setup in which bounded rationality and opportunism are featured (1996:53–56) and holds that the object is “to understand how the combined economic-political system evolves mechanisms to cope with the variety of transaction costs that it must face” (Dixit, 1996:xv). He also eschews normative analysis in favor of the study of alternative feasible forms of organization, all of which are flawed (Dixit, 1996:xv, 39, 77).

As between viewing the firm/public bureaucracy as a production function (a technological construction) or as a governance structure (an organizational construction), Dixit favors the latter. Accordingly, the earlier normative, black box optimizing apparatus gives way to the positive analysis of “various kinds of transaction costs” in which the “actual workings of the mechanisms inside” are examined (Dixit, 1996:9). Of these mechanisms, credible contracting is a recurrent theme (Dixit, 1996:62–66).⁷

5. If economizing purposes are being served and if political markets are especially prone to inefficiency, then one would expect that high transaction cost issues would be assigned to private sector governance structures, where superior economizing properties purportedly reside.

6. Not only have “businesses as well as governments . . . collected trash, swept streets, operated buses, managed hospitals, and run schools, [but] some of us are aware that private security firms have more employees than do municipal police departments . . . [and] the historically minded among us will recall that at one time private banks issued their own money and nations going to war hired mercenary armies” (Wilson, 1989:346). Indeed, fire fighting “was once done almost exclusively by private firms” (Wilson, 1989:346). The same is true of lighthouses (Coase, 1974).

7. Because political contracts work through the political process and because politics and eco-

1.3 What are the Questions?

The foregoing raises, directly or indirectly, a series of questions, answers to which will be attempted in the remainder of this article. The key questions are

- Q.1 What is the basic transaction cost economics setup (Dixit, North)?
- Q.2 What, if any, added hazards are posed by transactions that are organized in the public sector (Dixit, Moe, North, Wilson)?
- Q.3 What governance structure attributes would serve to mitigate these hazards, and does the public bureaucracy possess these attributes (Dixit, Moe, Wilson)?
- Q.4 Can a private bureaucracy, with or without the support of regulation, replicate the attributes of public bureaucracies (Wilson)?

Briefly, my responses are these:

- A.1 Always and everywhere, transaction cost economics compares feasible alternative modes of organization with reference to an economizing criterion.
- A.2 Sovereign transactions pose added hazards of probity.
- A.3 Added leadership, staffing, and process ramifications accrue thereto.
- A.4 Replication of a public bureau by a private firm, with or without the support of regulation, is impossible.

2. Transaction Cost Economics: A Sketch

The transaction cost approach to economic organization has been described elsewhere (Williamson, 1989, 1996, 1998). I merely sketch the highlights here.

2.1 Human Actors

Transaction cost economics concurs with Herbert Simon (1985) that the cognitive and self-interestedness attributes of human actors are core to the study of economic organization and describes these as bounded rationality and opportunism, respectively. All complex contracts are unavoidably incomplete because of bounded rationality, and contract as mere promise, unsupported by credible commitments, is not self-enforcing by reason of opportunism. As between myopic and farsighted contracting, transaction cost economics assumes that economic actors have the capacity to look ahead, recognize potential hazards, and factor these into the organizational design.

nomics are different, political contracts are “more complex and harder to enforce” (Dixit, 1996:48). Not only do political contracts have to be responsive to multiple principals, but political contracts are vague. Also political contracts are beset by loopholes (Dixit, 1996:48–49). Both Dixit and Jean Tirole (1994) interpret the low-powered incentives of public bureaus as a response to the added complications that accrue to multiple agency (1996:157–171). Because of the comparative weakness of natural selection in the political arena, the presumption of efficiency in political markets is weaker (Dixit, 1996:59).

2.2 Governance

John R. Commons anticipated much of the conceptual argument in his insistence that “the ultimate unit of activity . . . must include in itself the three principles of conflict, mutuality, and order. This unit is a transaction” (1932:4). Not only does transaction cost economics agree that the transaction is the basic unit of analysis, but it views governance as the means by which *order* is accomplished in a relation in which potential *conflict* threatens to undo or upset opportunities to realize *mutual* gains. Operationalizing this through the discriminating alignment hypothesis—according to which transactions, which differ in their attributes, are aligned with governance structures, which differ in their cost and competence, so as to effect an economizing result—entails (1) identifying the key attributes with respect to which transactions differ,⁸ (2) stating the core purposes/trade-offs of organization, and (3) identifying the structural attributes with respect to which governance structures differ. Economizing on transaction costs is held to be the main case (which is not to say the only case), in relation to which adaptation is the central problem of (private sector) economic organization.

Adaptations of two kinds are distinguished: autonomous adaptation (Hayek, 1945) and cooperative adaptation (Barnard, 1938). Markets enjoy the advantage in autonomous adaptation respects, but the advantage shifts to hierarchy as the needs for cooperative adaptation build up. The recurrent trade-off with which transaction cost economics is concerned is thus between the benefits/costs of autonomy and cooperation. Governance structures that feature autonomy encourage independence and enterprise. Governance structures that feature cooperation encourage greater compliance and a stronger systems (or mission) orientation.

The distinction between subgoals and global goals is useful in this connection. Absent bounds on rationality, every system would be organized to optimize global goals.⁹ Because efforts to continuously optimize with respect to the entire system place bounds on rationality under great strain, and since composite projects can often be “broken down into a sequence of small tasks, the conjunction of which adds up to the accomplishment of the larger” (March and Simon, 1958:151), simplification can be realized by factoring problems into “a number of nearly independent parts, so that each organizational unit handles one of these parts and can omit the others from its definition of the situation” (March and Simon, 1958:151). March and Simon nevertheless con-

8. Indeed, absent bounded rationality, comprehensive central planning becomes feasible—which can be interpreted as having everything organized in one large firm.

9. The key attributes out of which transaction cost economics works are asset specificity, uncertainty, and frequency. Asset specificity has reference to the degree to which an asset that is used to support a transaction can be redeployed to alternative uses and users without loss of productive value. Highly specific investments give rise to a condition of bilateral dependency. Uncertainty presents the need for adaptation and, in the face of bilateral dependency and incomplete contracting, poses the hazard of maladaptation. Frequency is also a pertinent dimension, in that recurrent transactions may support the setup costs of specialized governance and have better reputation effect properties.

cede that “The tendency of members of an organizational unit to evaluate action only in terms of subgoals . . . [can result in] conflict with the goals of the larger organization” (1958:152), but the conflicts to which they refer are entirely of an instrumental (as against strategic) kind: individuals and groups sometimes miss interaction effects because they are narrowly focused on the tasks to which they have been assigned.

Opportunism complicates subgoal pursuit by introducing strategic efforts to gain local advantage at the expense of the larger group of which the transaction is a part. Specifically, subgoal pursuit will be expanded to include the strategic use of asymmetric information, the strategic interpretation of contractual ambiguities, and recourse to perfunctory cooperation when net local advantages can be projected.

Such hazards are nevertheless held in check under conditions where identity is unimportant and competition obtains. As, however, identity matters, continuity takes on economic importance and what may have been a large numbers supply relation at the outset is transformed into a small numbers exchange relation thereafter. Discrete contracts give way to long-term incomplete contracts in which value will be realized if bilaterally dependent parties can be induced to adapt to disturbances in a cooperative way. Added governance structure supports—to include sharing and verifying information and crafting private ordering (as against legalistic) dispute settlement mechanisms—appear. In the limit, as maladaptation hazards become especially great, interfirm contracting is supplanted by unified ownership (internal organization).

Transaction cost economics holds that alternative modes of governance differ in discrete structural ways.¹⁰ Incentive intensity, administrative controls, and contract law regime are the key attributes out of which private sector governance works. As among market, hybrid, and hierarchy, the market mode supports autonomy by combining high-powered incentives with little administrative control and a legalistic dispute settling mechanism; hierarchy supports (internal) cooperation by combining low-powered incentives, extensive administrative control, and resolving most disputes within the firm—where the firm serves as its own court of ultimate appeal; and hybrid contracting is located between market and hierarchy in all three respects.

Table 1 summarizes the foregoing and provides a skeletal basis for interpreting the public bureaucracy as yet another discrete structural mode of governance.

10. As Simon has observed, marginal analysis and discrete structural analysis can be distinguished by the questions they ask. With reference to the employment relation, for example, the issue of “at what levels will wages be fixed?” is very different from “when will work be performed under an employment contract rather than a sales contract?” (Simon, 1978:449)—where the first of these questions is of a marginal and the second of a discrete structural kind. More generally, Simon avers that as economics “moves beyond its central core of price theory . . . we observe in it . . . a shift from . . . equilibration at the margin . . . to a much more qualitative institutional analysis, in which discrete structural alternatives are compared” (1978:449).

Table 1. Attributes of Private Ordering Governance Structures

Attributes	Governance Structure		
	Market	Hybrid	Hierarchy
Instruments			
Incentive intensity	++	+	0
Administrative controls	0	+	++
Performance			
Adaptation (A)	++	+	0
Adaptation (C)	0	+	++
Contract law	++	+	0

++ = strong
 + = semistrong
 0 = weak

2.3 A Heuristic Display

Figure 1 displays the “natural order” with which governance structures take shape in relation to the attributes of transactions. A contract, for these purposes, is described as a triple (k, p, s) , where k is an index of contractual hazard, p is the break-even price, and s denotes the contractual safeguards. All three elements are decided simultaneously.

