Journal of Economic Behavior & Organization
Vol. 52 (2003) 71–96

JOURNAL OF
Economic Behavior
& Organization

www.elsevier.com/locate/econbase

The organization of economic activity: insights from the institutional theory of John R. Commons

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Received 8 September 1999; accepted 27 March 2002

Abstract

This paper develops a theory of economic organization based on the concepts of property rights, sovereignty, transactions, bounded rationality, the interdependence of preferences and economies of scale in production. All of these concepts were central to the work of institutional economist John R. Commons. My new synthesis of his ideas delineates the structure upon which the market and non-market systems of an economy rest, or in modern terminology the choice between make and buy. It provides a more comprehensive framework for comparative analysis that encompasses much of the contemporary literature in the economics of organization, while providing alternative interpretations and implications at critical points.

JEL classification: B25; D23; L22

Keywords: Institutional theory; Economics of organization; John Commons; Transaction cost

1. Introduction

The large and burgeoning literature on the new institutional economics (NIE) and the economics of organization (EO) seeks to explain the types and structures of institutions used in modern industrial societies to produce and allocate scarce resources (Furubotn and Richter, 1997). Most attention has been given to the theory of the firm: why firms exist, the determinants of their size and structure, and the factors that determine the boundary line between firms and markets (Holmstrom and Roberts, 1998).

In this paper I describe and further develop the theory of economic organization contained in the writings of early institutional economist John R. Commons. Although Commons was one of America's preeminent economists in the first-third of the 20th century, his work

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PII: S0167-2681(02)00153-1

on economic organization has not had much impact on the contemporary literature, with the exception of the "transaction" concept utilized by Williamson (1985). In what follows I provide a brief overview of Common's institutional approach to economic organization, identify and elaborate the five key constructs in his theory that influence whether production and exchange take place across markets or within firms and other organizations, and then demonstrate how permutations in these five constructs lead to different patterns of economic organization—ranging from an economic system of perfect decentralization at one end-point to a system of perfect centralization at the other. Key features of alternative theories of economic organization, such as by Coase, Williamson, and Hart and Moore, are also compared and critiqued at several places in order to further highlight the relevance and insight of Commons's ideas.

2. Preliminary concepts

Since few economists are familiar with Commons's theoretical writings, a brief overview of central concepts is useful to ground the theory of economic organization that follows.

Commons observed that mankind confronts three fundamental challenges in overcoming scarcity: resolving *conflict*, dealing with *interdependence*, and creating civic *order*. He claims that the core version of neoclassical economic theory assumes away all three problems, i.e., the theory presupposes the existence of social order in the form of a stable government, well-defined property rights, and the rule of law; human interdependence is obviated by making behavior individualistic and parametric; and conflict is replaced by a harmony of interests as all sides gain from trade. The result is a body of theory that loses much of its relevance to real-life problems and has more in common with the physical sciences than the social sciences.

Commons reconstructs and extends classical theory to place the threefold problem of conflict, dependence, and order at center stage. A quotation gives the flavor of his approach.

> "It is only scarce things, actual or expected, that are wanted and desired. Since they are scarce, the acquisition of them is regulated by the collective action which creates the rights and duties of property and liberty without which there would be anarchy. Since this scarcity is recognized by economists, they have already presupposed the institution of property in their very concepts of wants and desires. Institutional economics openly avows scarcity, instead of taking it for granted, and gives to collective action its proper place of deciding conflicts and maintaining order in a world of scarcity, private property, and the resulting conflicts" (Commons, 1934, p. 7).

Given inevitable rivalry over the distribution of property rights and problems in the interpretation and enforcement of contracts caused by bounded rationality and imperfect information, a sovereign power is required to resolve disputes and maintain order. According to Commons, sovereignty operates through "working rules", such as laws, court decisions, business and trade union rules, social norms, ethical principles, and customs, that in totality delineate the opportunities and constraints for each person. All of these working rules, both formal and informal, are "property rights" (or simply "rights") in the sense that they give individuals control over scarce resources, including their physical self and political