

The Firm As An Institution And Influenced By The Institutions

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ABSTRACT

The purpose of this paper is to present the firm's dual vision. The firm is considered an institution. As pointed out, the firm is an organizational structure influenced by both internal and external institutions. In this paper, a conceptual approach is discussed, the aim of which is to highlight the terminological dichotomy of the said firm. This dual vision of the firm is the two research components of the neo-institutional theory that the firm remains the primary point of analysis.

1. Introduction

At a time when information has become the new challenge, the firm's response to the problem of information is in a situation of limited rationality, information asymmetry, and information that is transformed, transmitted and disseminated at a cost (Coase, 1937). Thus, and as Hayek (1978) suggests, any economic problem is a problem of information, problems of transaction costs, agency, supervision and control have thus become the main new peculiarities of the contemporary economy.

The firm has long been seen as a fictitious entity in a neoclassical market characterized by a transparent and free transfer of information between players with a perfect rationality of calculation with absolute certainty. Subsequently, the firm took on a new meaning after Coase's pioneering article (1937): *The Nature of the Firm*. The author, who is considered to be the founding father of the firm's theory, has opened the door to numerous theoretical analyses according to which the firm is depicted as an organization framing two paths of personal utility: maximization of profit among shareholders on the one hand and maximization of wages and the establishment of an adequate working environment on the other (Williamson, 1975). In addition, the firm thus appears as an institution that encapsulates rules, norms, and customs to specify an institutional step towards collective utility (North, 1989)

Under the name of a neo-institutional economy with its major founders North and Williamson, the firm has become the core unit of analysis, and is seen both as an institutional group and as a governance structure led and impacted by institutions that come from outside. In this sense, the firm is treated from two perspectives: the firm is an

institution and is affected by the institutions. In the following, a conceptual approach is taken to highlight the firm's terminological ramification. This branching originated from two analytical angles of the institutional and neo-institutional approach.

2. Institutions and institutional analysis

In order to carry out the analysis, one must first of all refer to the institution as an object of analysis that has been widely treated for a long time. The word institution has its origins in the political realms when the state or government develops and then proposes rules, laws and legislations aimed at putting society in a specific systemic framework. The divergence of citizens' behavior requires intervention by a higher power in order to define a strict status under which the rights and obligations of each individual are defined (Mijiyawa, 2010).

Over time, the term institution has conquered the sociological and economic field and has been the subject of an analysis that focuses on individual behaviors, organizational forms and the institutional environment (Mijiyawa, 2010). For example, Meyer and Rowan (1977) view institutions from a sociological perspective as a means of social coordination and institutional rules as socially constructed realities (Meyer and Rowan, 1977). In addition, writers such as Williamson (1975, 1991) and Nelson (1991) provide an institutional interpretation of the commercial and non-commercial relationships that make up society (Allouche and Huault, 2003).

More specifically, the verb *institute* is tantamount to organizing a human community within which individuals accept the existence of a common authority with regard to a higher end or what Castoriadis (1999) calls an *instituted heteronomy* (Pesqueux, 2010). However, Hayek (1945) considers the institution to be a rule of conduct that channels the behavior of the actors so that their interactions lead to a tendency towards equilibrium (Hayek, 1945). Hayek (1945) who focuses in his work on information as a major economic issue that immediately influences coordination, considers that the existence of adequate institutions that frame the behavior of agents enables effective coordination within the economic system (Hayek, 1945).

A second point proposed by Hayek is that institutions are embodied in morality and law. In other words, Hayek (1948) considers that morality, which is composed of cultural rules (values, habits or customs), is generally respected spontaneously by individuals (Hayek, 1948). The enrichment of institutional analysis is mainly observed through the work of North (1989). The author, who is considered as the founding father of the new economic institutionalism in an analytical framework, his work represents a basic reference for any scientific approach to institutions. For North (1989, p. 1321): "*Institutions are rules, enforcement characteristics of rules, and norms of behavior that structure repeated human interaction*". The author suggests that there are two main reasons why the need for these institutions emerges: the nature of the actor, whose limited rationality is an instinctive characteristic, and the uncertainty that surrounds life in general.

Because of limited rationality, North sees that individuals have frequently erroneous representation models, and thus the issue of information processing becomes central because information processing is the key to understanding the more complex behavioral model than that derived from the expected utility model (North, 1990). In addition, the nature of institutions is to reduce uncertainty. Under conditions of limited information and limited computational capacity, constraints reduce the costs of human interactions compared to a world without institutions (Mijiyawa, 2010).

