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**Economic Transactions,
Opportunistic Behavior
and
Protective Mechanisms**

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ECONOMIC TRANSACTIONS, OPPORTUNISTIC BEHAVIOR AND PROTECTIVE MECHANISMS

Abstract

Whenever actors participate in transactions they expose themselves to risks of various kinds. Some of these risks are attributable to events outside the control of the participants and are unavoidable. Others originate in, or are aggravated by, opportunistic actions undertaken by contract partners and other co-operators. This paper is concerned with the latter type of risk and the protection against it. Six protective mechanisms, which may serve as safeguards against opportunistic behavior, are presented and discussed. Special attention is paid to reputation effects. It is noted that such effects may account for the lack of opportunistic behavior with which networks are often credited. No protective mechanism is, however, effective under all circumstances.

Keywords: Network, opportunistic behavior, organizational economics, protection, reputation.

1. INTRODUCTION

Economic coordination - the allocation of resources to various economic activities - is accompanied by risk exposure by the participating economic actors. This is the case whether the transaction takes place in a market, a hierarchy or a network. Some of these risks are attributable to events outside the control of the participants and are unavoidable, whereas others originate in, or are aggravated by, opportunistic actions undertaken by contract partners and other co-operators. Consequently, decision making concerning participation in various transactions should include considerations on this risk exposure. This paper is concerned with the conscious attempts to supply protection against this type of risks.

Analytically and conceptually, the issue of protection can be seen as part of the more encompassing topic of conflict and cooperation, aspects of which are dealt with in many branches of sciences. The most encompassing of these, at least at the level of theoretical considerations, is game theory. Game theory occupies a prominent place in many branches of economic theory, but is also used in other disciplines of social science. Political science is an important case in point.¹ It is also an important analytical tool in branches of biology.²

Most developments concerning the issue of protection has not been explicitly considered in the extended framework of cooperation and conflict. A more restricted point of view is the field of cooperation that is consciously and voluntarily entered, but, even at this level, there are probably not very many contributions. This is, however, the level of analysis chosen in this paper. I assume that an important part of any transactional relationship (no matter its duration) is the establishment of an agreement. Often, but not always, a contract is also made. An important element of agreements and contracts alike are the promises, rights and obligations "allocated" among the participants to the transaction it regulates.

The emphasis here is on what appears to be the most important among the conceivable reasons our representative actor, P_i, may have for expecting that the actor with whom he contemplates to enter (or continue) a transactional relationship will behave according to the agreement. Such a "reason" is referred to as a protective mechanism.³ For some of the mechanisms, strengths and weaknesses are hinted at.

Special attention is given to the protective mechanism referred to as income-generating reputation effects. Reputation effects are sometimes presented as a panacea to curb opportunistic behavior. Here, it is argued that three fundamental problems must be overcome in order for reputation effects to be able to do so, and that a fourth problem will sometimes

¹Cf. the contributions to part I of the book in which Barry & Hardin (1982), which is used below, appears.

²Cf. Elster (1979:chap.3); Axelrod & Hamilton (1981).

³I do not claim to have identified all such protective mechanisms. But I have attempted to cover a great proportion of them, and am convinced that the most important ones are included.

be present also. It is further argued that networks offer almost ideal conditions for reputation effects to function effectively.

It is often assumed that opportunistic behavior is easily exposed and that the actors that performed it can, thereafter, be avoided. This presumes, however, that it is always easy to distinguish between opportunistic intentions on the basis of concrete actions. In this paper it is argued that it is often problematic, and sometimes impossible, to deduce the information needed to avoid opportunistic actors. More specific, it is argued that it is really necessary to distinguish between four qualitatively different kinds of behavior to achieve this objective.

In section 2, the concepts normal legal system, agreement, and contract are introduced. In section 3, opportunism is defined. In section 4, the process involved when making agreements is presented. In section 5.1, the fundamental problem concerning identification of underlying preferences/motives, which are essentially unobservable, on the basis of observed behavior is addressed. In section 5.2, eight protective mechanisms are presented. In section 6-13, they are discussed. In section 14 the additional problems raised when the actor with which one consider to transact is not a human actor but a firm is discussed. A summary follows in section 15.

The effort here represents an attempt to come to grips with the issue. In order to make it more useful for the reader, I have tried to relate the issues dealt with to chosen parts of the existing literature. But it has not been an objective to provide a survey or a review of the literature of the field. The paper reflects, rather, my considerations on the nature of the problem than a representative sample of the content of the literature.

2. OPPORTUNISTIC BEHAVIOR⁴

Following transaction cost economics in the tradition of Oliver E. Williamson, opportunism is defined as

"...self-interest seeking with guile" (Williamson (1985:47)),

and it is characterized as follows:

"More generally, opportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse" (Williamson (1985:47)).

Opportunistic actions can take place both before an agreement is made - ex ante opportunistic behavior - and after - ex post opportunistic behavior. The purpose for acting

⁴This section is mainly an abbreviated version of section 3.5.2 in Koch (1994).

opportunistic is to gain advantages that a contract partner would not voluntarily give. The classic example of ex ante opportunistic behavior is adverse selection.⁵ The classic example of ex post opportunistic behavior is moral hazard.⁶ What interests us here is not so much that opportunistic behavior is "self-interest seeking with guile". What will be concentrated on is the willingness of the individual given to opportunistic behavior to indulge in actions that violate what is explicitly agreed upon in the contract, or what is in the spirit of the agreement between the parties to the transaction, if he believe that it is in his best interests to do so.

Williamson notes that the assumption of opportunistic behavior is not meant to imply that every body is given to opportunistic behavior.⁷

"Although it is a central behavioral assumption, it is not essential that all economic agents behave in this way. What is crucial is that some agents behave in this fashion and that it is costly to sort out those who are opportunistic from those who are not" (Williamson and Ouchi (1981:351)).

This formulation of the assumption would be true even if there existed only one, opportunistic actor. If this were the case, it would hardly be of any concern to most economic actors. I shall, further, take the assumption of opportunistic behavior to mean that the two following requirements are simultaneously met:

(OB1) A non-negligible proportion of the actors involved in economic transactions have inclinations toward opportunistic behavior

(OB2) The opportunistic actors cannot easily be detected from the non-opportunists

3. OTHER IMPORTANT CONCEPTS

3.1. The Normal Legal System

In what follows, I shall repeatedly talk of the normal legal system. It is defined as the regulatory body that can impose sanctions on the parties to a transaction in order to force them to fulfill their obligations. In most "modern" societies, these functions are provided by the state. But law, and a system of law enforcement, is possible without a state. According to Benson (1988:773), this is the case in "primitive" societies. It is noted by Eggertsson (1990:59-60 and 304-311) that Iceland was, under the "Commonwealth" period (930-1262

⁵Cf. Williamson (1975:14), Williamson (1986:175) and Milgrom & Roberts (1992:149-153).

⁶Cf. Williamson (1975:15), Williamson (1986:175), Douma & Schreuder (1991:56-59) and Milgrom & Roberts (1992:chap.6).

⁷Cf. also Williamson (1979:234,n.3).

ad), characterized by the absence of a state. So the term "normal legal system" can refer to a system of private law enforcement.

