Convention Theory
A French Institutionalist Approach to Studying Economic Coordination

Roots
- Concerns about decision making in presence of imperfect and often asymmetric information, but taking account of:
  - Stronger tradition in French economics of collective or social action (beyond methodological individualism)
  - Strong interest of French in questions of product quality and problems of communicating it (cf. literature on signaling)
Starting point

- Recognition of shortcomings of Arrow-Debreu model
- Argument that much of coordination problem also more complex than that addressed in standard information economics approaches, characterized by:
  - Risk
  - Economic rationality

Problem addressed

- Problem of economic coordination in the presence of “radical uncertainty”
- Thus rejects the notion that all future contingencies can be specified ex ante.
- Focuses on how socially defined rules or “conventions” help coordinate activities in this situation and on how individuals invest in those rules.
Analytic approach

- Thus, like new institutional economics, convention theory concerned about the creation and evolution of rules of the game
  - Reject the metaphor of the market as the organizing tool for the firm or for society (cf. Agency Theory). The market is but one of several forms of convention, not the model for all of them.
  - Do not explicitly model rules as outcome of repeated games (Implicit?)

Analytic approach

- CT sees markets as one of several ways of coordinating activity, and the focus is on how these different forms “interpenetrate” each other (e.g., how non-market rules structure price competition).
The coordination problem

- Radical uncertainty leads people to act with bounded rationality. Specifically, actors are characterized by **procedural rationality** rather than **substantive rationality**.
- I.e., they develop standardized decision and action rules (SOPs), which are informationally efficient. Rationality refers to whether the rule makes sense rather than the outcome makes sense.

Conventions and bilateral contracting

- Conventions “interpose” themselves between two agents trying to work out contract by imposing “models of common behavior” on the actors.
- These models have been developed over time by the actors themselves, but have become, through practice, tradition, etc., “external” to them.
Types of coordination via conventions

- **Market coordination** - price as a (nearly) sufficient statistic for coordination.
  - Firms respond flexibly to changes in relative prices
  - Price differences adequately reflect quality differences

- **Industrial coordination**
  - Heavy investment, with coordination through standardization of products (often 3rd party standards)
  - Price less important in coordination

- **Domestic coordination**
  - Uncertainty about quality resolved through trust and personalized exchange
  - Each product is associated with a particular producer—emphasis on brand names, etc.
  - Products change only slowly, in response to muted effects of technology or demand

- **Civic coordination**
  - Coordination through unity built around a recognized common interest
  - Example: French wine appelations
Quality, Conventions, and Coordination

<table>
<thead>
<tr>
<th>Way of defining quality</th>
<th>Ways of recognizing quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Without Uncertainty</td>
<td>With Uncertainty</td>
</tr>
<tr>
<td>Externalized (standards, norms)</td>
<td>Market coordination</td>
</tr>
<tr>
<td>Internalized (trust, authority)</td>
<td>Civic coordination</td>
</tr>
</tbody>
</table>

Source: Sauvee, 1998

Empirical applications

Case studies of factors that affect shifts in coordination modes over time or over industries (like NEI). Focus on 3 characteristics of conventions:

- Temporal stability
- Spatial stability
- Objectification
Empirical applications

- Statistical/econometric analyses limited by lack of correspondence between coordination mode concepts and statistical data collected.
- Proxies for coordination modes--cost structures:
  - Market coordination—Heavy variable costs
  - Industrial coordination—Heavy fixed investment in equipment
  - Domestic coordination & civic coordination—specific investments, including non-material assets (e.g., goodwill)