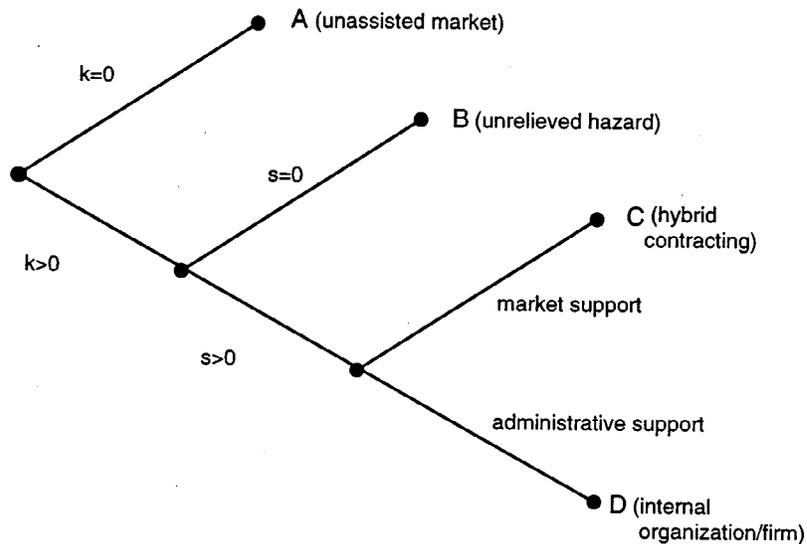


Figure 1. Private sector organization.

Thus consider a good or service that can be supplied by either of two alternative technologies. One is a general purpose technology ($k = 0$); the other a special purpose technology ($k > 0$).

Node A corresponds to the ideal transaction in law and economics: there being an absence of dependency ($k = 0$), autonomous adaptations suffice, added safeguards are unneeded ($s = 0$), and the competitive price prevails. Nodes B, C, and D are ones for which specialized investments are made ($k > 0$), whence maladaptation hazards will arise if one or both parties decline to cooperate when disturbances for which cooperative adaptations are needed occur. Such hazard potential will be recognized by farsighted players, who will craft safeguards and/or price out the risk. Suppliers will thus attach a risk premium to node B to reflect the absence of contractual safeguards ($s = 0$). Nodes C and D are nodes to which additional contractual supports have been provided ($s > 0$), either in the form of contractual safeguards (node C) or by internalizing the hazard through unified ownership (node D).

Because of the added bureaucratic costs that accrue upon taking a transaction out of the market and organizing it internally (Williamson, 1985:chap. 6), internal organization is usefully thought of as the organization form of last resort: try markets, try hybrids, and have recourse to the firm only when all else fails. Node D, the firm, thus comes in only as transactions have especially great needs for cooperative adaptation. (The schema is extended to regulation and public bureaucracy in Section 6.)

3. The Remediableness Criterion

It was once customary to prescribe government intervention—in the form of taxes, subsidies, regulation, nationalization—upon displaying a “market failure,” where the purported failure was ascribed to any deviation in an actual market condition from a hypothetical ideal. Ronald Coase took exception with this practice and urged that the pressing need, always and everywhere, is to “study the world of positive transaction costs” (Coase, 1992:717). Thus although contemplation (Coase, 1964:emphasis added)

... of an optimal system may provide techniques of analysis that would otherwise have been missed ... [in general] its influence has been pernicious. It has directed economists’ attention away from the main question, which is *how alternative arrangements will actually work in practice*. It has led economists to derive conclusions for economic policy from a study of an abstract of a market situation. It is no accident that in the literature ... we find a category ‘market failure’ but no category ‘government failure.’ Until we realize that we are choosing between social arrangements which are all more or less failures, we are not likely to make much headway.

What Demsetz (1969) refers to as “Nirvana economics” carries a similar message.

The appeal of hypothetical ideals is nevertheless very powerful. Recall that North (1990) invokes the zero transaction cost ideal in pronouncing that politics is inefficient. Zero deadweight losses, moreover, are commonly the standard for attributing inefficiency to redistribution, the U.S. sugar program being an example (Stigler, 1992).

Asymmetric comparison with a hypothetical ideal—the market deviates; the government is presumed to compare favorably—resulted in a propensity to intervene. It is elementary, however, that frictionless ideals cannot be implemented, and some ideals are so obscure that they are not even useful as a common reference condition. What, for example, does zero transaction costs mean? All of the relevant information is freely available and can be costlessly processed by the participants? Comprehensive contracting is feasible? Actions can be costlessly monitored? Decisions will be made in a benign way? Is this really a more informative way to proceed than taking a transaction (say foreign affairs) and examining the comparative efficacy with which two or more flawed but feasible modes of governance will implement it? Since crude and simple arguments will often suffice to demonstrate an inequality (Simon, 1978:6), might the remedialness criterion, with its continuous focus on alternative feasible modes, bring us into more productive contact with the real issues?

3.1 The Criterion

The remedialness criterion holds that an extant mode of organization for which no superior *feasible* alternative can be described and *implemented* with expected net gains is *presumed* to be efficient. Although some may believe that an extant mode enjoys an undeserved advantage by this presumption of efficiency, such a presumption is favored by the rough-and-ready test that an extant mode has survived a comparative institutional competition. Unless that competition is shown to be seriously defective (see Section 3.2, below), the extant mode is entitled to at least grudging respect.

Note in this connection that the absence of perfect foresight is not a “defect”—except as one appeals to a hypothetical ideal as the standard. All that we can ask of farsighted economic actors is that they do their best, which includes coming to terms with their cognitive limitations. That we would sometimes have done things differently with the benefit of ex post hindsight (in the fullness of knowledge) is not to discredit best ex ante efforts.

Suppose, however, that we discover a superior feasible mode after the fact. Ought not the extant mode [the QWERTY typewriter keyboard is a favorite example (David, 1986)] thereupon be supplanted by the superior feasible mode? Maybe, but then again maybe not. Differential implementation costs need to be included in the efficiency calculus. It is fanciful to treat two modes “as if” they were de novo entrants if, in fact, one has incurred initial setup costs and has durable, nonredeployable assets in place while the other has not. Accordingly, a would-be rival form that fares well in a simple side-by-side comparison may nevertheless fail by reason of differential setup and investment expenses—at least until such time as the investment renewal decision comes up for consideration (at which juncture the challenger form is at less of a

temporal disadvantage). As compared with the path dependency literature, which often ascribes inefficiencies to early arrival times and/or expresses regret because decision makers were not omniscient (Liebowitz and Margolis, 1990), the remedialness criterion demands more.

3.2 Rebuttal

The efficiency presumption of an extant mode can be rebutted by showing that the condition in question owes its origin to unacceptable initial conditions, to unacceptable operating practices, to conceptual error, or to pathology.

Unacceptable initial conditions can be either of a general or particular kind. For example, the polity of which the extant form of organization is a product may be declared to be corrupt or otherwise undeserving of respect (perhaps a totalitarian regime). Or the polity may be working well in general but defective with respect to a subset of its activities (for example, the voting franchise may have been denied to a part of the population on which legislatively “enacted” practices have concentrated disproportionate burdens). Short of a political reform, extant programs that have such unacceptable origins may persist. Upon a showing of unacceptability, a program so described lacks legitimacy and, persistence notwithstanding, the presumption of efficiency is withheld.

Alternatively, a program may have acceptable origins but is continued because unacceptable practices are thereafter used to defeat challengers. Practices of a more focused and strategic kind are especially problematic. *Contingent* practices that have the purpose and effect of defeating or deterring actual and potential rivals but do not confer benefits more generally are, at the very least, troublesome and may warrant withdrawing the presumption of efficiency.

An efficiency verdict may also be reversed if a mistaken calculus was employed in judging efficiency. Antitrust affords an example. The prevailing view among enforcement agencies in the 1960s was that possible economies could never justify a merger that had any prospect, however slight or speculative, of increasing market power. Although it took time for the merits of economies as an antitrust defense to register, the intuition that market power always trumps economies turned out to be mistaken (Williamson, 1968).

Finally, a verdict of efficiency may be withheld if a program has taken on a convoluted “life of its own.” Krueger (1990) examines the history of the sugar program and questions whether the errors, learning, strategizing, and convoluted political process that she documents warrant an efficiency conclusion. Amy Beth Zegart (1996) likewise questions the National Security Council. On her reading, the NSC was the product of “legislation by accident” (Zegart, 1996:245), after which the NSC developed into an organization “which their creators never intended or envisioned” (Zegart, 1996:58).

The upshot is that the presumption of efficiency can be challenged and will sometimes be rebutted by showing that the program in question is (1) the product of an unacceptable political regime, or otherwise has unacceptable political origins, (2) has been continued through recourse to unacceptable strategic ploys, (3) is wrongly classified as efficient because of a defective calculus, or (4) has

undergone a series of unforeseen and convoluted changes that defy a rational interpretation.