Constitutionally, in most democratic societies, the normal legal system is made up of two, preferable somewhat independent, administrative bodies, the court system and the police force. When they are subsumed here under the label system, it is because, as regards the citizens' contact with them in relation to agreement/contracting, they appear to be one "system". Although the normal legal system is not a monolithic being, but is represented by a group of agents (in the way that term is used in agency theory, not the older practice where it simply referred to a sentient actor), it is dealt with here as if it were, since it is the combined effects of its operations that are of importance.⁸

3.2. Agreement and Contract

Prior to the execution of the transaction is a phase that culminates in making an agreement between the participants. I shall define an agreement in relation to a transactional relationship as present when the belief is held, by at least one actor, and accompanied by a promise, that there is a mutual understanding between the parties to a transaction of what the appropriate actions each party is to take, are, possibly in a contingency form (i.e., as specifying what each is to do under some specified circumstances relating to the transaction in question). Note that this definition includes situations where one of the participants have been insincere.

Sometimes, the agreement is supplemented by a contract. As that concept will be used below, the rationale for the contract is to make it easier to carry out the transaction according to the agreement. These related concepts are dealt with below. We shall start by taking a look at some definitions taken from the literature.

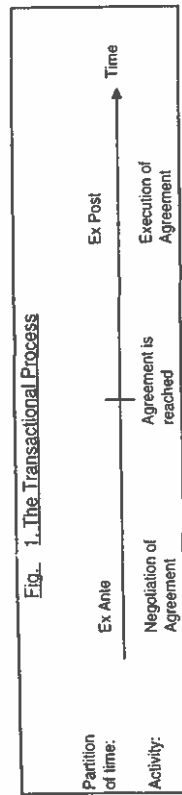
4. THE PROCESS OF MAKING AGREEMENTS

It would seem that the process taking place when a transaction or transactional relationship is negotiated proceeds as follows: Firstly, an agreement is negotiated prior to the execution of the transaction. Secondly, at some later point in time, an agreement is reached. Thirdly, if a contract is made to regulate the transaction, it is signed. Depending upon the character of the transaction, the signing of a corresponding contract may vary from being almost without real importance to be the most important event taking place at all. It is, of course, also possible that the parties cannot agree on the terms, in which case no agreement is made, no contract is signed, and no transactional relationship is brought in existence.

⁸Even if the judges possess the best education and their verdicts reflect unprecedented fairness, it is not much worth if the police force is corrupt.

That the term "signed" is used does not necessarily mean that the participants put their name on a piece of paper. It refers to the acts, made by the participants, that they believe makes the contract legally binding.⁹

The moment the agreement is made - the time of contract signing if a contract is used - is the basis for distinguishing between ex ante and ex post. After the contract is signed, the transaction is executed. An overview of the process is given in fig. 1:



As stated in section 1, I attempt to explain the decision of an economic actor to participate in a particular transactional relationship or not, and on what terms. Whenever reference is made to a particular transactional relationship, the criteria for "particularity" are the following:

- (A) The character of the transaction(s) to be performed, such as having P_2 digging a well for P_1
- (B) The payment(s), if any, to be made. It is possible that no payments are made, if the transaction is a kind of barter
- (C) The identity of the participants¹⁰

If P_1 considers entering a transactional relationship with P_2 , the following must be of importance for him, in fact, "should" be part of the premises for his decision:

- (I) How his situation will be if P_2 does not keep his part of the agreement
- (II) His expectations as to whether P_2 will keep his part of the agreement or not

⁹It is important to note that not all contracts are legally binding. It cannot be assumed that the participants we consider are always able to distinguish between legally binding contract clauses and clauses that cannot be enforced by the normal legal system. Consequently, the phrase "...that they believe makes the contract legally binding..." must be reited upon in stead of "...that makes the contract legally binding". One cannot exclude the possibility that actors make mistakes.

¹⁰This reflects the fact that some actors are more trustworthy than others.

I shall, for the latter part of this section, disregard considerations relating to (I) in order to concentrate on (II). This is the topic of section 5, where eight "reasons" P_1 could have for believing that P_2 will keep the agreement are presented.

5. PROTECTIVE MECHANISMS IN TRANSACTIONAL RELATIONSHIPS

Consider the situation where two potential partners to a transactional relationship, P_1 and P_2 , negotiates an agreement, and look at the prospects concerning fulfillment seen from P_1 's point of view. The question to be investigated is what determines P_1 's expectations as to whether P_2 will keep his part of the contract/agreement relating to the transactional relationship or not?

In what follows, I shall refer to any reasons P_1 could have for expecting that P_2 will keep his obligations according to the agreement as a protective mechanism. In section 6-12, various protective mechanisms are introduced and discussed.

5.1. Unobservable Motivation and Observable Actions

It is a basic problem of social science that we can only directly observe actions, but never decisions (nor directly observe mental phenomena more generally). The latter can only be indirectly revealed for us, via action.¹¹ More specifically, we cannot observe why actors acted as they did; their true interests and motivations are not necessarily revealed by their actions. And the situation is, of course, quite similar for an individual trying to gain understanding of other actors' preferences/motives in order to predict their behavior.

Apart from the more basic methodological issues in relation to achieving understanding of human behavior, this turns out to be a practical problem in relation to the functioning of the protective mechanisms. In some transactions¹², it is vital for one participant, say, P_1 , that his transactions partner, P_2 , stick to the agreement. P_1 will then have to consider how P_2 will in fact behave. In order to make a reasonable evaluation of this, he must know something about P_2 interests and motivations.

5.2. The Protective Mechanisms

Consider, once more, the outlined situation where a contract has to be made between P_1 and P_2 . Assume that P_2 is able to fulfill his part of the contract. It would seem that P_1 could rely on one or several of the eight following "protective mechanisms" for securing that P_2 fulfills

¹¹Which may, of course, in a concrete case be inaction.

¹²But not in all. Cf. Koch (1994:chap.7.8).

his obligations according to the agreement.¹³ Firstly, he could rely on P₂'s propensity to act "appropriate" according to the agreement independently of how it affects P₂'s other interests and goals. Secondly, he could rely upon a low degree of goal incongruence between him and P₂ (goal incongruence). Thirdly, he could rely upon the sanctions he could, himself, impose "directly" on P₂ (direct retaliatory power). Fourthly, P₂ could agree to deliberately restrict his capacity to harm P₁. Fifth, he could rely on the coercive power of the legal system to assure that the contract will be fulfilled (legal enforceability). Sixth, he could rely upon third-party intervention by other¹⁴ outsiders to the transactional relationship, that will "discipline" P₂'s behavior (selective third-party intervention). Seventh, he could rely upon P₂'s wish to preserve an income-generating reputation (income-generating reputation effects). Finally, he could rely upon P₂'s wish to preserve a reputation the chief purpose of which is not to generate future income (non-income-generating reputation effect).¹⁵

The list is probably not exhaustive in the sense that all the protective mechanisms that has been dealt with by sub-disciplines of social science, or any protective mechanisms conceivable, are mentioned.

