



Institutionalized Communication in Markets and Firms

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***The 2019 Clarence Ayres Scholar
Institutionalized Communication in Markets and Firms***

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Clarence Ayres address, 2019 AFEE meetings at the ASSA conference, Atlanta, USA by Wilfred Dolfsma, full professor and chairholder, Wageningen University and Research, wilfred.dolfsma@wur.nl, www.wilfredolfsma.net.

Abstract: How markets and firms function is critically related to what knowledge and information is exchanged between whom, how quickly. Exchange of (symbolic) information needs to be properly institutionalized in order to be understood by others, on the one hand, but, on the other hand, cannot avoid being ambiguous to some degree as well (Dolfsma et al. 2011). Ambiguity allows for the dissent that allows for innovation in the broadest sense of the term. Institutionalization of communication is community-specific. The tension between institutionalization of and ambiguity in communication explains why innovations cannot depart too much from what is known and accepted in a community to be (ultimately) accepted as a legitimate novelty. The view of markets and firms as settings for institutionalized communication and knowledge exchange offers a perspective that institutional economists are well positioned for to offer insights on.

Keywords: communication, institutions, markets as institutionalized communication, firms as institutionalized communication.

JEL Classification Codes: D01, D21, D40, D80

In this brief note and address, I will argue that how markets as well as firms work depends, to a very large degree, on the specific way in which communication of knowledge and information takes shape. Communication, however, only works if it is sufficiently institutionalized—an institutionalized communication theory of the market and of the firm is implied.

Institutions, Communication, and Innovation

In order for communication between two or more individuals to work, it needs to be institutionalized. The more individuals are involved in the communication, the higher the need for institutionalization, an institutionalization that is sufficiently well understood by individuals involved. If communication is not institutionalized, it cannot be understood—visual or audio messages come across as random noise without institutions. The description

of the relatively straightforward behavior of an individual buying something in a market—makes this clear. It also shows how institutionalized communication draws on and at the same time constitutes a body of knowledge.

Institutions indicate that a series of signs on a screen or on paper *are* actually words with a particular meaning. Institutions appropriately commonly understood indicate that a series of utterances are words spoken, words that have meaning. For *instance*, words that indicate that someone wants to buy a fish in the market, but not at the indicated price but rather at a haggled down price. The numbers written on a board indicated the price the fish is offered at by what is understood as a merchant. The numbers on the little pieces of paper that are handed by what is understood as a buyer to the merchant signify the value of the “money” that is the paper.

It takes an institutional economic approach, and a willingness to look for insights beyond the disciplinary boundaries of what even generously defined economics science would look like, as Clarence Ayres has advocated, to pursue research in line with these insights (cf. Hamilton 1980). Innovation small or larger in a way happens when communication changes. Innovations might happen when existing, institutionalized bodies of knowledge are combined—Schumpeter (1934) indeed claims this is what innovation is mostly all about (cf. Ayres 1944). Innovations, when adopted, changes the communications among those who adopt them. Innovation constitutes a conundrum—it must be recognizable in terms of previous communications, and still be perceived as new and valuable (cf. Dolfsma 2004). Individuals might perceive of an innovation as new in an understandable way and valuable in terms of a common institutionalized understanding that is not fully theirs (yet), but that they (believe they) know of (cf. Nooteboom 2000).

Knowledge, Communication and Markets

The community which shares an instituted communication can be a (niche) market as well as a firm, yet the dynamics in each is different. What information about a market comes available when and how has already been shown to affect the way in which markets work (Anand and Peterson 2000). In this article I will focus on the economically relevant entities of markets and firms to develop this line of work more, conceptually. The argument might be relevant more broadly. In a firm, one would argue, because of the hierarchy involved, the tolerance to the ambiguity that innovation brings can be both higher or lower than in a market. Looking at some particulars of firms and markets as institutionalized communication, a question one may ask is what it is about firm and market structures’ way in which communication is institutionalized that makes them more or less conducive to innovation. In the next section, I will focus, in my necessarily brief and general discussion, on structures of communications rather than specific contents or tone of communications.

