

**Notes on Convention Theory from E. Chevassus-Loza and E. Valceschini, “Les concepts de l’économie de conventions et leur articulation.” Paper presented at 1994 CIRAD conference on institutional economics. Montpellier, France, 1994 (mimeo)**

Convention theory does not reject standard neoclassical economics, but disagrees with standard Arrow-Debreu assumptions about perfect information that price perfectly coordinates the economy. It essentially deals with other non-price means of coordination that complement the price system. Some of these mechanisms are collectively determined rather than simply bilateral contracts, as hypothesized in both the information-economics and the transaction-cost economics literature. The CT also rejects the assumption that all contingencies in a contract can be spelled out in advance, as hypothesized in the info-economics lit.

Convention theory deals with how economic actors coordinate actions with others (bring stability to those relations) through various forms of “investment” in relationships, rules (e.g., standardized weights, descriptions, modes of behavior). “The generic term ‘rules’ or ‘convention’ is thus used by the economy of conventions to designate the diverse tools, processes and procedures which regulates a relation or more generally assure, totally or partially, coordination among economic agents.”

Aim of convention theory is to explain how market and non-market organizations interpenetrate each other. The idea is to have an overarching theory of rules that coordinate human activity, of which market rules are one part, but not the only one. The convention theorists reject the notion of using the market as the metaphor to describe all nonmarket organizations.

Convention theory deals with what it calls “radical uncertainty”, which is basically uncertainty in the Knightian sense of not being able to assign a probability distribution to future events. In this sense, information is always incomplete and one cannot write complete contracts, since you can’t assign probabilities to all future contingencies. The problem then is how does the economy get coordinated in the face of such uncertainty.

Says that the standard theory fails in the Akerlof market-for-lemons situation not due to asymmetry of information by because of the way people reason about their trading partner. It is a bilateral situation of game-theory reasoning of the “I know that you know that I know.....” kind of infinite reflection, where each player attributes to the trading partner the original actor’s own intentions/attitude. If each does this, with no reference to an outside standard of behavior, the market fails since nobody will commit. Combination of radical uncertainty plus “reflexive (self-referencing) character of speculation” about other person’s action renders action impossible.

Part of this impossibility of action is based on the assumption that actors are perfectly rational, what convention theorists call “**substantive rationality**.” In reality, given radical uncertainty, bounded rationality is a much more realistic assumption. This is equivalent to saying that actors are **procedurally rational**, i.e., they develop standardized decision rules and action rules

(standard operating procedures). The actors judgments deal not with just the results expected from a decision, but principally the validity or the efficiency of the procedure (rule) which allowed them to reach a decision. One thus talks about the actions that are “justifiable” or “reasonable” rather than rational.

Substituting procedural rationality for substantive rationality raises the question of how the rules develop. This begins to allow collective action (rules) to intervene for simply bilateral contracting. Convention theory deals with the different types of collective rules (conventions) that now interpose themselves between two agents simply trying to work out something bilaterally. [Thus, the theory is struggling with the same issue that North raises—what gives rise to social institutions, and how do they evolve over time. Convention theory does not seem to address this from a game-theoretic way.]

### **Convention as a procedure to manage uncertainty**

Faced with the impossibility of having all the information necessary to make their decision, actors seek “models of common behavior” which they themselves have defined, but which repetition, habit, and tradition have made “external” to individual decision making. These external models are rules, or conventions. They permit an “economizing of knowledge” and dealing with incomplete information.

#### 1. Conventions permit an economizing on knowledge

The example given is that of copying behavior in financial markets. If radical uncertainty makes it impossible to know the future, as in financial markets, then it is rational simply to copy the behavior of others, even if they themselves don’t know the future. This mimicking behavior is an example of a convention.

#### 2. Conventions are a self-organizing tool that relies on confidence in the rule.

The conventions are the result of individual actions but which constrain individual actions. As long as there is mutual confidence in the convention, it works.

Convention theory starts with the model of the enterprise and asks how actions are coordinated both within and among enterprises. A lot of attention is given to management of employment within the enterprise. It is the interaction of 3 concepts that help determine the form of coordination:

- Internal and external markets
- Models of enterprises
- Conventions of quality

4 Types of coordination are studied by convention theory:

1. Market coordination (*Coordination Marchand*): the enterprise is immersed in external markets. Supplies and demand equilibrate via prices. Enterprises try to respond to any change in effective demand.
2. Industrial coordination, in which market plays a limited role. Coordination is based on standardization of products, stabilized over time. The enterprise plays a critical role in the definition of the product, leading to a long chain of production, which the enterprise stabilizes. The client intervenes very little in its determination. Thus, the role of prices in coordination is weakened. [Sounds very much like Galbraith's New Industrial State].
3. Domestic Coordination - A large emphasis is given to the personal knowledge of the actors and building networks based on loyalty. Brand names help also build confidence (e.g., wine appellations). Each product is attached to a "house" (Maison), which itself is constrained by the rules of tradition. Products can only vary gradually, under the effect of maturation, through the muted effects of changes in the market or in technology.
4. Civic coordination—relations among actors are made through commitment, debate, and delegation. Coordination is achieved through unity built around a mutually recognized common interest or around some overriding objective that transcends individual interests.

The application of convention theory has, to date, been more through case studies (*monographies*) than through statistical analysis, because the statistical system for industries is not set up well to gather the data necessary to test or measure different types of conventions. Some attempts have been made to use proxies, arguing, for example, that certain types of conventions correspond to a predominance of certain types of investment. For example, there is a predominance of investments in equipment (fixed costs) for industrial products, in specific investments and in non-material investments (e.g., good will) for brand-name products (domestic coordination) and in variable costs for market coordinated goods. The analysis seems, then, to be in trying to do statistical analysis, à la Williamson, to match the type of convention that predominates in an industry to the characteristics of that product.

In the case study approach, conventions are described in terms of three dimensions: Their temporal stability (how long they last—in part a function of their capacity to assure equivalence of product over time); their spatial domain (how large an area do they cover—which gets at their economies of scale—and hence the willingness to invest in creating them) ; and their degree of "objectification"—the degree to which they are defined in terms of specific technical measures as opposed to less measurable features, such as tradition.