3.3 Applications to Public Bureaucracies

The customary practice of ascribing inefficiency to any public program that experiences a deadweight loss has been challenged by George Stigler, who disputes that the deadweight loss (on the order of \$3 billion) associated with the U.S. sugar program should be construed as inefficiency. This orthodox verdict assumes that economics trumps politics, at least among academics. Stigler, however, argues that “Maximum national income . . . is not the only goal of our nation as judged by policies adopted by our government—and government’s goals as revealed by actual practice are more authoritative than those pronounced by professors of law or economics” (Stigler, 1992:459).

Note, moreover, that the usual gambit of effecting reform by “promising” to compensate incumbents for their losses by annual direct payments from the Treasury is not self-enforcing. Such payment mechanisms are too transparent and suffer from a political disconnect. Why should we be surprised when redistributive mechanisms that are favored by economists are refused by incumbent politicians, whose interests have been ignored (Williamson, 1996:200–202)? Merely to display persistent deadweight losses is not dispositive. What are the superior *feasible alternatives*? What are the *mechanisms*, both economic and political, for effecting reform?

Note in this connection that we need to come to terms with the predictable consequences of cherished structural features of American politics. To condemn the attributes of public bureaucracies that are the foreseeable outcome of, say, the division of powers and yet to insist that the division of powers must be preserved is unacceptable. If the division of powers is a nonnegotiable constraint, we need to understand and come to terms with the ramifications.

Also, politics aside, we need to have a deeper economic appreciation for the properties of alternative modes of governance. To denounce public agencies because they have lower-powered incentives, more rules and regulations, and greater job security than are associated with a counterpart private bureau completely misses the point if those features have been *deliberately crafted* into the public bureau, thereby mitigating contractual hazards, albeit at a cost.

To be sure, some bureaucratic consequences may have been (at least initially) unforeseen. As, however, unforeseen consequences become disclosed, these can thereafter be folded into the design calculus. Regulation is an example. Thus whereas the “capture” of regulation by special interests (such as the industry to which regulation applies) may have been initially unforeseen (Bernstein, 1955), what was once unforeseen eventually becomes a predictable regularity. It is elementary that foreseeable consequences of all kinds, wanted and unwanted alike, should be factored into the decision of whether and how to regulate. Like any other contractual hazard, therefore, capture is folded into the design calculus. Even if the benefits of regulation decline over time and go negative, the discounted present value may remain positive. If the resulting condition is irremediable, then there is no occasion for regret.

4. Public Sector Transactions

Moe's contention that there are no markets is to be contrasted with Wilson (1989:346), who observes that it is actually difficult to think of a "government activity that has never been done or is not now being done by the private firm." To be sure, most of these markets will not approach the ideal transaction in law and economics, where there are large numbers of qualified suppliers and identity does not matter. But the absence of ideal markets in private sector transactions is precisely the opening through which transaction cost economics made its entry. What had previously been interpreted as nonstandard and anticompetitive contracting and organizational practices often turned out, when examined through the lens of transaction cost economics, to have economizing purpose and effect.

This same general approach is herein brought to bear on the study of public sector transactions. Six types of public sector transactions are distinguished: procurement, redistributive, regulatory, sovereign, judicial, and infrastructure. Of these six, only the organization of sovereign transactions is examined in a systematic way.

4.1 Procurement

Procurement transactions are akin to those of make-or-buy: Should the government produce to its own needs or contract out for the good or service in question? These transactions vary from mundane (e.g., office supplies) to complex (e.g., advanced space and weapons systems). The problems of organization for procurement transactions will not be developed here. I merely aver that (1) special circumstances aside (e.g., the "Manhattan Project" in World War II, when time was of the essence), government should rarely produce its own needs, (2) competition can be harnessed to provide a safeguard for mundane procurement, but (3) specialized procurement is often beset by asset specificity (whence small numbers competition/bilateral dependency obtain) and is more apt to be politicized.

4.2 Redistributive

Redistributive transactions vary from general purpose and broadly based (e.g., social security) to those that are narrowly focused and special interest (e.g., the U.S. sugar program). Whereas the administration of the former could be and possibly should be contracted out,¹¹ that would be much more difficult for narrowly focused, special interest redistribution, which is highly politicized.

11. The benign government tradition favors public administration of even mundane redistribution such as social security. Medicare is a more complex payment service and the IRS is a more complex tax collection service. It is not at all obvious that a public bureau—with its low-powered incentives, red tape, security of employment—is superior to a private bureau in discharging the routine operating duties for these transactions. The same is true of postal delivery (which, interestingly, has been invaded by private express delivery services where the law permits).

Administration through an agency to which Congress and the president have more direct access is favored for special interest redistribution.¹²

Note in this connection that the usual economic nostrums for supplanting actual, inefficient, economic mechanisms (e.g., quota systems) by ideal, efficient mechanisms (e.g., lump sum subsidies and taxes) are commonly irrelevant. As heretofore discussed, ideal mechanisms are not only nonoperational but they typically ignore the political purposes being served. Only feasible mechanisms qualify under the remediableness criterion (Williamson, 1996:chap. 8), and the political purposes and processes of government are properly factored into an efficiency assessment (Stigler, 1992).

4.3 Regulatory

Regulatory transactions are often beset with asset specificity, as with natural monopoly, or by information asymmetries, as with consumer and worker health and safety regulation. Milton Friedman has described natural monopoly as a condition for which there are no good choices (1962:128): all of the options—private unregulated monopoly, private regulated monopoly, and state operation—fail to implement an efficiency ideal. Subsequent claims that the natural monopoly problem can be “solved” by using franchise bids to award the monopoly to the firm that makes the best bid are also beset with difficulties (Williamson, 1976). The upshot is that, defects with rate of return regulation notwithstanding, such regulation (which combines the private firm and public regulatory agency) is sometimes “best” when the comparison is restricted to alternative feasible forms, all of which are flawed (Goldberg, 1976; Priest, 1993).

Regulation as a means by which to redress a condition of information asymmetry is usually intended to assist consumers (who are believed to be ignorant or naïve) and workers (who lack knowledge and organization). Complicated issues of long latency, branding, warranties, the efficacy of reputation effects, and bankruptcy are posed (Williamson and Bercovitz, 1996). Because regulation under the guise of information asymmetry is sometimes used to promote redistributive or ideological purposes, such regulation can be highly politicized.

4.4 Sovereign Transactions

The organization of sovereign transactions is developed below. Suffice it to observe here that there are some transactions that have special needs for probity and implicate the security of the state. As developed herein, but could be disputed, the management of sovereign transactions is one for which the executive (rather than the legislature) is chiefly responsible. The contracting out of sovereign transactions poses grave difficulties.

12. I conjecture that narrowly based redistribution is mainly responsive to the political purposes of the legislature, but such issues are beyond the scope of this article. See Weingast and Marshall (1988).

4.5 Judiciary

There is growing agreement that an independent judiciary beneficially influences the ability of the state to infuse confidence in investment and contract [see Levy and Spiller (1994, 1996) for an informed discussion]. There is also growing academic interest in the relations (sometimes subtle, sometimes not) between the judiciary and politics [see de Figueiredo and Tiller (1996)]. Such transactions are important but are beyond the scope of this article.

4.6 Infrastructure

The administration of police, fire, roads, parks, prisons, education, etc. is mainly a matter for state and local government. These transactions will not be considered here but are grist for the study of comparative economic organization and are increasingly coming under scrutiny.

5. Sovereign Transactions

Wilson describes sovereign transactions as ones that “are endowed with infeasible authority: There are certain commands that only the state ought to issue” (1989:398). Furthermore, he maintains that the government organizes these transactions itself not because the “government is cheaper or more efficient, but because it alone embodies the public’s authority” (Wilson, 1989:359). Examples of sovereign tasks include foreign affairs, the military, foreign intelligence, managing the money supply, and, possibly, the judiciary.

Sovereign transactions appear to be singularly unsuited for comparative institutional analysis of a transaction cost economics kind. “Of course” foreign affairs will be organized in a public bureau! That being obvious, why choose a transaction the organization of which is unproblematic? I offer three reasons.

First, even that which is obvious can sometimes benefit from explication, which is to say that intuitions about organizations need to be unpacked. Second, extreme instances are chosen for study precisely because they often help to uncover “essentials of the situation” that are not evident when more mundane transactions are examined. Third, although Wilson places sovereign transactions outside the reach of efficiency analysis, I entertain the possibility that, as compared with alternative feasible forms (all of which are flawed), the public bureaucracy is the most efficient mode for organizing sovereign transactions.

5.1 Added Hazards

The general rubric out of which transaction cost economics works is that of hazard mitigation through ex post governance. It being the case that all complex contracts are unavoidably incomplete, the fiction of comprehensive contracting, which concentrates all of the contracting action on ex ante incentive alignment, is untenable. Faced with incomplete contracts, governance mechanisms that facilitate cooperation (through ex post gap filling, dispute settlement, and cooperative adaptation) take on importance as contractual hazards build up. Note, moreover, that moving beyond ex ante incentive alignment to include ex post governance does not imply that incentives are neglected. Inasmuch as governance is defined as a syndrome of attributes, of which incentive intensity is one,

choice of a governance structure implies the (comparative) level of incentive intensity that appertains thereto. (Discrete structural analysis assumes that there are range restrictions on the values that the defining attributes of each generic mode of governance can take on.)