In a market, one would argue, the more players are involved, the more mutually dependent these players are, and/ or the more and the more standardized the information that is available, the less tolerance there is for innovation. (As an aside, the more standardized [i.e., institutionalized] the information is that is available, the lower transaction costs will be as well, of course. One could perhaps make the argument that Transaction Cost Economics may be subsumed into the view of communication of information view of markets, where they are expected to work in accordance to who has and exchanges what information with whom.)

Thus, in the “perfect market” of standard economics textbooks, while information may be widely available, innovation may not be expected as readily as elsewhere given how well-defined are patterns of interaction and behavior. Rather, innovative firms and individuals, to be successful, should (jointly) find or even create the institutionalized environment in which their novel contribution fits the institutionalized communications that support them (cf. Munir and Phillips 2005). These institutionalized environments for communication tend to be “local,” for instance in the sense of regional or local in a metaphorical sense, since tolerance for ambiguity requires trust and regular, informal “checking in” on shared tacit understandings.

When there is no common purpose among those involved in a community, and in particular when indeed participants’ interests can legitimately and feasibly be opposed, tolerance for novelty is larger. Having a large number of firms in a market helps, but there should be identifiable sub-markets from which firms can operate. This suggestion holds in particular when the novelty introduced is subsequently likely to be accepted by a large enough community (customers in particular) so the innovation can gain currency. Relatedly, the market dynamics often attributed to small (new) firms (Dolfsma and Van der Velde 2014) is then, if this argument is correct and assuming that small firms can sustain only one or a few innovations at the same time, due not to the small firm itself being flexible and dynamic, but due to dynamics and selection among small firms. Economic dynamics in this sense can, however, come at a substantial societal cost depending on what bankruptcy law looks like in a country (cf. Dolfsma and McMaster 2007)—a cost not considered often enough in policy circles.

In McCarthy and Dolfsma (2017) we explicitly point to the communication undergirding a market, in this case the market for corporate control, arguing that a better understanding of the specifics of communication among market players is needed if one is to understand how a market functions. Two rivalling theories of how markets work can be discerned—the neoclassical economic or textbook theory claiming that fluidity in a market determines how well a market works and the Austrian economic theory claiming that information in a market determines how well a market works. In the market for corporate control, fluidity nor availability of information can explain how well a market performs, however one defines performance. We suggest, in that chapter, that it matters how communication between players that have a focus on Merger and Acquisition (M&A) deals is *institutionalized*. The institutionalized communication also involves the parties preparing for an M&A transaction, and independent strategy consultants and legal and financial service firms as well. A way in which to go through the different stages of an M&A deal has institutionalized substantially, regulated by the market authorities, including stipulations about what information about positions, intentions, and next steps is to be provided to whom. It is also clear what information cannot be shared with others. Elon Musk, of Tesla Inc., has experienced that from close up recently.¹ Such formalized institutions, based in Anglo-Saxon contract law, confer trust to players that the process of a deal is predictable and that hence the outcome is likely to be a fair one.

The informal institutions of a community’s culture also affect the communication of knowledge and information in a market such as the one for corporate control. On some

¹ See The New York Times, October 2, 2018 (“Elon Musk Calls S.E.C. ‘the Shortseller Enrichment Commission’ on Twitter”).

