Goodwill and the spirit of market capitalism

HOBHOUSE MEMORIAL LECTURE

Why have large factories given way to the co-ordinated production of specialized family units in segments of the Japanese textile industry? One reason is the predominance of 'obligated relational contracting' in Japanese business. Consumer goods markets are highly competitive in Japan, but trade in intermediates, by contrast, is for the most part conducted within long-term trading relations in which goodwill 'give-and-take' is expected to temper the pursuit of self-interest.

Cultural preferences explain the unusual predominance of these relations in Japan, but they are in fact more common in Western economies than textbooks usually recognize. The recent growth of relational contracting (in labour markets especially) is, indeed, at the root of the 'rigidities' supposedly responsible for contemporary stagflation. Japan shows that to sweep away these rigidities and give markets back their pristine vigour is not the only prescription for a cure of stagflation. The Japanese economy more than adequately compensates for the loss of allocative efficiency by achieving high levels of other kinds of efficiency — in many respects thanks to, rather than in spite of, relational contracting. We would do well to be more concerned about those kinds of efficiency too.

One of economists' favourite Adam Smith quotations is the passage in the Wealth of Nations in which he sets out one of his basic premises.

It is not from the benevolence of the butcher, the brewer and the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity, but to their self-love, and never talk to them of our necessities but of their advantages.1

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I wish to question that sharp opposition between benevolence and self-interest. Perhaps, so that he should be alert for signs of possible bias, the reader should be warned that a prolonged soaking in the writings of Japanese eighteenth- and nineteenth-century Confucianists at an early age has left me with a soft spot for the virtue of benevolence, even a tendency to bristle when anyone too much disparages it. At any rate I wish to argue, apropos of benevolence, or goodwill, that there is rather more of it about than we sometimes allow, further that to recognize the fact might help in the impossible task of trying to run an efficient economy and a decent society—an endeavour which animated Hobhouse's life, and about which, as Ginsburg makes clear in his 1950s preface to *Morals in Evolution*, even the pains of old age and the rise of fascism in the 1920s did not destroy his eventual optimism.

My title refers to goodwill rather than benevolence because benevolence, in my Confucian book, though not I think in Adam Smith's, is something shown in relations between unequals, by superior to inferior, the reciprocal of which is usually called loyalty. Goodwill is more status-neutral, more an expression of Hobhouse's 'principle of mutuality'. And it is that broader meaning which I intend. A formal definition of my subject might be: the sentiments of friendship and the sense of diffuse personal obligation which accrue between individuals engaged in recurring contractual economic exchange. (By 'economic', I mean only that the goods and services exchanged should be commonly subject to market valuation.)

Goodwill, of course, is a term of art in the commercial world. In the world of petty proprietorships, familiar to most of us, if you are selling a corner store you set a price on the premises, a price on the stock and a price on the goodwill. Back in the old Marshallian days when economists took their concepts from everyday life rather than trying to take everyday life from their concepts, goodwill meant the same thing to economists too. Palgrave's 1923 dictionary of economics defines goodwill as:

The expectancy of a continuance, to the advantage of a successor in an established business, of the personal confidence, or of the habit of recurring to the place or premises or to the known business house or firm, on the part of a circle or connection of clients or customers.²

The next economics dictionary I find, McGraw-Hill's exactly half a century later, has a very different definition of goodwill:

An accounting term used to explain the difference between what a company pays when it buys another company and what it gets in the form of tangible assets.³
Samuelson, to his credit one of the very few textbook writers in whose index one will find the word goodwill, illustrates the concept with J. P. Morgan taking over Carnegie's steel interests, making it clear that Morgan paid a premium well over the market value of the fixed assets primarily because he thereby advanced significantly towards a monopoly position. In other words the goodwill concept is extended to cover not just the benefits accruing to the purchaser of a business from the affectionate or inertial habits of its customers, but also those accruing out of his consequent shift from the position of price-taker to that of price-maker — his enhanced ability to hold those customers up to ransom. To be fair to the economists who have adopted this use of the term, and partially to retract my earlier gibe, one could say that the standard definition of the term has changed because everyday life has changed. A world in which the terms appropriate to the small owner-managed business formed the dominant norm, has given way to a world dominated by the large corporations and their accountants' terms. Certainly, if anyone wanted to write an Old Testament Prophet-style denunciation of modern capitalism à la Marx, he could hardly ask for a better illustration than the corruption of the concept of 'goodwill', that primordial embodiment of basic social bonds, into a term for some of the more ugly anti-social forms of profit-seeking.