Another major contribution from North (1990) is its representation of the state as an institution and regulator. The author points out that the implementation of human, technical and financial resources in order to provide well-established content in the form of legal terms to the community requires a legal institutional organization.

In addition, and vis-à-vis Hayek (1948) who proposed a distinction between morality and law, North (1989) focused on formal and informal institutions. Formal institutions according to North (1989) represent all written political, legal and economic contracts and rules explicitly and require monitoring of performance by a specialized

administration. However, informal institutions are a set of customs and norms in the form of implicit rules which are implemented endogenously by individuals belonging to the same group or community. Formal institutional change may be discontinuous or abrupt. On the other hand, informal institutions evolve continuously and incrementally (North, 1989).

Thus, North (1989) was able to propose a causal relationship between the institutions and the economic development of the country. The author emphasizes that the existence of good private property rights institutions stimulates investment development and economic growth. This has inspired several subsequent empirical studies that have sought to shed light on the role of institutions in determining economic growth rates (Didry and Vincensini, 2011).

3. The organizational nature of the firm

The firm, the enterprise or the organization, represent three terminologies for the same meaning which is a group of individuals embedded within a legal framework to achieve a goal; a goal that proves to be the same from a macro-analytical point of view but it reflects some inter-individual divergences sometimes. Generally speaking, the firm is assimilated to a homogeneous entity subdivided into hierarchical levels in the form of a pyramid reflecting a breakdown of authority, power and missions. A contractual relationship based on a long-term contract called an employment contract is the one that characterizes the internal structure of the firm. A lower party called the subordinate agrees to submit to another higher power called the supervisor (Williamson, 1996).

In addition, according to North's vision (1989), the reason a firm is established is its ability to reduce uncertainty (Didry and Vincensini, 2008). Individuals' uncertainty and inability to accurately predict future events impact or destroy medium- and long-term decisions.

For North (1989), the firm's internal structure, which is based on a long-term contract of employment and institutions that identify employee behavior in the firm, in a way reduces uncertainty (Didry and Vincensini, 2008). In addition, it is clear that each part of this organizational scale has logically nuanced inter-individual peculiarities, both psychological and social, that differentiate the goals of each member and that it supports the decision-making and leadership domination of the top. This divergence of goals, accentuated by limited rationality and information asymmetry, poses the major challenge and hinders an absolute homogenization of the whole organization that aims to unite the goal while focusing on collective utility (Jensen and Meckling, 1976).

From this perspective, there is a need to put in place rules and procedures in the form of institutions whose purpose is to identify and thus bring together, as it were, the divergence of ends between parts of the firm. On the one hand, if the difference in goals that exists between members of the same firm appears to be a challenge that hinders the firm's sustainability, on the other hand, it will be noted that this difference between the firms that make up the society is a natural phenomenon, if not negligible in the academic literature. The division of labor and the specialization of tasks have remained an indisputable reality in the practices of firms since the work of Adam Smith.

In this context, North (1994) categorizes firms according to their main objectives into: economic organizations such as firms; political organizations such as political parties; educational organizations such as school and university; and social organizations such as sports clubs and associations.

4. The institutional nature of the firm

The firm is seen as an institution, that is, as a system of established social rules that structure social interactions (Hodgson, 2003). To this end, North (1989) considers that in order to exist, the organization must be established in advance. This is the founding or legal incorporation phase (*incorporation under the law*) in which the association of individuals becomes a legal person that exists through an organizational structure. On the other hand, the internal

structure is defined in relation to the aims of the institution and is therefore subordinate to the institution it embodies. In addition, the firm's institutional approach sees the firm as a group of individuals who share a collective goal.

Indeed, the multiplicity of objectives and outcomes for which agents are brought together reflects the multiplicity of organizations where we find economic organizations such as firms, political organizations as well as political parties, and educational organizations such as schools and universities (North, 1994).

As for Commons (1934), the essential criterion for considering the institutional nature of organizations is the question of the permanence and evolution of these organizations. Commons (1934, p69) suggests that an organization is an institution if it operates over time: "*A concern is an institution if it goes.*" In other words, resistance, survival and sustainable operation lead to the firm being seen as an institution in the face of changes in its organization, its actors or new events both internally and externally. This is why Commons (1934) uses the term "*going concern*" to specify the institutional nature of organizations. The "*going concern*" derived from the American jurisprudence means in the common language "*prosperous case*" by thus reflecting the ideas of movement (going) and active entity (concern). From this point of view, "*going concern*" can be translated as *organization in operation*.