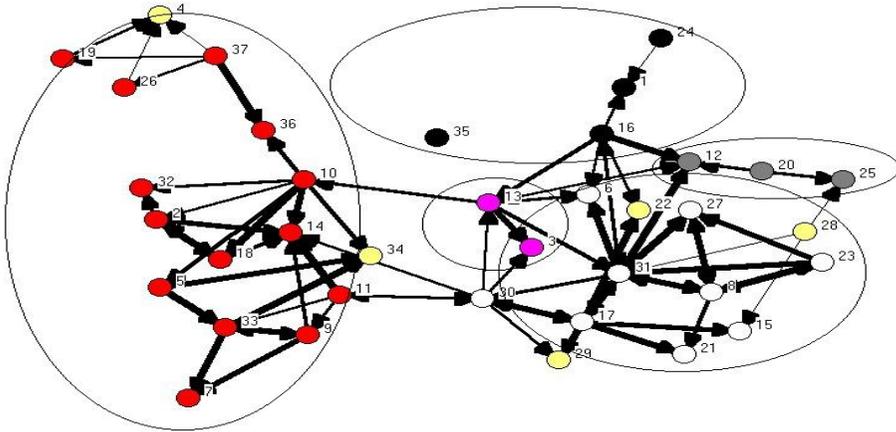
aspects about transactions in a market one would not want informal institutions to have a role to play, but if formal institutions to regulate or govern a practice are absent, informal institutions can exert an influence (cf. Olthaar et al. 2017). If that happens, arbitrariness and unpredictability might enter. London (emerging as a key market in financial markets, in general, and in the market for corporate governance, in particular) over the last few decades is only in part due to the regulatory changes implemented in the United States and the UK (amongst others the “Big Bang” policies of Prime Minister Margaret Thatcher). Entering the EU did not only allow UK players to increasingly see the European market as their terrain, making hefty profits (McCarthy and Dolfsma 2015), but it also became clear that informal institutions in the UK favorably underpin a market such as that for corporate control. A general and genuine *acceptance* of the rule of law, flavored with a pragmatic attitude, and a level of social and personal distance between individuals, help maintain a level playing field; an informal “pub culture,” for instance, then helps to keep open the informal flow of information that is needed to find solutions when, for instance, interests collide in a way that might be otherwise difficult or costly to reconcile (cf. Luyendijk 2015, or, e.g., Ogbonna and Harris 2000 and Greenley 1995 for a general case).

Knowledge, Communication and Firms

Different environments are welcoming of different extents of novelty (i.e., ambiguity or innovation)—to talk in the systems theory terms that Luhmann (1995) suggests: systems might be more or less open to irritation from an outside (Dolfsma, Finch, and McMaster 2011). The role of communication and information inside a firm has been recognized before, of course. William Ocasio (1998) has considered the attention focusing view of firms. Paul Milgrom and John Roberts (1988) have discussed what a lack of inappropriate distribution of knowledge inside the firm can lead to. When those involved in communications share a common purpose and the commonly supported institutions that guide communications, the tolerance of novelty is lower, *ceteris paribus* (see Dolfsma, Geurts, and Chong 2017). The tolerance to novelty is lower too when the organization is larger and thus more highly and perhaps rigidly structured and the higher formal and informal expectations of relevant stakeholders about the quality of the goods produced. This is, in large part, why larger firms are sometimes believed to be less innovative (cf. Dolfsma and Van der Velde 2014), despite efforts in some firms to counteract against this tendency (Gulati and Puranam 2009).

I have so far argued that the structure of communication in a community such as a firm impacts the likelihood of innovations being adopted in it. I define an innovation as a relative novelty for a community that is adopted by more than a single player. For an innovation to be successful, a large enough group of players needs to see its value added or usefulness. Figure 1 presents the innovation network of “Alpha company,” a multinational engineering company. An innovation network presents the group of individuals in a firm that communicate about “new ideas and innovations relevant to the company” (Aalbers, Koppius, and Dolfsma 2014; Rodan 2010; Cross and Prusak 2002), focusing on a specific technological or application area.

Figure 1: The Innovation Network at Alpha Company (Aalbers, Koppius, and Dolfsma 2014)



For the readers' understanding, Figure 1 does not include any individual node that did not have an ongoing connection in order to increase clarity. The individuals in the innovation network, collaboration among whom will give rise to technological change if successful, are highly skilled and experienced engineers who are highly motivated to jointly develop new products and services not just to boost Alpha Company profit and their own careers, but also to help society. The engineers are thus motivated intrinsically to a high degree (cf. Aalbers, Koppius, and Dolfma 2013). It is clear to them that collaboration is sorely needed to succeed, and yet the kind and level of collaboration to advance the technology on which these individuals work (related to transportation, broadly conceived) could be improved upon.