THE DISAGGREGATION OF FACTORY PRODUCTION

I have been caused to ponder the role of goodwill in economic life by the recent experience of studying the organization of the textile industry, or to be more precise, the weaving segment of it, in Britain and Japan. One place I visited in the course of that research was the small town of Nishiwaki in western Japan whose industry is almost wholly devoted to the weaving of gingham chiefly for export to Hong Kong to be made up into garments for Americans to wear when square-dancing in the Middle West. This is an area where hand-loom weaving goes back some centuries. Power-looms came in in the late nineteenth century and they brought with them the factory system as they did everywhere else. And 25 years ago, although many small weaving establishments had survived, the bulk of the output was accounted for by larger mills, many of which were part of vertically integrated enterprises with their own cotton-importing, spinning and finishing establishments.

By 1980, however, the picture had changed. The larger mills had closed. The integrated firms had retreated, as far as direct production was concerned, to their original base in spinning. Most of them were still, either alone or in collaboration with a trading company, producing their own brand cloth, dyed and finished. But they were
doing so through the co-ordination of the activities of a large number of family enterprises. The key family business was that of the merchant-converter who contracted with the spinning company to turn its yarn into a certain type of cloth at a given contract price. The converter would send the yarn to another small family concern specializing in yarn dyeing, then it would go on to a specialist beamer who would wind it on to the warp beams in the desired pattern and also put the warp through the sizing process. Then it would be delivered to the weaver who might do his own weft preparation and the drawing-in (putting the harness on the beams ready for the looms) or might use other family businesses — contract winders or drawers in — for the process. And so on to the finishers who did the bleaching or texturizing or over-printing.

What is the reason for this fragmentation? What changes in Japanese society and the Japanese economy account for what most orthodox notions of the direction of the evolution of modern economies would count as a regression — the replacement of a system of production co-ordination within a vertically integrated firm by a system of production co-ordination between a large number of fragmented small firms; the replacement, to use Williamson's terms, of co-ordination through hierarchy by co-ordination through the market?5

I can think of four possible long-term secular trends which might help to explain the change.

1. The first is the rise in wages and the shorter working week of employees in union-organized firms. Wages are commonly lower in small firms — especially in Japan where the privileged position of the large enterprise elite has become firmly conventionalized, and inter-scale wage differentials are very great. But that is not all. Family enterprisers themselves are often willing to work much longer than 40 hours a week for what may or may not be a larger total income than wage workers get, but for an average return per hour of labour — hence wage cost per metre of cloth — which is below the employee's wage. If you like, family enterprisers are now willing to exploit themselves more than the unions or the law permit employees to be exploited — a condition which did not hold when employees were already working close to the human maximum — a 70 hour week for a subsistence level wage. The clear superiority of the factory system at that time may have been lost since.

2. Second, the secular trend to high taxation and higher levels of taxation-allergy make the family enterpriser's advantage in both tax avoidance and tax evasion more attractive — vide the growth of the secondary 'black' and quasi-black economy in many other countries.
3. Third, there is a technical factor: the capital lumpiness of some of the new technology. For example expensive, large and fast sizing machines can hardly get the through-put necessary to make them profitable within a single firm. Inter-firm specialization becomes the best way of realizing economies of scale.

4. Fourth, much higher levels of numeracy and literacy mean a much wider diffusion of the accounting and managerial skills necessary to run a small business, the prudent ability to calculate the rentability of investments, etc.

These are all features common to societies other than Japan and may well be part of the explanation why the woollen industry of Prato has also moved to a fragmented structure in recent years. But there is another factor which applies especially in Japan. The reason why the dominant trend in the west seems to be in the reverse direction — away from co-ordination through the market towards co-ordination through the hierarchy of a vertically integrated firm — is, as Oliver Williamson is never tired of telling us, because of the transaction costs entailed, the costs arising from the imperfections of markets with small numbers of buyers and sellers in which the bargaining transactions are made difficult by what the jargon calls 'impacted information'. These features so enhance the bargaining power of each party that, when there are no significant economies of scale to be gained by their mutual independence one party (usually the stronger one) buys out the other to put a stop to his 'opportunism' (rapid response not only to price signals — which of course is always admirable — but also to information about vulnerable weaknesses of the other party.)