It seems reasonable to see contracts as devices made in order to "ease" fulfillment of the agreement. In view of the protective mechanisms, it is obvious to see contracts as means for allowing one or several of the protective mechanisms to operate more reliably than it would if only the agreement was relied upon.¹⁶

A particular protective mechanism may be seen as possessing a "degree" of reliability, as offering sufficient protection with some likelihood, instead of just being sharply reliable or not. It seems reasonable to expect that a given protective mechanism's reliability for, say, P₁, will depend both upon the nature of the transaction as well as upon the identity of P₂. In what follows, it will be assumed that it has meaning to speak of the degree of reliability for a specific protective mechanism used in a particular transactional setting. I shall shortly argue for this position.

Given a certain transactional problem situation, neither of these mechanisms are necessarily either sharply reliable or not in the sense that P₁ "objectively knows" (that is, knows truly)

¹³None of these protective mechanisms are discoveries. They are lumped together from various disciplines.

¹⁴That is, other than the normal legal system.

¹⁵Note that this is not identical to "trustworthiness": One may be trustworthy even without being concerned with one's (non-income-generating) reputation. The latter focus attention on appearance, not necessarily moral substance.

¹⁶I am perfectly willing to acknowledge that contracts may serve other uses. The law may demand that a contract is made for some transaction, although it does not serve any function as seen from the view of the participants. Another possibility is that it is made up of habit.

that a given protective mechanism will yield protection or not. Without unbounded rationality, he must act on beliefs. This follows simply from the very nature of the protective mechanisms: Except for trustworthiness and, partly, legal enforceability, which is dealt with below, they work via the incentives facing P₂. They do not (except for the same cases as the "partly" legal enforceability, but not trustworthiness) provide compensations for P₁: Their effect is to motivate P₂ to carry out his obligations according to the agreement. But, unless P₁ possesses detailed information of P₂'s preferences, he cannot predict P₂'s actions on this basis: It may be that P₂ simply does not care about the sanctions, or do not care enough about them to force him to carry out his obligations.

Legal enforceability can take one of two forms. Firstly, it can provide actors with incentives to take, or abstain from taking, particular actions. According to Richard A. Posner, this is similar to what is achieved by a law: "The basic function of a law, in an economic perspective, is to alter incentives."¹⁷ Secondly, it can attempt to further P₁'s interests not by providing suitable incentives for P₂ to fulfill his obligations but by compensating P₁ with economic means (primarily money) taken from P₂.

Relying upon a low degree of goal incongruence does not work by providing P₂ incentives over and above his obligations, according to the agreement, but rely on those incentives being closely aligned to the fulfillment of P₁'s objectives. But as P₁ cannot know P₂'s preferences, he cannot exactly establish the degree to which their goals are congruent. It follows that the reliability of this protective mechanism is uncertain also.

The exceptions from "effect" via incentives for P₂ mentioned for legal enforceability are those cases where the legal authority decides to compensate P₁ for P₂'s lack of fulfillment by expropriating parts of P₂'s assets and give them to P₁. If a fine of a given size is established in the contract for non-fulfillment, P₁ has a better basis for judging whether he is ready to run the risk, because he, presumably, knows the value to himself of receiving the fine from P₂.^{18,19} Compared to the protective mechanisms that gain their main effect through P₂'s incentives, one source of uncertainty for P₁, knowledge about P₂'s preferences, is eliminated by recourse to this protective mechanism.

Before discussing the various protective mechanisms, it should be noted that the protective mechanisms are not, as defined here, totally mutually exclusive categories. This is dealt with when discussing them individually.

¹⁷Cf. Posner (1972:393)).

¹⁸That he does know them cannot be assumed to be the general case. Simon (1947/1976:83) notes that lack of knowledge about "real" preferences over future consequences is one reason why "unbounded rationality" fails.

¹⁹There is, of course, the added source of uncertainty on whether P₂ is able to pay the fine. I shall disregard this.

5.2.1. Protective Mechanisms, Incentives and Relationship Design

In the preceding sections, eight protective mechanisms were introduced. The protection any of them may offer differs over transactions. But it should be kept in mind that it is often possible to "design" the relationship in a way that makes one or several protective mechanisms more effective. Writing a contract may increase the protection offered by the legal system. Designing appropriate incentives may decrease the degree of goal incongruence. Attempts to ensure credible commitment is a related approach to the problem. Offering a hostage may increase the possibilities for sanctioning by the actor that has the hostage put at his disposal.²⁰

5.2.2. Protective Mechanisms and the Scientific Challenge

It seems reasonable to say that a protective mechanism is not either effective or not in any absolute sense. What may, under some circumstances, serve as an excellent protective mechanism may, in another situation, be unapplicable. The protective mechanisms must be considered as substitutes.

One implication of this is that we cannot gain complete understanding of the topic of protection without understanding all the protective mechanisms. To do so is a formidable task, and is not, of course, neither attempted nor accomplished here.

6. RELYING UPON MORAL RESTRAINTS ON BEHAVIOR

In some situations, P_1 may believe that P_2 will keep the agreement because he wishes to act according to some higher moral principles that dictates this behavior. Such considerations are, of course, closely related to the topic of opportunistic behavior. In terms of transaction cost theory, what P_1 would like to know is whether P_2 is given to opportunistic behavior or not. In what follows, I shall investigate this problem more systematically.

Consider, once again, P_1 and P_2 . Assume that, at a particular occasion, P_2 is to perform an act according to the agreement. There are several possibilities for P_2 's actions. For simplicity, it is assumed that

(1) It is (principally) possible, on an objective²¹ basis, to determine whether a particular

²⁰In Koch (1994:chap.10), contracts as mean for increasing the protection offered by the normal legal system in situations referred to as non-trivial contractual problems are considered.

²¹Use of the phrase "objective basis" does not indicate that there is not a subjectivistic basis (in the sense of preference-dependency) for this judgement. When I talk about objective facts, I include aspects of the mental states of individuals as objective: It is an objective fact that I prefer to listen to George Friedrich Händel's "Water Music" (o, say, the latest from the Heaven Seventeen, although that evaluation itself is, of course, subjective. In this sense, the notions of objective and subjective are not mutually exclusive. Some of the confusion about the precise objective nature of, and the

action (including inaction) on the side of P_2 , is opportunistic or not according to the agreement

- (2) P_2 can act either (objectively) opportunistic or non-opportunistic
- (3) P_2 's underlying propensity is either opportunistic or non-opportunistic

There are, then, four possible situations as illustrated in fig. 2 on the next page. A_1 are opportunistic actions made with opportunistic intentions.²² Of course, opportunistic actors will only act opportunistic when they judge it to be in their best interest to do so. Consequently, A_1 is not generally to be seen as the "fundamental" category of actions performed by an actor with underlying opportunistic inclinations.

A_{11} are opportunistic actions performed by a non-opportunistic actor by mistake. One might argue that "innocent opportunistic behavior" is a contradiction in terms. As far as the "action" category is concerned, the categorization as either opportunistic or not relates to an "objective" evaluation of the action independent of why it was performed.²³ Take an example from another context: Assume that one person kills another by firing a rifle on him. Whether this was done purposefully or not is quite independent of the action and its consequences: A rifle was fired and a person died as a result.

alleged impossibility of an objective, social science probably has its roots in a confusion about the nature of the characteristics of mental states. Cf. Bunge (1993) for a similar position.