Technological development is, as Clarence E. Ayres (1953) observes, what drives industrial growth. Ayres' observation that technological development was and still is largely ignored in economics relates, no doubt, to the observations Ayres (1953, 282) has made about "all skills [being] cultural," including the skills required to develop technologies. Yet, there is something about technology that makes it different for Ayres: "because technology is objectified in physical tools and apparatus, it is always capable of progressive development" (Ayres 1953, 282).

This, it seems to me, is where the core of Ayres' argument about instrumental vs. ceremonial valuation lies—what may turn physical objects into tools rather than icons or fetishes (cf. Ayres 1944, 155 in particular). Tools, according to Ayres, as observed by Clive Lawson (2009), then have "trans-cultural characteristics." Even if one is ready to accept the view that the culturalized path for a tool to be created does not prevent its instrumental value from materializing fully, one would need to ask why, necessarily, a tool in its use in social contexts should have instrumental rather than ceremonial value. The value of tools, however conceived, is *perceived* by humans and therefore the human-object interaction on the one hand, or the human-human interaction mediated by the tool on the other hand, is what gives a tool its value. Tools can, of course, indeed be used by many different individuals, potentially in different contexts, which would make it more likely that instrumental use for them is found. Tools' instrumental uses may not, however, come about automatically and independent of a social and institutional situation. The usefulness of tools or the knowledge underlying them may then not become clear for some time, or at all, as the cases described in the next section indicate.

Speciation and Open Innovation

Technologies develop in the social context of a community of engineers. Many have argued that technologies develop according to paths or trajectories in or through which some uses are preferred over others (Dosi 1982). Sometimes uses that are obvious with the benefit of hindsight, are not pursued or only pursued after some time. Perhaps the most striking example of this is the way in which wireless telegraphy as a technology developed and found widespread use—Marconi won the 1909 Nobel Prize in physics for its development (Levinthal 1998). Marconi, and others along with him, had however worked on the technology for a long time, making what they themselves believed, as well, were incremental changes. It was only when engineers and particularly investors from another context or practice saw the potential of the wireless telegraphy technology that large investments in the further development and in its deployment were made, transforming in fundamental ways how large parts of society functioned and business was conducted. This is what Daniel Levinthal (1998) calls “speciation”—bringing the knowledge from one domain to another—was relatively coincidental and cannot be assumed to have happened when it did.

Even when players are actively looking for new insights and knowledge to improve their tools, and have identified relevant parties with relevant contributions, use of such knowledge may not happen, because of communication failure (cf. Wilhelm and Dolfsma 2018). The German car manufacturing industry, for instance, was actively seeking insights from outside its usual circles of inputs and collaborators by organizing what they referred to as an open innovation competition. Few ideas, even those that won the competition, made it through to the production stages of the players in this industry, however. The main reason is the assumed or preferred shape that communication should take by each of the sides involved. Automobile manufacturers, in order to incorporate ideas into the production specifications, expected to work with physical prototypes rather than intangible or at most impressionist representation of ideas. Some of the ideas for improvement of the tools (automobiles) were never used even when they were deemed valuable and relevant by the jury of the competition.

Conclusions

In this brief article I have tried to argue how understanding *institutionalized* communication is a key to understanding how both firms and markets work. Institutional economics is well positioned to contribute to advancing this understanding, if and when it is to pay closer attention to communication and language as some institutional economists have done (see, e.g., Dolfsma, Finch and McMaster 2011). Even as “innovation” may lead to technological change, it should as well be understood as necessarily giving ambiguity in communication between economic players that will only be accepted and gain currency as the result arising from it to have enough value to individuals. Looking at how institutionalized communication inside a firm aiming to innovate actually takes shape, suggests that the Ayresian, conceptually strict divide between ceremonial and instrumental valuation might be more blurry in empirical practices. A distinctly empirical, and therefore originally

institutionalist approach, to studying the economy and what drives it can be more vigorously adopted—an approach in which one is not afraid to be, as Ayres called himself, a heretic.²

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² Institutional economics, more influential in the pre-WWII era, was accused at times of being too empirically oriented (e.g., Atkins 1936).

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