RELATIONAL CONTRACTING

Here is another of those timeless generalizations about 'capitalist economies' about which Japan gives pause. Transaction costs for large Japanese firms may well be lower than elsewhere. 'Opportunism' may be a lesser danger in Japan because of the explicit encouragement, and actual prevalence, in the Japanese economy of what one might call moralized trading relationships of mutual goodwill.

The stability of the relationship is the key. Both sides recognize an obligation to try to maintain it. If a finisher re-equipps with a new and more efficient dyeing process which gives him a cost advantage and the opportunity of offering discounts on the going contract price he does not immediately get all the business. He may win business from one or two converters if they had some other reason for being dissatisfied with their own finisher. But the more common consequence is that the other merchant-converters go to their finishers and say: 'Look how X has got his price down. We hope you
can do the same because we really would have to reconsider our position if the price difference goes on for months. If you need bank finance to get the new type of vat we can probably help by guaranteeing the loan.'

It is a system, to use a distinction common in the Williamson school, of relational contracting rather than spot-contracting or to use Williamson's more recent phrase 'obligational contracting'. More like a marriage than a one-night stand as Robert Solow has said about the modern employment relation. The rules of chastity vary. As is commonly the case, for those at the lower end of the scale, monogamy is the rule. A weaver with a couple of dozen automatic looms in a back garden shed will usually weave for only one converter, so that there should be no dispute about prior rights to the fruits of his looms—no clash of loyalties. Specialists with faster, larger volume, through-puts, like beamers—scarcer, more attractive, more in demand, therefore—may have a relation à trois or à quatre. For the converters themselves, at the top of the local hierarchy, there have grown up curious conventions rather like polyandrous concubinage. The Japan Spinners Association is dominated by the so-called Big Nine firms. None of the Big Nine will tolerate one of its converters taking cotton yarn from another of the Big Nine. However, one rank below the Big Nine are the so-called New Spinners, and below them the post-war upstarts, the New New Spinners. A Big Nine spinner will tolerate its converters having relations with them, though, of course a New Spinner will not tolerate a relation with another New Spinner. So the converter can end up with one of each—a first husband and a number two and a number three husband as it were.

As in nearly all systems of marriage, divorce also happens. That is why I said that a finisher with a cost advantage could attract other converters who happen for other reasons to be dissatisfied with their finisher. When I use the analogy of divorce, I mean traditional divorce in obligation-conscious societies, rather than the 'sorry I like someone else better: let's be friends' divorce of modern California. That is to say, the break usually involves recrimination and some bitterness, because it usually has to be justified by accusing the partner of some failure of goodwill, some lack of benevolence—or, as the Japanese phrase is more often translated, 'lack of sincerity'. It is not enough that some external circumstances keep his prices high.

I have made these relations sound like the kinship system of a Himalayan village, but of course the specific patterns of who may trade with whom are of very recent origin. What are entirely traditional, however, are, first, the basic pattern of treating trading relations as particularistic personal relations; second, the values and sentiments which sustain the obligations involved, and third
such things as the pattern of mid-summer and year-end gift exchange which symbolizes recognition of those obligations.

But how on earth, the economist will want to know, do the prices and ordered quantities get fixed? The answer seems to be that, once established, prices can be re-negotiated at the initiative of either party on the grounds either of cost changes affecting either party, or else of changes in the competitive conditions in the final market in which the brand cloth is sold. There are also fringe spot-markets for cotton yarn and grey cloth, and the prices ruling in these markets and reported in the daily textile press provide guides. To further complicate the issue there is some collective bargaining. Both the weavers and the converters in Nishiwaki have their own co-operative union and guide prices may be agreed between them; alternatively, in some other textile areas, the weavers co-op sets a minimum contract price which its members are not supposed to undercut, though there is general scepticism about the effectiveness of such an agreement.

RELATIONAL CONTRACTING BETWEEN UNEQUALS

The basic principles on which these price and quantity negotiations rest appear to be three-fold. First that the losses of the bad times and the gains of the good times should be shared. Second, that in recognition of the hierarchical nature of the relationship — of the fact that weavers are more dependent on converters than converters are on weavers — a fair sharing of a fall in the market may well involve the weaker weaver suffering more than the converter — having his profits squeezed harder. But, third, the stronger converter should not use his bargaining superiority in recession times, and the competition between his weavers to have their orders cut as little as possible, to drive them over, or even to, the edge of bankruptcy.