²²If a complete analysis were to be made, we should categorize the motivation in accordance with whether these intentions were instrumental for the chosen behavior or not. It is, e.g., not impossible that an opportunistic actor performs an opportunistic act although he did not intend to do so.

²³This does not indicate, of course, that it is always easy to find out what happened. But it is, in a good many cases, easier to find out what happened than why it happened.

Fig. 2. The \bar{r} -relation between Action and Motivation

	P ₂ 's Motives	
	Opportunistic	Non-Opportunistic
P ₂ 's Actions	Opportunistic	A _{II} A _{IV}
	Non-Opportunistic	A _I A _{III}

A_{III} are non-opportunistic actions performed by an opportunist. Of course, opportunists will only, intentionally, act opportunistic if they believe that it serves their best interest. There is, then, nothing mysterious about the observation that they are not carrying out opportunistic actions.

A_{IV} are non-opportunistic actions performed by a non-opportunist. This behavior is, I believe, uncontroversial and shall not be dealt with further.

Consider a certain act, A. We may characterize it as opportunistic as not, but can, at most, have indirect evidence on P₂'s motives. The implication of this is that we cannot distinguish between acts of category A_I and A_{III}, and, likewise, cannot distinguish between acts of category A_{III} and A_{IV}.

That we cannot distinguish A_{III} and A_{IV} has the implication that, no matter how many times we have seen an actor behave non-opportunistic, we cannot thereby conclude (at least not in a logical sense; what we believe may differ) that the actor under observation is not given to opportunistic inclinations. This has the consequence that, as long as he has not acted opportunistic, we cannot say anything about his propensity to be so or not.

That we cannot distinguish between A_I and A_{III} has the consequence that, even though P₂ behaved opportunistic, he may have intended no malice, i.e., there might have been a case of A_{III}. Although the logic remains the same here, in that we cannot know whether there was a case of A_{III} or A_{IV}, the situations differs from the situations concerning A_I and A_{III} in at least one respect. Assume that the actor under consideration acted opportunistic (A_I/A_{III}). If it is possible for him to make "corrective" behavior, his attitude towards a suggestion to do so may give us some ideas about his inclinations to opportunistic behavior. But in the case where a non-opportunistic act was performed (A_{III}/A_{IV}), there would be no sense in asking him to change it or attempt to alleviate its consequences.

So much for the delineation of the logic. What cannot be taken into account in such an analysis is that, although it is impossible to deduce underlying motives from performed actions with certainty, it is sometimes possible to do so to our complete satisfaction. We cannot know with absolute certainty that senator McCarthy disliked communist intensely, but we can say that if he did not, his behavior is very hard to rationalize. Although few cases are as clear-cut, it is possible, I submit, to distinguish between A_I and A_{III} with reasonable certainty in a good many cases.

It should be noted that an outsider to the transaction who wishes to find out whether one participant willfully acted opportunistic, face exactly the same identification problem concerning motivation.

7. RELYING UPON A LOW DEGREE OF GOAL INCONGRUENCE

It should be noted that, although it is probably not possible to change a transaction partner's "deeper" preferences, it may well be possible to change the degree of goal incongruence. This is possible because the degree of goal incongruence depends upon both the situation and the preferences of the participants. To some degree, the situation is not given, but can be designed. Consequently, goal incongruence can, to some extent, also be regulated by, e.g., suitable design of the contract relied upon to regulate the transaction. One example is to design the contract in a way that provides P₂ with incentives to act in a way that further P₁'s interest. This is, of course, a basic idea of principal agent-theory.²⁴

There are two problems related to reliance upon a low degree of goal incongruence as a protective mechanism. Firstly, that the goals imputed to others may be wrongly perceived. In this case, the incentives offered according to a compensation scheme may be deficient. The source of this problem is akin to the reflections of the possibility for detecting underlying motives for behavior in section 5.1. A complicating factor of this is the idea of the relative nature of goals, as dealt with by Simon (1947/1976). According to this view, most goals or ends are really means for higher-order goals. Simon refers to this as a means-ends hierarchy, where lower-level ends are higher-level means. To write a particular letter may be the end for which the secretary's work are directed, whereas the letter may only be a means used to obtain some other end, e.g., be a reminder to a customer to pay for a deliverance of goods.

Secondly, since, as we saw, the degree of goal incongruence is partly determined by the situation, it will often change with it. Changes, unexpected or expected, originating "outside" the transactional relationship may change the situation to a considerable degree as

²⁴For an introduction to principal-agent theory, cf. Arrow (1985); Douma & Schreuder (1991:91-99); Milgrom & Roberts (1992).

well. In this case, low ex ante goal incongruence may well turn into high ex post goal incongruence.

8. SANCTIONS IMPOSED BY P₁ HIMSELF: DIRECT RETALIATORY POWER
Sometimes, P₁ is able to sanction P₂ in some way.²⁵ If P₂ would like to enter transactional arrangements with P₁ later, he may put these later arrangements at hazard by behaving opportunistically at one occasion. As exemplified by Axelrod's famous tournaments²⁶ between players (computer programs playing a specified strategy) using different strategies, for one possible prisoners' dilemma pay-off structures, going from a one- to a multi-round prisoners' dilemma made a corporative attitude worthwhile. Although I suspect that too much has been made²⁷, in terms of unconditional interpretations, of these results, they clearly demonstrate, if nothing else, that cooperation may, when interacting with some other strategies, well pay off compared to frequent non-cooperative behavior, at least of an unreflective kind. As noted by Hill (1990:500)), opportunism may, under conditions of uncertainty, go undetected. The contract partner "against" whom opportunistic behavior has been conducted will, under ceteris paribus conditions, probably be the in a privileged position, compared to outsiders, to detect this. But, in a good many interesting cases, everything else will not be equal. There may, e.g., be outsiders with superior ability to judge whether appropriate actions has been taken or not, such as doctors may have a more qualified opinion than patients when judging the appropriateness of applying a certain treatment.

To impose sanctions on transaction partners behaving opportunistically is not always without problems. Even assuming that it is possibly for P₁ to sanction P₂, it may be costly/disadvantageously for him to do so, e.g., because he cannot avoid hurting himself in the process. Consider an agreement (which we assume to be legal) between producers on an oligopolistic market to increase profits by raising prices. In such a situation, the prime mechanism for sanctioning defection is to reduce prices. But this will also hurt the parties "punishing" the defector, because all the suppliers are hit by the lowered price.

One possibility for making this protective mechanism more effective is that P₂ puts a "hostage" at P₁'s disposal (Williamson (1983)). The purpose of this is to increase P₁'s possibilities to sanction P₂, should he not keep his part of the agreement.

²⁵In many situations analyzed in game theoretic studies, this is the only possible protective mechanism.

²⁶Cf. Axelrod (1980a), (1980b), and Axelrod & Hamilton (1981).

²⁷Linster (1992) has performed a computer tournament akin to Axelrod's famous simulations. Whereas a strategy that did not try to take advantage of other, tit-for-tat, won both of Axelrod's major tournaments, this strategy and all others were severely beaten in Linster's experiments by a strategy named GRIM. This strategy differs in many respects from tit-for-tat.