So what contractual hazards afflict sovereign transactions? The two on which I focus herein are: asset specificity, which is prominent among the hazards in private sector transactions, and probity. Viewing governance as "the institutional framework within which the *integrity* of a transaction is decided" (Williamson, 1979:235), reference to probity is not altogether surprising. It is nonetheless new. (The surprise, perhaps, is that express reference to probity did not come about earlier.)

Recall that Moe contends that asset specificity is negligible in the public sector. Although that appears accurately to describe the physical assets employed in many public sector transactions (but by no means all; see Section 7.2), the human assets in many public bureaucracies, of which foreign affairs is one, involve considerable specificity (nontransferable training and social conditioning). The government, after all, is a monopsonist for the foreign affairs transaction. At least in the past (this may be changing),¹³ the requisite deep knowledge of the protocols and procedures for the conduct of foreign affairs, to include specialized knowledge of obscure regions and practices, has for the staff if not for the leadership, often had little value in best alternative employment. As in the private sector, so also in the public sector: the added hazards of human asset specificity are relieved by providing added security of employment, more fully developed information disclosure, and more refined dispute resolution mechanisms. These are discussed below. *What really distinguishes the foreign affairs transaction, however, is the hazard of probity*—where by probity I refer to the loyalty and rectitude with which the foreign affairs transaction is discharged. As shown in Figure 2, probity has three parts: vertical, horizontal, and internal.

One could argue, correctly, that probity is important for all transactions, public and private alike. That it has not hitherto "surfaced" is, I conjecture, because the importance of differential probity becomes evident only in conjunction with extreme instances (of which sovereign transactions/foreign affairs is one) and because probity is delivered through leadership and management attributes of governance that have hitherto been outside the ambit of comparative contractual analysis—being more of the nature of the sociology of organization (Selznick, 1992:chap. 12) rather than the economics of organization. It is elementary, however, that the economics of organization should be responsive to all significant regularities whatsoever. If and as probity is important, due allowance should be made.

The vertical aspect of probity concerns the relation between the president, who is primarily responsible for the administration of foreign affairs, and the foreign affairs agency. Does the president have confidence in the information and

13. The demand for the background and skills of Foreign Service officers has been increasing as the multinational corporation has become more important.

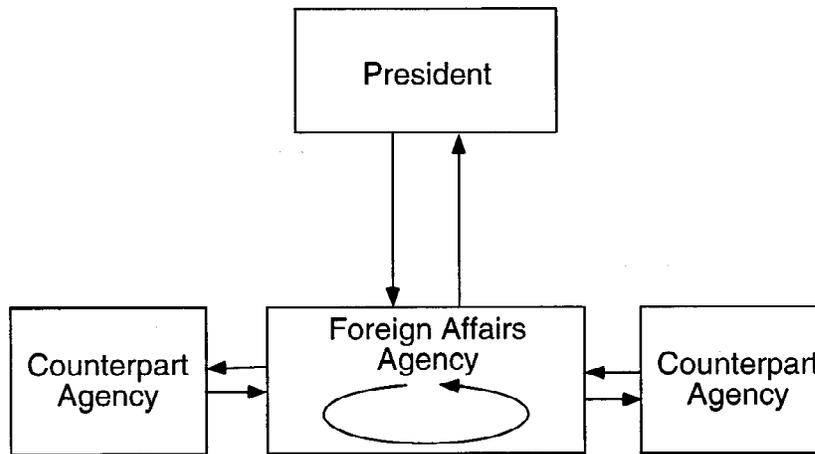


Figure 2. Probity considerations.

assessments that are provided by the foreign affairs agency? Does the agency comply with directives in a timely and efficacious way? Is the agency perceived to be adventurous? The foreign affairs transaction is one to which Talleyrand's imperative applies: "above all, no zeal."¹⁴ Probity concerns will be relieved by governance structures to which reliable responsiveness to the president—goal congruence, timely compliance, and lack of adventurousness—can be ascribed.

As herein employed, probity implies a high standard of integrity, to include professional excellence, in the organizational unit to which a task has been assigned. According to Philip Selznick, "The chief virtue of integrity is fidelity to self-defining principles" (1992:322), of which "each type of institution . . . has a distinctive set" (1992:323). The unifying principles that are associated with sovereign transactions include (1) abiding respect for the mission, (2) reliable responsiveness to the president (to include the absence of adventurousness), and (3) accurate communication to counterparties of intent (which, in some cases, may be to remain ambiguous or undecided). Social conditioning and procedural safeguards are pertinent to all of these. The powers to appoint and remove the leadership of an agency are important in both responsiveness and communication respects.

Expressed in terms of hazards to foreign affairs, hazards to probity would be posed if the president lacked confidence in the information and assessments that are provided by the foreign affairs agency and if the agency were perceived to be noncompliant (to include being adventurous). To be sure, a trade-off arises when the president's near-term political interests and the longer-term mission interests of the state collide. Lest the integrity of the state be seriously compromised, mission safeguards need to be introduced into the design. The

14. As quoted by Dean Acheson (1969:47).

comparative efficacy of alternative modes of governance with respect to the integrity of the mission is thus part of the choice calculus.

A perceived lack of authority poses an external hazard of probity. Perceived weakness of expertise and lack of assured political support undermine the ability of an agency to deal effectively with counterpart agencies. The first of these implicates the professional stature of the staff; the second links to the appointment process. Less authority will be delegated to and will be enjoyed by a leadership that does not enjoy the confidence of the executive and the approval of the legislature, *ceteris paribus*. Crafting a governance structure to which counterpart agencies will ascribe authority is thus part of the exercise.

Expressed contractually, transactions for which probity is important are very long term (of a self-renewing, ongoing kind) and are highly incomplete. But many transactions are so described. What distinguishes “probity transactions” are their needs for loyalty (to the leadership and to the mission) and process integrity. Because breach of contract/lapse of probity can place the system at risk, probity represents a condition of contractual hazard the mitigation of which cannot be realized through pecuniary penalty. Rather, breach against probity is better described as inexcusable incompetence or even betrayal. In the limit, such breach is punishable as treason.

Finally, consider the hazard of operating cost excesses—which hazard always lurks in the background but deserves to be brought up front. Albeit a core concern for private sector economic organization and a serious concern for some public sector activities (e.g., defense procurement), the potential operating cost savings that would accrue to higher-powered incentives in foreign affairs are not great.¹⁵

By way of summary, the degrees of contractual hazard that arise in the foreign affairs transaction are: asset specificity, some (mainly human assets); probity, great; operating cost excesses, small. The first two of these favor cooperativeness (as against autonomy) in the design of the agency and its administration, and the countervailing importance of the last is not great. Given that both workers and agencies have an interest in preserving the continuity of the employment relation, a specialized internal labor market will arise in support of human asset specificity. Similarly, a governance structure that supports a presumption of or predisposition toward cooperativeness will relieve the hazards of probity. And there is little reason to restore autonomy by reason of cost concerns.

5.2 Responsive Governance

Recall that private sector governance was described in terms of incentive intensity, administrative controls, and the contract law regime (see Table 1). How do these relate to the above-described autonomy-cooperativeness features of the foreign affairs transaction?

15. The budget of the State Department was less than 2% of the budget of the Department of Defense over the interval 1985–1995. Obviously, the latter poses greater “cost concerns.” Separating the policy side of defense from procurement and privatizing the latter relieves the cost concerns without losing policy control.

Very low-powered incentives will deter unwanted enterprise and zeal. Not only will compensation in such an agency be very flat, but resource redeployment from cost savings will be restricted. Something akin to civil service (see below) will help to accomplish the first of these, and limiting the uses to which realized cost savings can be put will contribute to the second. Specifically, payments contingent on realized cost savings will not be made to individuals who discover and implement cost savings. Neither will such savings be used to improve on-the-job consumption of amenities. Lest pressure to realize operating cost savings arise at the systems level, unexpended budgets will not accrue to the agency but will be returned to the central treasury. The purpose of these restrictions is to ensure that the low-powered incentives of salaried employment will not be undone by introducing conditional payment or reward schemes. The abiding concern is that, above a (relatively low) threshold, added incentive intensity undermines probity.

Also and related, meticulous respect for protocol will help to ensure probity and communicate credibility. The ideal type bureaucracy described by Max Weber (and now widely scorned) actually meets many of the needs of foreign affairs: jurisdictional ordering by official rules and regulations; clearly established hierarchical authority and appeal through administrative due process; the separation of business assets from private wealth; deep knowledge of procedure; and a vocational commitment to include training and loyalty to the office (Weber, 1946:956–959). High-powered incentives, according to which individual (or groups of) agents appropriate streams of net receipts, are notably absent in the Weberian description of bureaucracy. That is because high-powered incentives place the fidelity of the system at risk.