It is in the interpretation of these principles, of course, that ambiguity enters. Benevolence all too easily shades into exploitation when the divorce option — the option of breaking off the relationship — is more costlessly available to one party than to the other. There is, even, an officially-sponsored Association for the Promotion of the Modernization of Trading Relations in the Textile Industry in Japan which urges the use of written rather than verbal contracts in these relationships and is devoted to strengthening moral constraints on what it calls the abuse — but our economic textbooks would presumably call the legitimate full use — of market power. As for the nature of such abuse, surveys conducted by the Association show that suppliers with verbal contracts are more likely to have goods returned for quality deficiencies than those with proper written contracts. Weavers will wryly remark that returns become
strangely more common when the price is falling (and a rejected lot contracted at a higher price can be replaced by a newly contracted cheaper lot).

The work of the Association is an interesting illustration of the formal institutionalization of the ethics of relational contracting — doing, perhaps, for contracting what the post-war labour reform did to transform the employment system of large firms from manipulative paternalism into something less exploitative and better described as welfare corporatism. All one can say about the contemporary trading reality is that those ethics appear to be sufficiently institutionalized, to be sufficiently constraining on a sufficient number of the firms and families in Nishiwaki textiles, for the pattern of trading I have described to be a stable and viable one.

That pattern is repeated in many other areas of the Japanese economy — between, for example, an automobile firm like Toyota and its sub-contractors. Here again, the obligations of the relationship are unequal; the sub-contractor has to show more earnest goodwill, more 'sincerity', to keep its orders than the parent company to keep its supplies. But equally the obligatedness is not entirely one-sided, and it does limit the extent to which the parent company can, for example, end its contracts with a sub-contractor in a recession in order to bring the work into its own factory and keep its own workforce employed.

I have been taken to task by Okumura, the Japanese economist who has written most interestingly about these relationships, for speaking of the 'obligatedness' of a firm like Toyota as if a corporation was, or behaved like, a natural person. But I still think the term is apt. The mechanisms are easy to intuit, if ponderous to spell out. First of all, there are real personal relations between the purchasing manager of Toyota and the manager or owner-manager of a sub-contracting firm. But, of course, managers change frequently, particularly in firms with a bureaucratic career-promotion structure like Toyota. It is part of the commitment of such managers, however, that they identify with their firm and their department. If it were said, therefore, in the world outside, that Toyota, or its purchasing department in particular, had behaved badly by playing fast and loose with its sub-contractors, the manager responsible would feel that he had let his firm down. If the accountants in the costing department urge a tough line with sub-contractors, he may well tell them that they are short-sighted and even disloyal to the firm in under-estimating the importance of its reputation. These seem to me readily understandable mechanisms by which the patterns of obligation between individual owner-managing converters and weavers in Nishiwaki can be duplicated between corporations.

I have discussed two cases of obligated trading relationships
which are explicitly hierarchical. If there is any doubt as to who pecks whom in the pecking order look at the mid-summer and year-end gifts. Although it may vary depending on the precise nature of the concessions sought or granted in the previous six months or anticipated in the next, the weaver’s gift to the converter will usually cost more than vice versa — unless, that is, either of them miscalculates the gift inflation rate, the point of transition, say, from Black Label against Suntory Old to Napoleon brandy against Dimple Haig.

RELATIONAL CONTRACTING BETWEEN EQUALS

But these relations are not confined to the hierarchical case. Even between firms of relatively equal strength the same forms of obligated relational contracting exist. Competition between Japanese firms is intense, but only in markets which are (a) consumer markets and (b) expanding. In consumer markets which are not expanding cartelization sets in rather rapidly, but that is a rather different story which does not concern us here. What does concern us here are markets in producers’ goods, in intermediates. And for many such commodities markets can hardly be said to exist. Take steel, for instance, and one of its major uses for automobiles. The seven car firms buy their steel through trading companies, each from two or three of the major steel companies, in proportions which vary little from year to year. Prices, in this market, are set by the annual contract between the champions — Toyota on the one side, New Japan Steel on the other.