5. The firm is influenced by the institutions

To develop this analytical point, reference should be made to Williamson's work that the firm is seen as an alternative governance structure to the market and hybrid form (Williamson, 1991, 1992). The choice of internalizing a transaction also called: hierarchy rests on the characteristics of the transaction itself.

Williamson, through his enrichment of Coase's (1937) contribution, is based on the idea that the characteristics of the transaction (asset specificity, uncertainty and frequency) accentuated by the characteristics of the players (limited rationality and opportunism) in the same transaction determine the situation where the firm has become the appropriate structure for a given transaction.

In contrast, Williamson's analysis of institutional arrangements was enriched by the introduction of the institutional approach led by North (1986). The question of the institutional context is thus seen as a complementary determinant to the traditional determinants taken into account in the choice of a coordination structure that will impact the relative effectiveness of different governance structures (Brousseau, 1999).

The institutional environment that designates institutions, whether informal (social, moral) or formal (political, legal, state) regulates economic activity and reduces transaction costs. Specifically, it is the formal institutions in particular that dictate the rules of the game and thus provide support for human interactions by influencing transaction costs and thus the choice of one of the three organizational forms. In this sense, the institutional context is mainly treated as a fact that will affect the relative efficiency of the different governance structures and thus the arbitration between them (Williamson, 1996).

In this context, the Williamson see the firm as a governance structure that forms with the market and inter-firms cooperation an organizational form influenced by both internal and external institutions. By establishing the rules of the game, institutions create a stable structure for human interaction and reduce the uncertainty surrounding transactions (North 1989). By way of example, institution-building reduces the cost of information collection, thereby weakening the impact of information asymmetry. In addition, institutions define and strengthen property rights by establishing supervisory procedures to protect property rights (Boutry, 2011).

It should be noted that Smith (1776) and Marshall (1919) made the first attempt to institutionalize the decisions taken by the firms. Smith's book examines the *wealth of nations* on the firm's institutional character by stating that the various state-proposed institutions have an impact on the firm's nature and practices. According to Smith, the firm is considered to be a legal entity characterized by conduct described in a legal framework. For his part, Marshall (1919) in his book *Industry and Trade* points out that the firm is thus within a legal framework by adding that 19th century legislation has encouraged and facilitated the ability of firms to raise equity capital.

6. A neo-institutional comparison of organizational forms

For Williamson, the market, firm and hybrid form are seen as governance structures that form an alternative to organizational choice (Williamson, 1991,1992). After introducing the concept of governance structure, which means an institution capable of managing and coordinating transactions, in order to answer a central question: “make or buy” (El-Filali El-Youssefi, 2000), Williamson focused his work on the choice between these three economic poles by naming it discriminating alignment (Williamson, 1991).

To distinguish each of these modes of governance, Williamson (1991) has identified three main attributes of differentiation: the mode of adaptation in the face of disturbances, the use of incentives, and the instrument of control. As for adaptive capacity, Williamson (1991) considers that each governance structure has its own capacity to adapt in uncertain situations. Referring to Hayek’s work (1945) on type (A) adaptation, Williamson (1991) considers that adaptation (A) in the sense of autonomy amounts to spontaneous adaptation in the face of unexpected change and where the individual retains his autonomy.

Williamson referred to Barnard (1938) for type (C) adaptation. The latter refers to conscious co-operation and dependence between agents influenced by the same change. In this situation, it is necessary to ensure coordination between the two parties in order to cope with this change. Obviously, type (C) adaptation is often found in commercial relationships. The market has a type (A) adaptation mode, as the relationships within the market are characterized by absolute independence and unilateral decision-making. In this context, Williamson (1991, p. 283) suggests that: “[. . .] *the bureaucratic costs of internal organization exceed those of the market because the latter is superior in adaptation (A) respects*”.

For its part, the internal structure has a capacity for cooperative adaptation (C) in the face of the changes in which the parties find themselves. The firm, which distinguishes itself by an authoritarian system and voluntary subordination, is able to adapt to the fluctuations of the environment in a cooperative manner between the internal poles. In this sense, Williamson (1991) indicates that as bilateral dependence increases, and adaptive capacity increases, the firm has a better type (C) adaptive capacity.

However, the hybrid form that lies in the middle of two organizational extremes is still characterized by a combination of both types of adaptive capacities (A) and (C). This hybrid form of economic relations preserves the autonomy of the parties (type A adaptation), and ensures a certain degree of legal dependence and hierarchical relationship (type C adaptation).