9. DIMINISHING THE CAPACITY FOR HARMFUL ACTIONS

It is a sine qua non for opportunistic actions on part of P₂ to present difficulties for P₁ that P₂ is able to hurt him. If he is not, opportunistic actions cannot be a problem for P₁. A reduction of P₂'s capacity to carry out harmful actions against P₁ may, however, not be easy to agree on. The reason is that these capability may be considered by P₂ as the sanctions he could exercise against P₁ in order to keep him from acting opportunistically, i.e., as P₂'s capacity for direct retaliatory power (cf. section 8 above). In other words, P₂'s position may be endangered by the mean whereby P₁'s position is secured.

10. RELYING UPON THE COERCION BY THE NORMAL LEGAL SYSTEM

Williamson has referred to the view that the legal system can secure the fulfillment of obligations according to the chosen contractual arrangement at negligible costs as "legal centralism" (Williamson (1984:199-200)). One proposed justification for transaction cost economics as a discipline distinct from neoclassical economics, is, more or less, the view that the legal system cannot always be relied upon to ensure that agreements/contracts are fulfilled.²⁸ Some kind of "private ordering" (defined (ibid:208-209)) may prove to be superior.

11. SELECTIVE THIRD-PARTY INTERVENTION

The third party that is, perhaps, of the greatest importance in modern capitalist and democratic societies, is the normal legal system. When I have distinguished between that body and other relevant third parties, it is in order to emphasize two differences between them: Firstly, that the normal legal system is the body that can, legally, inflict sanctions upon others, and can, even, in extreme cases, legitimately resort to physical violence to fulfill its objectives. In this, it differs from other actors. Secondly, that, in opposition to all other actors, the normal legal system cannot decide which actors to support, in case of conflict independently of a set of given rules.²⁹ The normal legal system is never able to decide that Mr. Jones from Mercer Street no. 8 will be excluded from its services. All other actors are free to choose between potential partners for economic transaction and other social

²⁸If it could, opportunistic behavior would be of no consequence.

²⁹These rules may, however, be more or less given to interpretations. There will presumably always be room for some discretion for the servants of the normal legal system. The reason for this is analogous to the reasoning for the practical impossibility of complete contracting in a good many cases. Cf. Milgrom & Roberts (1992:127-128) for the latter argument in relation to one such situation, applying for college.

interaction, at least initially.³⁰ They may then decide to make ties with other actors. But, initially, they have a choice.

P₁ could try to create a coalition, or enter an existing one, with partners that are sufficiently powerful to force his transaction partners to behave according to the agreement.

Note that the creation or joining of such a coalition is in itself accompanied by an agreement³¹ and is, therefore, principally given to the same kind of problems as other agreements. But these problems need not, of course, be of the same degree, and the "combined" effect in terms of protection may be found adequate (if P₁ believes that there is a 50 pct. change that his transaction partner will defect, and the same goes for the confidence that the coalition partners will support him if necessary³², and it is further assumed that these two possible defections are independent events, then there is a combined 75 pct. probability that the transaction will be carried out according to the agreement).

12. EFFECTS CONCERNING INCOME-GENERATING REPUTATIONS

Another possibility for P₁ is to rely on a "reputation effect" whereby P₂'s behavior is constrained by the fact that P₂ will, in the future, have to take part in other transactional relationships. The idea expressed in the heading is that reputation may be valued as an economic resource because an actor's reputation may be a factor partly determining the size of his future income. The reason for this is simple. If opportunistic behavior is costly - and if it is not, its possible appearance is economically irrelevant - then a reputation for not behaving in this way will carry a premium over a reputation as unreliable and probably also over unknown "new-comers". I shall, as noted above, refer to such reputation effects as income-generating reputation effects.

If P₂ must, according to P₁'s expectations, enter transactional relationships in the future that are similar to the one with P₁, P₂'s failure to fulfill the agreement with P₁ could mean a worsening of the terms of these future transactions. This is related to the so-called "ex post settling up" mechanism relied upon to curb opportunistic behavior in parts of the literature on agency (Williamson (1988:574)). Obviously, such a mechanism cannot be relied upon in the general case, partly for the reasons given below. Greif (1989) reports one case where the

³⁰This qualification is necessary in order to "cover" situations where two actors have voluntarily "locked" themselves to each other, as is still the case for couples once married in many countries.

³¹That agreement may well be tacit, but it must be there.

³²In the example given, it is further assumed that the coalition partners can, with certainty, "force" P₂ to keep the agreement.

effect seemed to work, in the community of the Maghribi traders. This will be considered below.

12.1. On the Reliability of Income-Generating Reputation Effects

Some authors have been very enthusiastic when outlining the potential for reputation effects to curb opportunistic behavior. But to believe, as Hill (1990) apparently does, that, in the long run³³, a state will be realized where opportunistic actors have been driven out because of reputation effects, is rather naive.³⁴ But even if Hill's claims on the properties of that state were correct, it would be largely irrelevant for the problem faced by an economic actor that must decide which protective mechanisms to rely upon to secure fulfillment of the agreement/contract in the period before it state is obtained. Accordingly, we need not assume that such a state will not be brought about eventually in order for the following to be relevant. It is sufficient that it is not yet realized in order for considerations concerning the reliability of income-generating reputation effects to be relevant for economic actors.

I do, however, believe that it is possible to reject Hill's claim that opportunistic actors disappear over time. His argument is basically that results from iterated prisoners' dilemma is applicable to the problem of opportunistic behavior. One of the results drawn on (Hill (1990:506-507)) is Robert Axelrod's prisoners' dilemma tournament.³⁵ In these tournaments, the players (different computer programs) played repeatedly with each other, but pair-wise so. Axelrod's results do not, however, say anything at all about reputation effects, since the players could not communicate their knowledge about other actors' strategies to each other, and could not see what happened in the other pair-wise contests. The only kind of reputation effect possible was that each player was allowed to remember his immediate opponent's moves from round to round. So the player knew whether its immediate opponent cooperated or defected in earlier rounds, provided that the programmer had incorporated this facility in the program. They had no knowledge about the moves his opponent had made against other players. But Hill does not hesitate to use the results of these tournaments in support of his position.³⁶ More generally, it shall be argued below that reputation effects will prove reliable under some specific conditions, and that it cannot be taken for given that

³³Actually, the claim was that an equilibrium without opportunistic actors would be realized. Cf. the criticism of this is Koch (1994:chap.4).

³⁴And without prohibitively high entry barriers, "newcomers" may well enter markets. There are no reasons for assuming that some of them are not be given to opportunistic behavior.

³⁵Cf. Axelrod (1980a); (1980b); Axelrod & Hamilton (1981).

³⁶Hill (1990) is not the only example of interpretations of the importance of Axelrod's results far beyond what they can reasonably be used to. Cf., e.g., Huber (1984), for the view that Axelrod's results, which were obtained in situations with repeated two-persons prisoners' dilemma, can be generalized to situations with more than two players.

these conditions are fulfilled. Whether they are fulfilled or not may well sometimes be unclear, at least ex ante. For the moment, I shall return to Hill's allegations.