It is the concentration of such relationships which is the dominant characteristic of the famous large enterprise groups, known to Japanese as grūpu, and to foreigners, usually, as zaibatsu or keiretsu. There are six main ones of which the two best known are Mitsui and Mitsubishi. These groups are quite distinct from the hierarchical groupings of affiliates and subsidiaries around some of the giant individual firms like Hitachi or Matsushita or MHI. The Mitsubishi group, for example, has no clear hierarchical structure. In its core membership of 28 firms, there is a certain amount of intra-group share ownership — on average about 26 per cent of total equity widely dispersed throughout the group in three or four per cent shares. There is a tiny amount of interlocking directorships — about three per cent of all directors’ seats. And most of the firms have the group bank as their lead bank, and bank of last resort, but that bank provides on average less than 20 per cent of all loan finance to group firms. The only thing which formally defines the identity of the group is the lunch on the last Friday of the month when the Presidents of every company in the group get together,
often to listen to a lecture on, say, the oil market in the 1990s, to
discuss matters like political party contributions, sometimes to hear
news of, or give blessings to, some new joint venture started up by
two or more member firms, or a rescue operation for a member firm
in trouble.¹²

But the main raison d'etre of these groups is as networks of
preferential, stable, obligated bilateral trading relationships, net-
works of relational contracting. They are not conglomerates because
they have no central board or holding company. They are not
cartels because they are all in diverse lines of business. Each group
has a bank and a trading company, a steel firm, an automobile firm,
a major chemical firm, a shipbuilding and plant engineering firm and
so on—and, except by awkward accident, not more than one of
each. (The ‘one set’ principle, as the Japanese say.) Hence, trade in
producer goods within the group can be brisk. To extend earlier
analogies; it is a bit like an extended family grouping, where business
is kept as much as possible within the family, and a certain degree
give and take is expected to modify the adversarial pursuit of
market advantage—a willingness, say, to pay above the market
price for a while to help one’s trading partner out of deep trouble.

THE PREFERENCE FOR RELATIONAL CONTRACTING: CULTURAL
SOURCES?

The starting point of this discussion of relational contracting was
the search for reasons to explain why it made sense for the spinning
firms producing brand cloth to co-ordinate production neither
through hierarchy in the usual Williamson sense of full vertical
integration, nor through the market in the normal sense of con-
tinuously pursuing the best buy, but through ‘relational contracting’.
It was, I said, because such arrangements could be relied on in Japan
more than in most other economies. There is one striking statistic
which illustrates the extent to which it is in fact relied on. The
volume of wholesale transactions in Japan is no less than four times
as great as the volume of retail transactions. For France the multiple
is not four but 1.2; for Britain, West Germany and the USA the
figure is between 1.6 and 1.9.¹³

How does one explain the difference between Japan and other
capitalist economies? Williamson has ‘theorized’ these ‘obligational
relationships’ and explained the circumstances in which they will
occur—when the extent to which the commodities traded are
idiosyncratically specific (such that the economies of scale can be
as easily appropriated by buyer or by seller), and the extent to which
either party has invested in equipment or specialized knowledge for
the trading relationship, are not quite such that vertical integration
makes sense, but almost so. He also asserts that in such relationships quantity adjustments will be preferred to price adjustments and price adjustments will be pegged to objective exogenous indicators (though he allows, in passing, for the not very 'relevant' or 'interesting' possibility that 'ad hoc price relief' might be given as an act of kindness by one party to the other.)\textsuperscript{14}

Perhaps Williamson has evidence that that is the way it is in America and the fact that his argument is couched in the terms of a timeless generalization merely reflects the tendency of American economists to write as if all the world were America. (Just as British economists write micro-economics as if all the world were America, and macro-economics as if all the world were Britain.) Or perhaps he does not have much evidence about America either, and just assumes that 'Man' is a hard-nosed short-run profit-maximizer suspicious of everyone he deals with, and allows everything else to follow from that. At any rate Williamson's account does not provide the tools for explaining the difference between the Japanese and the British or American economies. There is nothing particularly idiosyncratic about the steel or cloth traded in many of the obligated relationships, little specialized assets involved (though there are in automobile sub-contracting). Nor is there clear avoidance of price adjustments — weaving contract prices, in fact, look like graphs of nineteenth century business cycles.

Clearly we have to look elsewhere for an explanation. Try as one might to avoid terms like 'national character' which came naturally to Hobhouse, in favour of the scientific pretensions of, say, 'modal behavioural dispositions', it is clearly national differences in value preferences, or dispositions to action, with which we are concerned. And, as Macfarlane showed when he looked into the origins of English individualism,\textsuperscript{15} to attempt to explain those takes one on a long speculative journey — at least into distant ill-recorded history, even if, for ideological reasons, one wishes to rule out genes. But it is legitimate and useful to ask: what are the concomitants of these dispositions? What do they correlate with? Are they an expression of more general traits?