On the other hand, the incentive depends on the degree to which the economic agent bears the consequences of the choices they make. A low incentive is therefore that which amounts to a distribution of the consequences of the choice of agent between several economic parties and vice versa. Since the agent individually supports the outcome of its decision in the market, the market is therefore specialized by a strong incentive.

Nevertheless, within the firm, the results of the decision are shared by all parties despite the unilateral nature of the decision. The incentive in the internal structure is therefore low. With regard to the hybrid form, this form of inter-enterprise cooperation provides a medium degree of incentive, since the results achieved, whether negative or positive, are shared between the two poles.

For its part, the monitoring instrument refers to the adoption and enforcement of strict rules to identify the behavior of the parties. Consequently, it is clear that administrative control remains weak in the market, but very strong in the firm where it is necessary to put in place control and supervision procedures in order to ensure collective utility. In the case of the hybrid form, the latter is distinguished by an average intensity of implementation of the control instruments, the aim of which is to secure the contractual relationship for a predetermined period while protecting a degree of dependence for the two parties involved in the contract. The following table summarizes the attributes proposed by Williamson for each governance structure:

Table: Neo-institutional comparison of organizational forms

Attributes	Market	Hybrid	Hierarchy
Incitation	Strong	Average	Weak
administrative Control	Weak	Average	Strong
autonomy adaptation	Strong	Average	Weak
cooperative adaptation	Weak	Average	Strong

Source: according to Williamson (1991, p. 281)

It should be noted that for hybrid forms, and since they are between the two extremes, their characteristics come from a hybridization of characteristics of the firm and the market. This means that for each attribute proposed by Williamson to differentiate the three governance structures, the hybrid form is located between market and hierarchy in terms of incentives, adaptability and bureaucratic costs (Williamson, 1991).

7. The firm and the subordination contract

Within the firm, there is a contract of subordination, also known as a relational contract or employment contract. This type of contract defines the employee's agreement to obey the superior's directives within a certain limit in order to achieve compensation. Perceived command and subordination relationships within the firm complemented by the coordination and control mechanism provide greater flexibility and adaptability to unforeseen changes. The wage contract means that one of the parties accepts a certain dependence on the other. In this context, Simon (1951) defines the analysis of the subordination contract as follows: the Boss exercises authority over the Worker and the Worker (the employee) contractually authorizes the Boss (the employer) to select the specific actions he will perform in his work within a set of actions.

Coordination of resources within the firm is handled by the firm's management team. The latter has decision-making power over lower parties subject to voluntary subordination after signing an employment contract (Williamson, 1991). On the other hand, the subordination contract provides an incentive and protection of the rights of each party within the firm. Conversely, it is necessary to set up a control system to ensure that the contract is properly carried out, as opportunistic temptations can easily arise.

Thus, the form of the subordination contract is more detailed and personalized than the conventional contract, which refers to the market structure, and the neoclassical contract, which illustrates the hybrid form. The length of the relationship between the parties belonging to the same firm becomes more important and the subordination contract encompasses transactions of a complex and lasting nature.

Unlike the conventional contract, the subordination contract guarantees a lasting relationship in an uncertain situation affecting future labor market developments. In addition, the subordination relationship promotes coordinated adaptation and control of actions in an uncertain environment, and the modalities of interaction between the higher and lower levels with less power are governed by formalized processes.

With regard to the resolution of internal disputes, internal disputes are resolved without recourse to the courts or external actors. According to Masten (1988), the court proved to be incompetent to settle disputes within the firm. The costs associated with the search for information and the arbitrations to be made are therefore lower in the hierarchy than in the hybrid form.

8. Conclusion

The firm is approached according to two main approaches that form the two facets of neo-institutional theory. The institutional nature of the firm reflects, on the one hand, the need to follow both formal and informal institutions in order to build a kind of homogeneous internal structure and, on the other hand, organizational resistance to internal and external changes that have a direct impact on the firm's structure.

In addition, the firm also remains a governance structure whose strategic decision to internalize, outsource, or transact through market transactions depends on transaction costs assessed through the use of one of these three organizational forms. These transaction costs do not depend solely on the characteristics of the transaction or the characteristics of the contracting parties, as Williamson (1975) has previously pointed out, but the institutional environment also plays a determining role, particularly with regard to the behavioral characteristics of the actors involved in the transaction.

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