What is the result, one might ask, if we just investigate whether the market mechanism can generally be relied upon to drive out non-cooperative behavior?³⁷ The answer to that is that, in some cases, the market will in fact drive out non-cooperative behavior, whereas in others, it will not. It is noteworthy that the market mechanism (competition) will sometimes drive out cooperative players. Consider, e.g., a market characterized by perfect competition.³⁸ Assume that total demand for the product is a decreasing function over the price of it. We know that there will then be a collective loss for the producers, since, if all the separate producers' production and pricing decisions were coordinated, they would restrict output, since they would achieve maximal joint profit by equating marginal revenue and marginal cost. When they do not coordinate their production decisions in this way, the individually rational action is to produce and sell until the price is equal to the marginal cost.

Now, everybody producing and selling at marginal costs is, in fact, following a non-cooperative strategy, since he sells "to cheap": In order to follow a cooperative strategy, he should either raise prices or, at least, restrict output to a smaller amount than the amount that will equate his marginal costs and the price of the product. When there is not one, but a multitude of non-cooperative strategies, as is clearly the case here, following any such strategy is referred to as free-riding.

It is true that, in the long run, cooperative behavior will drive out non-cooperative behavior in this setting? Let us consider the fate of a producer who decided to behave cooperatively. If he raises his price, he will sell nothing and go bankrupt. If he only restricts his output, he will receive a lower income than the suppliers that does not follow that practice. Neither of these seems to indicate that our cooperative supplier should obtain any long-run advantage. At the contrary, unless he has access to other sources of income, one would expect, following standard economic theory, him to be eliminated by competition. The conclusion of the analysis of this situation is the opposite of Hill's: Non-cooperative behavior will drive out cooperative behavior.

Although I have not made a detailed investigation of the empirical results relevant for this conclusion, it would seem that agricultural markets largely confirm this. Without intervention by the state, or some other coercive body, farmers tend not to restrict their output.³⁹ If they did so by themselves, they could probably generate enormous incomes from

³⁷This example is inspired by Barry & Hardin (1982).

³⁸I shall assume U-shaped marginal cost curves and other "nice" assumptions about demand and supply.

³⁹The reader that is interested in how cooperation between farmers and, more generally, groups of persons engaged in non-cooperative behavior, can be brought about, and why it is frequently not, is referred to Olson (1965/1982) and Barry & Hardin (1982). The papers contained in part 1 of the

the rest of society. After all, it is impossible to survive without food, and the majority of all food originates in agricultural products. Even the amounts transferred to the agricultural sector by governments would probably be modest in comparison.

Although many markets are not perfect, to say that output restriction is the overwhelming case in most markets in modern economies does not seem convincing. Hence, the conclusion that competition should drive out non-cooperative behavior is not generally valid.⁴⁰ As we have seen, competition will sometimes eliminate those actors following a cooperative strategy.

Let us take a closer look at reputation effects. Bendor & Mookherjee (1990) offer the following characterization of them:

"...if Smith reneges on a deal with Jones, the latter may spread the word about the former, and other members of the same community may punish Smith in a variety of ways, despite being uninvolved in the original agreement" (cf. Bendor & Mookherjee (1990:34)).

In their analysis, they further state that

"...we assume that every member's action are observed without error by the entire group: such information is presumed to be naturally available, or collected and disseminated by an "observer institution" (cf. Bendor & Mookherjee (1990:35)).

This approach can, undoubtedly, be used to illuminate some important aspects of "reputation effects" or "third-party sanctions", as is Bendor & Mookherjee's term for reputation effects. But when the potential of a protective mechanism, in *casu* reputation effects, is to be analyzed, one cannot start by assuming that it will in fact function.⁴¹ Therefore, this analysis takes another approach: To investigate the necessary conditions for reputation effects to work as effective protective mechanisms. There would seem to be at least three such necessary conditions.⁴² Firstly, there must be no problems concerning identification of an actor's traits: Once he has acted opportunistic, there are no ambiguities relating to the interpretation of the motive behind the behavior. There must, e.g., not be any doubt about

same volume in which the two mentioned papers appear all deals with these and related issues.

⁴¹I certainly admit that cooperative behavior, or, at least, only rather mild forms of free-riding, is often observed.

⁴²This is not to indicate that Bendor & Mookherjee believe otherwise.

⁴³All of them are, I believe, implicitly present in Avner Greif's historical case study, Greif (1989). In order to do Hill justice, it should be mentioned that he also considers the second and third of the necessary conditions mentioned in the text. But, for him, it is clearly only in very special cases that they are not fulfilled.

whether an unsatisfactory effort reflects a lack of ability the necessity of which could not have been foreseen⁴³ or was due to bad will. We have already seen that this is problematic (section 6). Secondly, once an actor has observed that another actor behaves opportunistically, he can communicate this "reliably" to all concerned actors. Thirdly, the value (in utility terms) of the loss of good reputation by behaving opportunistically must outweigh the gain foregone by not acting opportunistically. This includes conditions under which future transactions are made.

The first two conditions both relate to problems concerning the reliability on reputation effects that must be taken into consideration when judging their efficiency: They are referred to as the problem of initial actor's traits identification, and the problem of actor's traits communication, respectively. If at least one of them is not fulfilled, reputation effects will not be effective protective mechanisms, and even less will the system converge toward a state without opportunist behavior. The third necessary condition is that future contract partners will act in a way that deviates, negatively as judged from the potential culprit's point of view, from what they would otherwise do, and that this (expected) "reaction" decreases the culprit's position sufficiently to off-set his advantages for acting opportunistically in the first place. This third requirement is akin to the second one contained in Bendor & Mookherjee (1990:35), although they assume that some kind of "formal institution", a term they do not define further, will administer it. Presumably, they refer to a public organ or chosen representatives for a business community, or something akin. It is not clear, however, that reputation effects should only be possible when such institutions exist. It could be argued that it is often in the absence of such formalized institutions that reputation effects are useful.

12.1.1.1. The Problem of Reliable Actor's Traits Identification

When a dispute between contract partners occurs as the result of opportunist behavior on who acted opportunistically in the first place. This need not be easy, for several reasons. First, it may be in the interest of a transaction partner to claim neglect, even if his transaction partner behaved non-opportunistically. The reason is that it may serve to camouflage mistakes or bad performance on his own part. Consequently, if the participant, P_i , to a transaction claims that his contract partner, P_j , behaved opportunistically, we must be able to exclude the possibility that this claim is in itself an opportunist act on P_i 's part in order to rely on his information. Second, if one participant neglects contractual duties, the other may reciprocate and neglect his obligations, according to the contract, as well ("if you don't deliver timely, I won't pay timely"). In this case, it may be difficult for outsiders to see "who began". And

⁴³This qualification is needed because it is clearly opportunist behavior to undertake a task knowing that one does not possess the necessary qualifications.

it is probably only the latter that should be avoided.⁴⁴ Third, and partly modifying the immediately given remark, even if the party who was the first to violate the agreement/contract can be identified, it must be possible to find out whether his failure to meet his obligations was due to a calculated act or not. If it was due to circumstances outside his control which he could not reasonably have foreseen, then it is not only unjust to categorize him as an opportunist, it also means a loss to those the actors that may avoid him on this account. Fourth, in order to see who is to blame in case of a conflict between transaction partners, it is necessary to know their obligations. Shortly put, one has to have if not detailed, then at least some knowledge as to the content of the contract, in order to know whether a certain behavior actually constituted a violation or not.⁴⁵ It does not seem unreasonable to say that, very often, these problems cannot be overcome, or cannot be overcome very effectively.