To be sure, flat compensation comes at a cost, in that noncontingent compensation will induce some workers to shirk. Bureaucratic rules, regulations, standard operating procedures, and the like are thus partly explained by the fact that egregious shirking can be limited in this way. On the argument advanced here, however, the main purpose of administrative controls is to promote probity in mission, responsiveness, and communication respects.

Going beyond flat compensation to include other aspects of the employment relation, consider the differential use of termination at will and termination for cause in the foreign affairs agency. It is elementary that an agency chief who is appointed by and serves at the pleasure of the president will be more responsive to the perceived needs of the political leadership, *ceteris paribus*. Such leadership can also communicate with greater authority to counterpart agencies, which contributes to probity in that respect. Also, in a division of powers system where presidential appointments need to be approved by the legislature, the integrity of the mission can be buttressed through the hearings and approval process. Not only will the president have a stronger incentive to choose (nominate) a candidate who inspires confidence (as against naming someone who is driven to advance the president's personal agenda), but the legislature can reach an understanding with the agency chief as to his policy and plans, whereupon "deviations" from this can be made the subject of hearings during the candidate's term of office. The issues here are ones to which Positive

Political Theory relates [see especially Spulber and Besanko (1992:133–140, 152)]. Students of politics (including politicians) who take a long view will recognize that a bureau to which sovereign tasks have been assigned has a special responsibility to the state to be protective of its mission.

Whereas the leadership of foreign affairs is a prestigious appointment that opens doors to outside employment and career moves, the staff at foreign affairs looks inward for career moves. The career staff are involved with the administration of foreign affairs for the long haul. Deep knowledge and the integrity of the mission figure more prominently than does responsiveness to the president in crafting the employment relation for the career staff. Lest the career staff be reluctant to specialize their human assets or will consent to specialization only upon payment of a hazard premium, the employer (monopsonist) has an incentive to mitigate the hazard by offering security of employment. The practice of termination at will is thus replaced by termination for cause. Also, specialized training and social conditioning will be used to inculcate the distinctive values and practices of the foreign affairs organization. Because official communications with counterpart agencies in other countries need to be artfully crafted and unintended ambiguities avoided, form in foreign affairs is also substance. Diplomatic correctness will thus be included in training exercises and will count high in the promotion calculus. Not only will there be many rules, regulations, and complex procedures to manage operating affairs (horizontal coordination), but extensive vertical consultation will be employed to effect vertical coordination in responding to nonroutine events. Autonomous adaptations will be rare in such an agency. Instead, “caution, an aversion to bold language or action, and a desire for consensus” will prevail (Wilson, 1989:94). Finally, security of staff employment will be better assured if the bureau to which the sovereign task is assigned has little risk of bankruptcy and has a reliable budgetary base in the face of economic adversity.

So as to avoid distractions and compromise to its mission, foreign affairs will benefit from having an undivided purpose. Proposals to expand the scope of responsibilities for the foreign affairs agency will reflect this. Although divisionalization can be used to effect a degree of separation between disparate tasks, potential conflict can be avoided by assigning such tasks to other (possible newly created) bureaus. As against the acquisitive propensity that William Niskanen (1971) ascribes to public bureaus, the bureau to which a sovereign task has been assigned will be reluctant to expand in ways that compromise the mission.¹⁶

5.3 An Actual Bureau: The State Department

Although the above description is intended to apply to foreign affairs bureaus quite generally, the only actual agency that I compare with the abstract bureau-

16. The multitask complications on which Tirole (1994) relies for much of his agency theory assessment are mitigated as a consequence.

crazy described above is that of the United States Department of State.¹⁷ Note, moreover, that my treatment of the State Department has been overtaken by events, especially the progressive emergence of the National Security Council and by increasing globalization of production and trade. The former partly owes its origins to the perceived need for quicker real-time responsiveness and raises issues that are beyond the scope of this article (Zegart, 1996). The globalization of the economy has expanded employment opportunities for the foreign service, thereby relieving an earlier condition of asset specificity. Be that as it may, it is instructive to consider the organization of foreign affairs in the Truman–Acheson era. The employment relation is the obvious place to start.

5.3.1 The Leadership. The purposes served by the choice of agency executives vary (Wilson, 1989:198):

Agency executives are selected in order to serve the political needs of the president, and these may or may not involve policy considerations. Some are appointed to reward campaign workers, others to find places for defeated members of Congress, and still others to satisfy the demands of interest groups.

Although the chief executive of most federal bureaucracies is not chosen from the career staff, the heads of the Bureau of Prisons, Weather Service, Forest Service, and Bureau of Standards are exceptions (Wilson, 1989:198).

The chief executive of the State Department is a political appointee who is expected to promulgate the foreign policy program of the president. The same applies to the under and assistant secretaries. But the leadership of an agency to which a sovereign task has been assigned also has responsibilities that transcend politics, including responsibilities for the integrity of the state. Such appointments need to inspire confidence, both foreign and domestic. Because any lack of competence or want of probity would be a matter of grave concern in the Senate confirmation process, a judicious president will more carefully screen proposed State Department appointments for these qualities before submitting nominations than would be the case for, say, the Department of Commerce.¹⁸ (Transaction cost economics is always and everywhere an exercise in comparative institutional analysis.)

Leadership appointments to the State Department are made by the president, are expected to be loyal to the president, and serve at the pleasure of the president. A presumption of responsiveness results. Mission considerations aside,

17. I would nonetheless expect that other foreign affairs bureaus would be organized similarly, albeit with more top-down control and insistence on loyalty to the regime (as against loyalty to the state) in a totalitarian government.

18. Leadership appointments to the Department of Justice are highly politicized, the importance of the principled administration of justice notwithstanding. The court system provides fallback integrity against politicizing justice. Appointments to the judiciary take on added importance as a consequence.

personal differences are resolved in favor of the president. Thus although Dean Acheson differed with Truman over Palestine, he reports that he did his “best loyally to see that the President’s wishes were understood and carried out” (1969:169–170).

Not only did Truman look “principally to the Department of State in determining foreign policy and—except where force was necessary—exclusively in exercising it, . . . [but the] Secretary saw his role as Chief of Staff to the President in foreign affairs, directing and controlling the Department, keeping the President abreast of incipient situations that might call for decisions or action, acting as principal assistant in making decisions and assuring action upon them” (Acheson, 1969:734–735).¹⁹ Often this decision-making role was consequential, as when Robert Lovett and Acheson persuaded Truman to modify the atomic weapons agreement that he had privately reached with Clement Atlee, thereby avoiding an embarrassing defeat in the Congress (Acheson, 1969:484).

5.3.2 The Staff. The employment relation for the staff in the State Department is two part. Generic administration works through civil service; foreign service applies to the more sensitive task of diplomacy. Both are very low-powered incentive schemes that afford great security of employment. [Although “it is not impossible to fire a government employee, . . . it is very difficult” (Wilson, 1989:145).]

Johnson and Libecap describe the U.S. civil service system as follows (1994:154):

Over a 100-year period, a civil service system has been put into place that makes it difficult for the president, senior agency officials, or members of Congress to motivate workers to be productive through the use of basic instruments, such as merit promotions, or to remove those employees who do not perform adequately in their jobs. Rather, under civil service rules, pay and promotion are based on time on the job, not productivity; salaries are set within a national pay plan and statutory salary adjustments that generally involved across-the-board percentage increases; and job-tenure guarantees are granted to virtually all career civil service employees. Within this structure, federal supervisors are constrained severely in their ability to reward or to punish their subordinates according to job performance.

To be sure, there is more to civil service employment than flat pecuniary incentives and job security. Prudential promotions are awarded to those who excel, work within the rules, and are patient. But while adherence to the

19. Things have changed as the National Security Council has taken on greater prominence. The trade-offs are examined elsewhere (Zegart, 1996). President Nixon took control of foreign affairs by working with his National Security Advisor, Henry Kissinger, to make bold new moves rather than work through his Secretary of State. Quicker responsiveness and greater adventurousness are favored by bypassing State.

rules is expected, it also comes at a cost: perfunctory performance by lazy or disenchanted employees who work to the letter of the rules is a common complaint.

Because of the importance of probity, even minor breakdowns of confidentiality are viewed as embarrassments and treated as “grave breaches of discipline” (Acheson, 1969:49).²⁰ Deepening the employment relation beyond civil service to provide added social conditioning thus warrants consideration. Of interest, the Rogers Act of 1924 created the Foreign Service, which is an elitist group that “places great emphasis on the intellectual and social superiority of its members. . . . [There is] widely shared support for rigorous selection, entry at the bottom rather than laterally, the choice of a man for a lifetime career” (Warwick, 1975:30). That many Foreign Service officers “have little in the way of marketable skills” (Warwick, 1975:106) is part of the career calculus.²¹

Moreover, the Service places a “strong value on being in the mainstream of foreign policy decision-making, and on the ‘diplomatic approach’, including subtlety, skill in negotiation, cultural sophistication, and good manners” (Warwick, 1975:30–31). Often the tacit knowledge—“personal skills and non-communicable wisdom of experienced” Foreign Service officers—was more valuable in operations abroad than in Washington (Acheson, 1969:347). What the president needed was a meaningful translation, which it was the responsibility of the leadership at State to provide (Acheson, 1969, 348).