12.1.2. The Problem of Reliable Actor's Traits Communication

The second difficulty regards the dissemination of information on an actor's demonstrated inclination to act opportunistically. In order for opportunist actions to be curbed by reputation effects, a sufficiently large proportion of potential future transaction partners must be informed about the misconduct, and their reaction must be to worsen the culprit's future economic prospects. A further complication is that, in order for this to function, it may sometimes be necessary that the information is communicated and retained across time. There are two possible causes for this. Firstly, consider transactions of a type in which our potential culprit is not engaged all the time, but only occasionally. In such situations, the once recognized opportunist trait may well have to be remembered for a considerable period of time in order for the reputation effect to function. Secondly, although an actor is given to opportunist behavior, he will behave so only if he believes this behavior will serve his interests better than non-opportunist behavior. Therefore, repeated instances of flawless behavior must not lead to the conclusion that the actor has changed his basic attitudes towards cooperation.⁴⁶

12.1.3. An Aside on Repeated Interactions

There is one situation in which reliable communication (but not identification) of actors' traits cease to be problematic. This is the case where a possible long-term relationship with

⁴⁴It is a situation very like that of parental interference in a fight between two small boys. Both may well try to put all blame on the other, and unless the whole incident has been observed, it may not be easy to find out who started, and who is to be blamed the most.

⁴⁵The latter points to one advantage of relying upon standardized (content in) agreements/contracts, because (a) then it is easier to see whether an act represented a deviation from the contract, (b) it is more difficult for a violator of contractual terms to claim ignorance.

⁴⁶But here is still another hazard: If the actor mentioned is a firm, and vital decision-makers in the firm has been replaced, the firm may have changed its attitude towards cooperation.

repeated transactions are considered.⁴⁷ If a transaction partner acted opportunistic against his transaction partner before, the latter need only be concerned about the identification problem. He does not have to consider his own trustworthiness, since he, given the framework of this paper⁴⁸, has no interest in lying to himself. Note that in this situation, the protective mechanisms of direct retaliatory power and income-generating reputation effects are identical.

12.1.4. The Necessary Amount of "Deterrence"

We saw above that effective reputation effects necessitates that the problems concerning reliable actor's traits identification and reliable actor's traits communication be solved. Likewise, this must be accompanied by a sanction with some minimum amount of disutility, whether brought about by actions whose *raison d'être* are that they punish the culprit (and not, perhaps, perform any other function), through embarrassment, or whatever. If there are no sanctions whatsoever against opportunistic actions, a reputation effect cannot function as protective mechanism.

Greif (1989) contains a very interesting case in point, a historical study of the Maghribi traders. They were Jewish merchants that originating in Fustat (ancient Cairo) in the eleventh century. They were interesting because they developed a system of cooperation based on a reputation system, in fact, what is here referred to as an income-generating reputation effect. One of the services they provided for each other was that they acted as each other's agents (in the sense of agency theory) in towns they did not visit themselves. This enabled each trader to operate across considerable distances. Considering the means for communication available in the eleventh century, the "system" offered its participants major advantages over independent traders (given *ceteris paribus* conditions, especially as regards size). The punishment for defection was exclusion from the services the traders provided each other. This was a major punishment, and, according to the Greif's study, one that only very seldom had to be used.

A difficulty in this respect is the problem that if an actor knows that he will cease to be active in, say, period x , then the value of his income-generating reputation in period $x+1$ is zero. Therefore, he need not be worried about how his reputation is influenced by his actions in period x . Consequently, considerations concerning his income-generating reputation cannot make him abstain from opportunistic actions.

⁴⁷Examples of such relationships are repeated prisoners' dilemma interactions. Note, however, that the mere repetition of the choice situation is in itself not sufficient for cooperative strategies to be dominant. Cf. section 12.1.5.

⁴⁸This qualification has to be made, because there is evidence that actors sometimes lie to themselves in order to justify past actions.

According to Greif's historical study, the problem was solved as follows in the community of traders:

"...for merchants and agents alike, membership in a coalition was a valuable asset that could be transferred from father to son. The intergenerational transfer was also desirable from the coalition's point of view since it enabled the traders to base their relations upon a reputation mechanism despite the fact that the human life is finite and thus a merchant might cheat in his old age" (Greif (1989:875)).⁴⁹

12.1.5. Further Problems with the Reliability of Reputation Effects

Both the problem of actor's traits identification and the problem of actor's traits communication point to necessary conditions for reputation effects to be effective. The probability of the correct judgment being conveyed of an economic actor's inclination toward opportunistic behavior in his reputation is dependent upon the degree to which the problems of reliable actor's traits communications and identification can be overcome. But although reputation effects can hardly be seen as a adequate contractual protective mechanism in general, they are probably very efficient in situations where the two mentioned problems can be overcome, provided that the deterrence is adequate.

12.1.6. The Costs of Reputation Effects as Protective Mechanisms

It should be remembered that the fact that actors rely on reputation effects does not in itself witness the superiority of them. There are two kinds of errors in such a system: The first is to assume that opportunistic actors are not opportunistic, because they have a good reputation. The second is not to engage in transactions with actors that are reputed to be opportunists, but are, in fact, not. The effectiveness of reputation effects as protective mechanisms can only be evaluated if it is possible to establish both kinds of errors. But, whereas it may sometimes be possible to observe the first kind of errors, it is practically impossible to observe the second. Consequently, when somebody claims that they can provide examples of well-functioning reputations effects, they should promptly be asked how they are able to account for the second kind of failure. In terms of lost opportunities, the reliance on reputation effects may well be quite costly in terms of opportunity costs.

12.2. Reputation Effects and Network Organization

The type of cooperation engaged in in industrial network organizations⁵⁰ may be illuminated by income-generating reputation effects. In such relations, it is claimed, considerable degrees of trust and confidence are held by the participants *vis-a-vis* each other. The proponents of the school claims that the cause for this is that people are not opportunists

⁴⁹Cf. also Hill (1990:504) and Klein, Crawford & Alchian (1978:307.n.17).

⁵⁰Cf., e.g., Håkansson & Johanson (1993) and Johanson & Mattsson (1987).

after all. Instead, focus should be on trust, which factor can replace opportunistic behavior as (co-) determinant of behavior. It is extremely difficult to explain the existence of many contract-related phenomena without the possibility of opportunistic behavior. And good support for the existence of opportunistic behavior is supplied by those advocating the economic importance of investments in trust.⁵¹

I am willing to accept the claim that actual behavior in networks is often very far from being opportunistic. There are, I believe, good reasons to assume that participants in networks behave so with a lesser frequency than those in most conventional business arrangements. This can probably be partly explained with reference to the functioning of reputation effects in networks. It would seem that the conditions for reputation effects to be effective are excellent in networks. There is repeated interaction between the participants, and dyadic relations in the network are relatively transparent for other network members. The problems referred to as the problem of initial actor's traits identification and initial actor's traits communication in section 12.1.1-12.1.2 are probably less severe in networks than in many other forms of cooperation. Furthermore, there is probably to some degree a "hold-up" possibility in networks: The participants have made investments that are specific to the network.⁵² It would seem, however, that any one participant in the network is much more dependent upon being member of the network than the remaining firms in the network is dependent upon that firm staying in the network. What are for them a mere nuisance may be a matter of life or death for the expelled firm. The "necessary amount of deterrence" seems to be there. These are conditions that seems ideal for making reputation effects serve as good "protectors".

13. EFFECTS CONCERNING REPUTATION VALUED FOR "ITS OWN SAKE"
P₁ could rely on a wish on P₂'s part to "preserve a good reputation" that is not motivated in gains in income. Apart from its possible ability to influence the size of future income, an actor may value his reputation for its own sake. This mechanism is probably not very important in an economic/organizational context. An example from another context than the present one, of economic organizing is the wish, held by many kings and prominent politicians, to enter "history" as having this or that personal characteristic, as we may know them, perhaps as manifested in the form of nicknames (such as Ivan the Cruel).

⁵¹The argument is simply that without opportunistic behavior, there would be no reason for distrusting anybody. Consequently, any "investment" in trust would be a waste of resources. Cf. Foss & Koch (1995) and Koch (1994:chap.4).

⁵²Johanson & Mattsson (1987:45) notes that "To us, a high degree of asset specificity is the rule rather than the exception, and that variable in itself can hardly explain integration".

14. PROBLEMS RELATED TO THE TYPE OF ACTOR INVOLVED

There is, however, a further problem, besides the three mentioned that will, sometimes, be present. Consider the term "economic actor". Some economic actors are persons of flesh and blood, while others, such as firms, are not. But, for fundamental reasons, although firms may be said to exist, in some senses, independently of persons (and, e.g., possesses legal rights and liabilities), they do not decide or act independently of persons. A firm cannot decide anything, and cannot do anything. But managers may decide in its place, and employees can act in its place. And it is such decisions and actions of persons that determine whether a firm/an organization can be said to act opportunistic or not.

The implication of this is that such acts performed in the past, apparently by a non-human economic actor, may never be repeated, simply because the person(s) responsible for them is no longer active. And it may, of course, just as well happen that opportunistic behavior suddenly becomes the policy of an hitherto blameless firm. These considerations throw further doubt on the efficiency of reputation effects as a protective mechanism against opportunistic behavior in the general case.

15. SUMMARY

When discussing the issue of protection in transactions, considerations concerning the reasons our representative actor, P₁, may have for expecting that his (potential) transaction partner, P₂, will fulfill his obligations according to the agreement are clearly relevant. We referred to these reasons as protective mechanisms.

The protection given by a particular protective mechanism in a certain situation will depend upon the identity of the participants as well as other characteristics of the situation. None of them will offer relevant protection in all conceivable situations. The view proposed here was that the conditions under which the protective mechanisms provide protection, as well as the degree of protection they offer, differ from one protective mechanism to another. There is not one protective mechanism that is, under all circumstances, superior to the others. The obvious implication of this is that the protective mechanisms can be used as substitutes for each other, according to the prevailing circumstances.

Most of the protective mechanisms relies upon an indirect effect. They rely upon the provision of P₂ with (mostly negative) additional incentives for keeping the agreement. But such incentives will only influence his behavior if they have direct or indirect consequences for the attainment of P₂'s goals. Therefore, evaluating the ex post "effectiveness" of a particular protective mechanism when the agreement is made is always difficult. Fundamentally, the underlying problem is that we can never observe an actor's preferences/goals/motivations. We can, at most, observe his actions, and it is only through

the evaluation of these actions that we may hope to gain understanding concerning the nature of his preferences/goals/motivations.⁵³ This was the topic of section 5.1.

An overview of the protective mechanisms were given in section 5.2. Shortly put, P_1 could rely upon

- 1) P_2 's propensity to act "appropriate" according to the agreement
- 2) a low degree of goal incongruence between him and P_2
- 3) the sanctions he could, himself, impose "directly" on P_2
- 4) reducing P_2 's capacity to harm him
- 5) the coercive power of the legal system to assure that the contract will be fulfilled
- 6) selective third-party intervention performed by other "outsiders"⁵⁴
- 7) P_2 's wish to preserve an income-generating reputation
- 8) P_2 's wish to preserve a non-income-generating reputation

In the remainder of this summary, I shall only be concerned with the first and the seventh of these protective mechanism. The reader is referred to the respective sections for the other protective mechanisms.

One of the protective mechanisms does not depend upon providing P_2 with additional incentives. It is the possibility that he will not act opportunistic because he is, basically, not given to opportunism. The problem with this mechanism is that we cannot, for the same reasons as those outlined on the effect of incentives on P_2 's behavior, know for sure whether he is given to opportunism or not. The problem is not so much that it is never possible to distinguish, with justified confidence, between opportunists and non-opportunists. Obviously, sometimes it is. Fundamentally, the problem is the mentioned unobservability of motives. If this problem is acknowledged, even a blameless record of non-opportunistic acts does not in itself guarantee non-opportunistic intentions. The reason for this is that opportunistic actors will only perform opportunistic acts when they judge that to be better than a non-opportunistic action. That a given actor does not appear to have behaved opportunistic may just as well reflect that he did not believe that it to be in his best interests to do so as it may reflect that he is not given to opportunistic tendencies.

The protective mechanism most intensely discussed was income-generating reputation effects (section 12). It is sometimes claimed that opportunistic behavior will be unimportant in the long run, because reputation effects will eliminate opportunistic actors. Hill (1990) is an example of this. This question was discussed in section 11.1. It was, firstly, argued that Hill's main argument, Robert Axelrod's famous computer simulations of pair-wise, repeated two-player prisoners' dilemma, is irrelevant for reputation effects, since it is impossible for

⁵³This is similar to the claim, made by austrian and neo-austrian economists, that it is impossible to evaluate whether other actors behaved rationally or not. Cf. Shand (1984).

⁵⁴That is, other outsiders than the normal legal system.

the player to observe how the other players act in the other pair-wise interaction. Secondly, it was demonstrated that, under perfect competition, exactly the opposite occurs: Cooperative behavior will be driven out by non-cooperative behavior. It is argued that this is the case for agricultural products in the absence of a coercive body.

The reliability of reputation effects is often more or less taken for granted. But there are, in fact, three necessary conditions (in the logical sense) that must be fulfilled in order for them to be effective. Firstly, there must not be any problems concerning identification of an actor's traits: Once he has acted opportunistic, there are no ambiguities relating to the interpretation the motive behind the behavior. Secondly, once an actor has observed that another actor behaves opportunistic, he can communicate this "reliably" to all concerned actors. Thirdly, the value (in utility terms) of the loss of good reputation must outweigh the gain forgone by not acting opportunistic. It is certainly not clear that these conditions are fulfilled for "typical" transactions, though there are probably circumstances where they are, or approximately are.

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