The State Department is highly bureaucratized: hierarchical structure; prescribed duties, formal rules, regulations, and standards; and a professional/career orientation are all attributes that Warwick (1975:4) ascribes to the State Department. He further notes that rules, regulations, and formal procedures operate both to effect control over foreign affairs and to protect foreign affairs “against the shifting tides from above” (Warwick, 1975:68–69). Painfully slow responsiveness sometimes results, which many presidents have found frustrating (Warwick, 1975:71–72).²² That is partly because integrity to “the mission” sometimes conflicts with political expediency—which is reflected in awarding a degree of autonomy to State: “The attitude that presidents and secretaries may come and go but the department goes on forever has led many presidents to distrust and dislike the Department of State” (Acheson, 1969:157).

Some students of the State Department, including insiders, also express dis-

20. Acheson illustrates by describing a leak where (1969:49)

. . . the usual stir to find the perpetrator of the leak had about ended in the usual failure, when . . . I saw that the excerpts were taken from not one [confidential] paper but two. The members who had seen both papers might be more limited than those who had seen only one. This proved to be true. Those who had seen both and knew the columnist as well would be even more limited. In a short time the FBI had the culprit, a well-meaning but overzealous assistant to Stettinius. He resigned, went into the Army, and made an excellent record in the Pacific theatre.

21. See, however, note 13, *supra*.

22. The creation of a “National Security Advisor” attached to the President can be explained as a device to work around (rather than correct) this condition.

may over its bureaucratic propensities (Argyris, 1967:1):

Secretary Rusk has told his Business Advisory Group that one of his biggest problems is getting people to accept and enlarge their responsibility. . . . Foreign Service officers . . . question the selection and promotion process, yet when asked to provide a viable alternative, they were unable to do so.

Chris Argyris concludes that “the State Department in general, and the Foreign Service in particular, is so constructed that it predisposes the State Department to managerial ineffectiveness” (1967:2). The possibility that this purported ineffectiveness is a predictable consequence of the syndrome of attributes that define the sovereign bureau (hence should be interpreted as part of the design trade-off) goes unremarked.

As a public agency, the State Department can expect continuing funding from the public fisc and is thus insulated against bankruptcy. Its budget is, however, subject to presidential, OMB and especially congressional review, which can be a sobering (Warwick, 1975:73–75, 192) and contentious exercise (Acheson, 1969).

Of interest, the State Department has resisted taking on additional tasks that could compromise its core diplomatic and consular missions. Faced with the need for added military and diplomatic intelligence, the Office of Strategic Services was set up outside the State Department in World War II. When the intelligence analysts from OSS were transferred to State in 1945, veteran members of the Foreign Service were unwilling to accept the new activity. A separate unit, the Central Intelligence Agency, was created in 1947 (Warwick, 1975:15–16).²³

6. Replication by a Private Bureau?

Could the organization of foreign affairs as herein described, both abstractly and by the U.S. Department of State, be replicated by a private bureau? If replication is possible and if, in the process, cost saving benefits accrue, then privatization has a lot to recommend it. Might the concerns of presidents (such

23. Wilson’s examination of public bureaus in the United States lends further support to this argument. Within the Defense Department, for example, each armed force has been permitted to “retain control over the definition of its critical tasks,” efforts by Robert McNamara and the “whiz-kids” to centralize notwithstanding (Wilson, 1989:179–180). Also, the FBI resisted taking responsibility for drug trafficking, even though a big increase in the FBI budget was proposed (Wilson, 1989:180). The Department of Agriculture, moreover, urged that the food stamp program be removed from its jurisdiction and awarded to the Department of Health, Education, and Welfare (Wilson, 1989:180). The Forest Service was much more successful than the Park Service in delimiting its tasks and therefore enjoyed a much more committed sense of mission (Wilson, 1989:63–65). The Occupational Safety and Health Administration, however, has struggled with its combined task of safety and health (Wilson, 1989:64). It is not, therefore, that multitask strains never arise; the argument, rather, is that such strains are recognized and are often dealt with by avoidance.

as Truman), of secretaries (such as Rusk), and of analysts (such as Argyris) be relieved in the process?

I proceed in a two-part way. First, I examine a “pure” private bureau and then I ask whether a hybrid form, the regulated firm, can effect replication.

6.1 Full Privatization

Although it is mind-boggling to contemplate a fully privatized agency for foreign affairs, it may be instructive to look behind the intuition that a private firm is poorly suited to this purpose. What would the contract for a firm to take on responsibilities for foreign affairs look like?

6.1.1 General. It is undisputed that the contract to manage foreign affairs will be highly incomplete. As Wilson (1989:358) puts it, “It would be difficult if not impossible to write a contract that specified in advance what the firm . . . should do in each case, in large part because the government does not know.” Although Wilson goes on to attribute this condition of ignorance to the fact that the preferences of the government “are formed by the process of negotiation” (1989:358), I would put it differently: adaptive, sequential decision making is the only feasible way by which to play a negotiation game in which contingent events and countermove strategies are rich beyond description. Acheson, for example, describes the strategic concept for NATO as “extremely sketchy” and contends that “It could hardly have been otherwise” (1969:352).

Such massive incompleteness greatly complicates and even vitiates any effort to privatize foreign affairs. Unable to describe contingent events, much less cost them out in a meaningful way, what does a competitive bid entail? How are rival bids to be compared? If the president requests responses to unanticipated events that differ in degree or in kind from that provided by the contract, what reconciliation mechanisms will be employed? All of the problems that attend franchise bidding for natural monopoly in circumstances where assets are highly specific and conditions are uncertain are posed (Williamson, 1976), only more so. Contracting out, if it is to be done at all, will be more akin to cost-plus contracting in defense procurement for high technology projects (see Section 6.2).

For the purposes of this subsection, however, assume that a private agency (like a public agency) is awarded a budget by the government and is told to create a leadership and professional staff to manage foreign affairs. Can the resulting agency both implement the low-powered incentives that will support responsiveness/check adventurousness in the administration of foreign affairs while at the same time appropriate the net receipts that accrue to cost savings?

As set out above, the realization of very low-powered incentives in the public agency is accomplished in part by returning cost savings, if any, to the treasury. Such a requirement is inimical to—indeed, is antithetical to—privatization. The resulting added incentive intensity in the private agency has massive ramifications for (1) cost saving/cost bearing, (2) executive appointments, (3) the career staff, and (4) agency procedures.

Not only will the private agency be more alert to and assiduously implement

cost saving opportunities, but it will also be concerned if the president were to ask the agency to take on added (costly) burdens between contracting intervals. The behavior of the agency could be tilted in problematic ways by the former, and the responsiveness of the agency will be weakened when added cost burdens attend presidential requests for adaptation. (Even if the contract is renegotiated, assured and timely responsiveness will be compromised in the process.)

Similar problems attend the appointment of agency executives. To be sure, boards of directors in private firms are normally passive and give nodding approval to the management of the enterprise. Absent adverse experience, the board approves of "business as usual." When, however, things go badly, the board can intervene; and if it does not, it runs the risk that others will offer a rival slate (incumbent board is subject to replacement by vote of the ownership) or to buy up shares (incumbent board is subject to replacement by takeover). In either case, a new board will almost certainly make changes in the top management. Even if things continue to go well so that intervention is unneeded (period by period, the incumbent board, like the Maytag repairman, is idle), executive retirements pose periodic needs to replace the management.

Tension is plainly posed between business and politics. A board with bottom line responsibilities to the ownership always has a significant voice in the appointment and termination of the management. Yet the management of foreign affairs requires that the president and the congress make these calls.

Providing the career staff of a private firm with great security of employment and giving them considerable training and social conditioning nominally fares better. Identical procedures, rules and regulations, and the like does not, however, ensure that public and private bureaucracies will be operated identically if the purposes to be served differ. Except as assignments and promotions are fully constrained by objective indicia (e.g., by seniority), the exercise of judgment will permit managers to tilt for or against outcomes in which net receipts considerations have a bearing. Net receipts thus reappear, even if they are never expressly referred to (may even be disavowed) by the rules. Put differently, identical *de jure* rules do not imply identical *de facto* assessments.

The assumption, moreover, that identical procedures, rules and regulations, and the like will be adopted is gratuitous. The private bureaucracy will view these through the conflicted lenses of foreign policy efficacy and the bottom line, which is to say there are trade-offs. Moreover, the government is not in a position to impose rules and regulations from above if it lacks direct experience with the foreign affairs transaction and is therefore imperfectly informed of the needs.

The upshot is that the effort to replicate the public administration of foreign affairs by a private firm will fail. The private firm will be characterized by greater incentive intensity, less complete administrative controls, less responsive management, and a less protected career staff. This is not to say that foreign affairs will be a disaster. Rather, it will be different in that cost control will get greater emphasis, probity will be sacrificed, and the career staff will be less protected/socialized/committed. Also, because the polity will less fully delegate in such circumstances (thereby to safeguard the interests of the state),

counterpart bureaus in other nation states will regard the representations of the private bureau as less definitive (subject to more review and a greater likelihood of change if not reversal).

6.1.2 Particular. Hart, Shleifer, and Vishny (1997) recently addressed the choice between public and private bureaucracies in an article titled “The Proper Scope of Government: Theory and Application to Prisons.” Although the main question that they address is the privatization of prisons, they also consider foreign policy. They observe that the investments needed to conduct foreign affairs are small and that the contract to conduct foreign policy will be highly incomplete. According to Hart, Shleifer, and Vishny (1997:1155) privatization would work as follows:²⁴

Suppose that the State Department were to be privatized, and a set of policies toward different countries specified in the contract. In this case, when the government wants to change its policy toward a country (say because Russia renounces communism), it would have to persuade the private contractor to change what it does. In this renegotiation the government would presumably have to pay the private contractor more than it would pay an employee, who is totally replaceable when few *ex ante* investments are involved. In-house provision in this case of few investments and enormous *ex post* holdup opportunities seems clearly superior.

Rather than focus on renegotiation and holdup, I would describe the privatization problem differently. Faced with unanticipated disturbances for which coordinated adaptations are needed, the question is which mode of governance is best suited to effect adaptation and restore efficiency. Adaptation entails eight steps: (1) the occasion to adapt needs to be disclosed, after which (2) alternative adaptations are identified, (3) the ramifications of each are worked out, (4) the best adaptation is decided, (5) the chosen adaptation is communicated and accepted by the agency, (6) the adaptation is implemented, (7) follow-up assessments are made, and (8) adaptive, sequential adjustments are thereafter made.

Of these eight steps, Hart, Shleifer, and Vishny (1997) consider only steps 1, 4, and 5. Step 1 is easy: the Russians renounce communism—but of course most events are not so dramatic or unambiguous as this. In the degree to which alternative modes of governance differ in their capacities to detect and credibly communicate impending changes, that should be included in the calculus. According to step 4, the government decides what it wants to do. How it does this without benefit of steps 2 and 3 is not disclosed. Again, if public and private differ in identifying possible adaptations and working out the ramifications, that should be factored in. Step 5 entails persuasion/renegotiation, which is where

24. They also argue that efforts to auction off the foreign policy franchise would encounter severe financial difficulties (Hart, Shleifer, and Vishny, 1997:1155–1156).

the potential holdup resides. As between a private contractor and an in-house provider, Hart, Shleifer, and Vishny argue that the government will have to pay more to the former. The choice of make-or-buy is therefore clear: go in-house.

If, however, all eight steps are important to the management of foreign policy—and for sovereign transactions more generally—then to focus on holdup, to the exclusion of earlier and later stages in the process, not only misses much of the crucial action but can be actively misleading. As envisioned by the eight step process, the foreign policy transaction *evolves* as a product of real-time interactions between the president and the foreign affairs agency. Step 5 is pertinent, but holdup is not a stand-alone, or even the most important, consideration. Probity is operative throughout this eight step process, whereupon governance structure differences in terms of leadership, the social conditioning of the staff, and procedural regularities—as well as differential incentives—are implicated.²⁵

Thus although they and I project serious difficulties with the privatization of foreign affairs, theirs is a renegotiation/holdup story. By contrast, I emphasize an ongoing relation between the president and the foreign affairs agency in which information inputs, decision making, and implementation are overlapping and interdependent and where considerations of probity are operative throughout.

6.2 Regulation

In consideration of the problems posed by full privatization, might rate-or-return regulation be applied to a private firm to which the responsibility for foreign affairs has been delegated? This could be thought of as a very long-term incomplete contract of a cost-plus reimbursement kind in which the interests of the government are protected by (1) embedding the agency in a complex regulatory apparatus, whence extensive rules, regulations, and procedures will appear and provision will be made for periodic auditing, (2) executive appointments are made in consultation with the president and with the tacit (or actual) approval of Congress, and (3) the staff of the agency is provided with both added security of employment and greater social conditioning to the mission of the agency, possibly through training by the staff of the regulatory agency.

Such a regulatory arrangement would permit closer replication of the public bureaucracy than would full privatization. Better contractual support for the asset specificity and probity needs of the foreign affairs transaction would thereby be realized. Differences from the public bureaucracy would nevertheless arise.

25. Wilson's (1989:198) observation that the leadership of some federal bureaucracies—Bureau of Prisons, Weather Service, Forest Service, and Bureau of Standards—can be and is chosen from the career staff, but that the president chooses the leaders of other bureaus from the population at large, plays no role in the Hart, Shleifer, and Vishny analysis. The idea that sovereign transactions pose severe probity hazards, which in turn have leadership ramifications, thus goes unremarked. Their suggestion, moreover, that Foreign Service officers are “totally replaceable” (Hart, Shleifer, and Vishny, 1997:1155) and my treatment of such officers as highly specialized, hence embedded in protective governance (whence ready recourse to replacement is not contemplated), are also very different.

One of the differences is that an additional level of bureaucracy (the regulatory agency) is inserted between the president and the administration of foreign affairs. Does the president work through the agency or work around it? Also, the possibility that the regulatory agency will proliferate controls (which is, after all, what regulatory agencies do) to the detriment of foreign affairs performance must be considered. Given the vague and open-ended nature of the “contract” and the felt-need for defensibility in the regulatory agency, differences of control arise.

Control differences of both omission and commission will occur. Because the regulatory agency operates at one remove (as a controller rather than a player), it lacks the first-hand knowledge and experience to accurately perceive the same needs for control as would a more self-contained public bureaucracy. Omission differences will thereby arise. But also, because the agency is awkwardly positioned between the political leadership and the regulated firm, the regulatory agency experiences the aforementioned defensibility concerns. Differences of commission will thereby arise. The upshot is that the rules, regulations, and procedures will not be fully replicated.

Also, the leadership of the regulated firm is more apt to be selected from its career staff rather than from distinguished outsiders. Choice of a consummate bureaucrat, who will not rock the boat and will therefore be acceptable to the regulated firm and the president alike, is thereby favored. It is unrealistic, however, to expect the president to be indifferent between such an appointment and the selection of a person of his own choosing with whom he has prior experience and shared values.

A whole series of operating questions also present themselves. How does the government induce the regulated firm to which foreign affairs has been delegated to adapt cooperatively when changes in direction are needed? Is this negotiated? How are cost consequences decided, or are they just uncritically reimbursed? Also, how does the government satisfy itself that it is adequately informed? In anticipation of perceived needs to act decisively, the president has the incentive to bypass such an agency by creating a parallel structure (such as the National Security Council).

And there are further complications. Since causality is hard to establish, how does the firm defend itself against accusations of indolence or incompetence or disloyalty when things go wrong? Note, moreover, that if “an outsider” can be made a scapegoat when things go badly, then additional problems accrue. Presented with the prospect of termination or recriminations for contrived (possibly political) reasons, an outside supplier will be more vulnerable, with the result that the regulated firm will be especially reluctant to undertake actions to which high-variance outcomes accrue. (The regulated firm is not more risk averse than the public bureau, only more vulnerable.)

The upshot of this brief comparative exercise is that although regulation is better able to replicate the public bureaucracy than can a private bureaucracy, full replication will not be achieved. Instead, regulation is akin to a hybrid mode in the markets and hierarchies setup discussed earlier: it possesses a syndrome of attributes that are located between the polar modes of public and private

Table 2. Comparative Public Sector Organization

	Governance Structure		
	Privatization	Regulation	Public Agency
Instruments			
Incentive intensity	++	+	0
Bureaucratization	0	+?	++
Performance attributes			
Adaptive autonomy	++	+	0
Adaptive integrity	0	+	++
Contract law			
Employment relation			
Executive autonomy	++	+	0
Staff security	0	+	++
Legalistic dispute settlement	++	+	0

++ = strong
+ = semistrong
0 = weak

bureaus. Table 2, which bears a strong resemblance to Table 1 but introduces executive and staff attributes, summarizes.

As shown in Table 2, private bureaucracy (contracting out) has the strongest incentives and the least administrative control, the strongest propensity to behave autonomously (display enterprise and be adventurous) and the weakest propensity to behave cooperatively (be compliant), works out of a (comparatively) legalistic dispute settlement regime, appoints its own executives, and affords the least degree of security of staff employment. The public bureaucracy is the polar opposite in all of these respects, while regulation (public agency plus private firm) is located in between these two along all dimensions (with the caveat that regulation may have more administrative controls, possibly of a dysfunctional kind). Figure 3 is a heuristic extension of Figure 1 to include these additional governance modes.

7. Commentary

The foregoing reaches the obvious conclusion: foreign affairs is not a transaction that is easily privatized. This is not, however, to say that foreign affairs is never “delegated” (or quasi-privatized). Both in the past (as with the East India Company) and in the present (as in dealings with “pariah states”), delegation has occurred. The former is explained by costly transportation and communication and by diseconomies of small scale. Such delegation is regularized (relocated to the public bureau) as contacts and interests build up. Contemporary delegation is explained by the need to maintain informal contacts when formal recognition has broken down. (Adventurousness, as in Iran-Contra, sometimes results.) Regularization always attends the restoration of formal recognition. Since no one recommends privatization on a regular basis, why explicate the obvious?

First and foremost, that which is intuitively obvious often operates in subtle

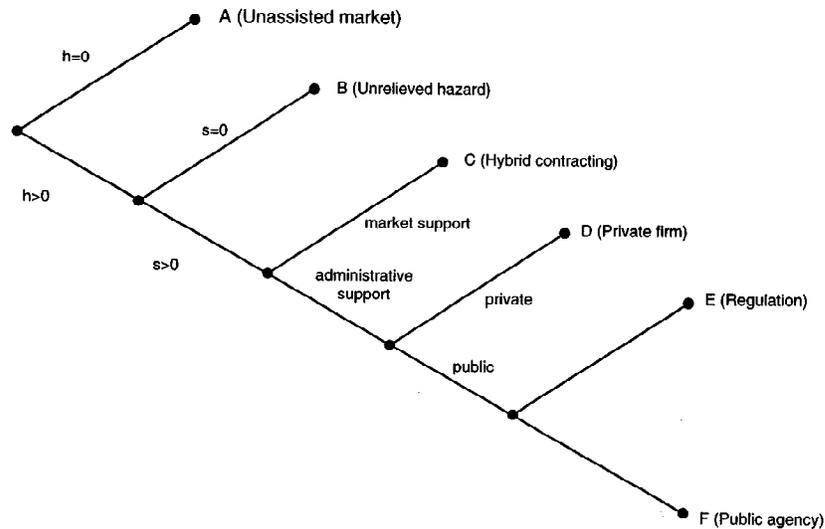


Figure 3. Contracting schema extended.

ways [the elusive concept of trust is an example (Williamson, 1993)]. Finding an entre through the use of extreme instances, of which foreign affairs is one, can help to uncover attributes that do not come up or are a good deal less important in more standard and familiar transactions. In that event, explicating the obvious may help to expand the “dimensionalization” of transactions in ways that would not have otherwise occurred.²⁶ Also, there may be several explanations for why obvious transactions, such as foreign affairs, are not privatized. Are these equivalent? If they differ, what are the differences and what are the ramifications?

7.1 Perspective

Transaction cost economics interprets the use of rate of return regulation in public utilities as a response to extreme conditions of bilateral dependency and information asymmetry. Such regulation provides safeguards beyond those that can be crafted through private ordering.

One interpretation of sovereign transactions is that they are like public utility

26. There are some parallels in the “discovery” of probity with earlier developments in which additional forms of asset specificity and additional modes of governance were successively recognized and folded in. Thus whereas physical and human asset specificity were obvious forms of specificity early on, some of the more subtle forms of asset specificity became evident only as new (and different) transactions were brought under review. Similarly, the contractual import of hybrid modes of governance became evident only as the concepts of credible commitment and incomplete contracting were joined. What this article does is expand the reach of transaction cost economics by asking and attempting to answer the question “What’s going on here?” with respect to sovereign transactions.

transactions, only more so: *even greater* conditions of bilateral dependency and information asymmetry are presented, to which the added safeguards of the public bureau arise in response. As developed herein, that is not what mainly distinguishes sovereign transactions. The hitherto *unremarked hazard of probity* is what complicates the administration of foreign affairs.

That is both instructive and disconcerting. It is instructive if, as argued herein, probity hazards really are important for sovereign transactions in general and foreign affairs in particular. In that event we need to inquire into the governance structure attributes that would relieve such hazards. And we need further to ascertain what mode of governance is best able to implement these features. As interpreted herein, a public agency is a best governance structure reply to the hazards of probity.

Appeal to probity is nevertheless disconcerting, in that it is always possible to invent some new contractual hazard and ascribe importance to it, thereby to explain hitherto puzzling anomalies. Much better if this hazard had been previously identified, whereupon its bearing on the organization of foreign affairs is a straightforward application of the logic. Given the primitive state of transaction cost economics, that is evidently asking more than it can deliver. But transaction cost economics has company. Assuming that probity really is important, the entire economics of organization movement has been remiss. In that event, transaction cost economics actually deserves credit for helping to uncover and explicate this condition.

But probity is disconcerting in another respect as well: the concept is vague. What are the key attributes with respect to which the importance of probity differs? There are no definitive answers herein. Again, however, transaction cost economics has company. Consider the “elusive concept of trust” (Gambetta, 1988:ix), or the elastic idea of “relational contracting” (Macneil, 1974), or the expansive concepts of “influence costs” (Milgrom and Roberts, 1988) and “corporate culture” (Kreps, 1990). All of these concepts are important and have helped to inform our understanding of complex economic organization, but all stand in need of operationalization.

Lack of operability notwithstanding, responsive governance to the hazards of probity will, I think, be realized as follows: (1) very low-powered incentives, (2) extensive administrative controls and procedures, (3) appointment and termination of the leadership of the agency by the president (and confirmed by the legislature), and (4) an elite staff with considerable social conditioning and security of employment. As between public and private, those attributes are best realized by a public bureau.

7.2 Other Transactions

What follows is sketchy and should be regarded as suggestive at best. Believing, as I do, that the microanalytics matter, application of the foregoing to other transactions should be worked out in a “modest, slow, molecular, definitive” way. I nevertheless believe that the governance of a large number of transactions is informed by the following two propositions: (1) hazards take one or more of three forms: cost excesses, bilateral dependency, and probity; and (2)

Table 3. Impressionistic Contractual Hazards

Composite Transaction	Contractual Hazards		
	Cost Control	Asset Specificity	Probity
Foreign affairs	+	+	++
Defense procurement	++	++	+
Office supplies	+	0	0
Income tax collection	+	0	+
Prisons	+	++ ^a	+

^aPhysical assets
 ++ = strong
 + = semistrong
 0 = weak

governance structures differ mainly in autonomous and cooperative adaptation respects. The basic argument with reference to the latter is this: modes of governance that feature autonomous adaptation have good cost control properties but do poorly in bilateral dependency and probity respects, whereas modes of governance that feature cooperative adaptation have weak cost control properties but do better in bilateral dependency and probity respects.

Consider the hazards associated with the following transactions and the organizational consequences that accrue thereto: foreign affairs, defense procurement (for high technology), office supplies, income tax collection, and prisons. Table 3 is a (first-impressions) effort to describe the contractual hazards—cost control, bilateral dependency, probity—associated with each. As heretofore described, and as shown in the table, foreign affairs poses modest cost control hazards, some (human) asset specificity concerns, and great probity concerns. Defense procurement, by contrast, presents significant cost control and bilateral dependency hazards, but probity is of a lesser concern. Office supplies present cost control hazards alone. Tax collection presents cost control and probity concerns of intermediate degree. And prisons involve a large investment in specialized physical assets while cost control and probity are operative in intermediate degree.

The governance of foreign affairs by a public bureaucracy is warranted on the argument advanced above. Office supplies is likewise easy: procure these in the market. Defense contracting and tax collection are more problematic. Cost-plus procurement (a form of regulation) may be warranted for defense contracting. Some form of regulation might also be warranted for income tax collection, but this would require more detailed analysis. Ownership of the specialized physical asset (the prison) by the government and franchising out the operation of the prison is a possibility for prisons, but quality considerations—herein reflected as probity—signal precaution. The Hart, Schleifer, and Vishny model, which deals expressly with quality (rather than probity), appears to engage the key issues for this.

8. Conclusions

What is novel about this article is not that foreign affairs is organized by a public agency. That is what we observe everywhere and what our intuitions support. What is novel are that (1) this result is reached by the application of transaction cost reasoning, (2) the hitherto unremarked hazard of probity is posed, in relation to which the public administration of foreign affairs enjoys a comparative advantage, (3) practices that are widely condemned (low-powered incentives; convoluted bureaucratic procedures; excesses of employment security) actually serve legitimate economizing purposes in this context,²⁷ and (4) management considerations (both the leadership of the agency and the career staff) take on greater importance than has been ascribed to them in earlier transaction cost assessments of comparative economic organization. Also, as with transaction cost economics more generally, (5) the action resides in the microanalytics and (6) inefficiency is judged not in absolute but in remediableness terms.

Moe contends, and this article bears out, that politics is different. North contends, and this article bears out, that some (perhaps many) difficult transactions gravitate to the polity. But whereas North interprets this outcome as evidence of inefficiency, I argue the opposite: the difficulties that North refers to are inherent in the transactions—to which public bureaucracy, its apparent inanities notwithstanding, is the best feasible governance response. Recourse to public bureaucracy for those transactions for which it is comparatively well-suited is properly regarded as an efficient result.

The use of extreme instances is intended to uncover important but hitherto neglected features. That the unremarked hazard of probity surfaces in the foreign affairs transaction is precisely because it is so clearly important in this context. Once disclosed, the relevance (or not) of probity for the leadership and staffing of other agencies and of other modes of governance (e.g., nonprofits) can be worked out. The idea of “governance as integrity” thus has broader scope than is evident from prior treatments of bilateral dependency, weak property rights, measurement, and the like. But while probity seems to resonate, it is also vague. Applications need to be delimited. Operationalization is wanting.

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27. Holmstrom (1996) also forcefully makes this point.

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