One candidate explanation is that the Japanese are generally very long-term-future-oriented. At this moment, for example, the Japanese Industry Ministry's Industrial Structure Council is already composing what it calls a 'vision' of the shape of the world economy in the mid-1990s. The economist is likely to seize on this explanation with relief, because it will allow him to ignore all dangerous thoughts about benevolence, and accommodate the relational contracting phenomenon in the conventional micro-economics of risk aversion and low time-discounts. Any sacrifice of short-run market advantage is just an insurance premium for more long-term gains.

And he would find some good evidence. Nakatani has recently
done an interesting calculation comparing 42 large firms inside one of the large kinship groupings like Mitsui and Mitsubishi which I have just described and a matched sample of 42 loners. The loners had higher average profit levels and higher growth rates in the 1970s. But they also had a considerably higher dispersal around the means. The group firms were much more homogeneous in growth and profit levels. What went on in the groups, he concluded, was an overall sacrifice of efficiency in the interests of risk-sharing and greater equality.16

Relational contracts, in this interpretation, are just a way of trading off the short term loss involved in sacrificing a price advantage, against the insurance that one day you can ‘call off’ the same type of help from your trading partner if you are in trouble yourself. It is a calculation, perhaps, which comes naturally to a population which until recently was predominantly living in tightly nucleated hamlet communities in a land ravished by earthquake and typhoon. Traditionally, you set to, to help your neighbour rebuild his house after a fire, even though it might be two or three generations before yours was burnt down and your grandson needed the help returned.

But you could be sure that the help would be returned. And this is where we come back to Adam Smith. The Japanese, in spite of what their political leaders say at summit conferences about the glories of free enterprise in the Free World, and in spite of the fact that a British publisher with a new book about Adam Smith can expect to sell half the edition in Japan, have never really caught up with Adam Smith. They have never managed actually to bring themselves to believe in the invisible hand. They have always insisted — and teach in their schools and their ‘how to get on’ books of popular morality — that the butcher and the baker and the brewer need to be benevolent as well as self-interested. They need to be able to take some personal pleasure in the satisfaction of the diners quite over and above any expectation of future orders. It is not just that benevolence is the best policy — much as we say, rather more minimally, that honesty is the best policy. They do not doubt that it is — that it is not a matter of being played for a sucker, but actually the best way to material success. But that is not what they most commonly say. They most commonly say: benevolence is a duty. Full stop. It is that sense of duty — a duty over and above the terms of written contract — which gives the assurance of the pay-off which makes relational contracting viable.

Note that this is a little different from what Durkheim had in mind when he was talking about the non-contractual elements in contract and refuting Spencer’s claim that modern societies were held together solely by an organic web of individualistic contracts.17 Durkheim was talking about the intervention of society both in enforcing the basic principles of honesty and the keeping of promises,
and in regulating the content of contracts, deciding what was admissible and what offended social decency or basic human rights. And in Durkheim's book it is the consciousness of an obligation imposed by society as a whole—or, on its members, by an occupational group of professional practitioners—which enforces those rules. Hobhouse, likewise, in his brisker and more historically rooted discussion of the way freedom of contract and the rights of private property come to be curtailed by, for example, redistributive welfare measures, stressed the benefits the individual receives from society and the corresponding obligations to society.\textsuperscript{18} In Japanese relational contracting, by contrast, it is a particular sense of diffuse obligation to the individual trading partner, not to society, which is at issue. To put the matter in Parson's terms, relational contracting is to be understood in the universalism/particularism dimension, whereas the Durkheim point relates to the fifth dichotomy that Parsons later lost from sight: collective-orientation versus individual-orientation. To put it another way, the Japanese share with Durkheim the perception that contract, far from being fundamentally integrative, is basically a marker for conflict. Every harmonization of interest in a contract simply conceals a conflict either latent or adjourned, as Durkheim said.\textsuperscript{19} The Durkheim solution is to have universalistic social institutions contain the conflict—an engine-cooling system to take away the heat. The Japanese prefer particularistically to reduce the friction in all the moving parts with the emollient lubrication of mutual consideration.

Perhaps one should not overdraw the contrast, however, in view of the empirical fact that the Japanese, who stand out among other capitalist societies for their addiction to relational contracts, also stand out as the nation whose businessmen and trade unionists seem to have a more lively sense of their obligated membership in the national community than those of other nations. Japan has fewer free-rider problems in the management of the national economy; patriotism seems to supplement profit-seeking more substantially in, say, the search for export markets, and so on. Perhaps the common syndrome is a generalized dutifulness, or to put it in negative form, a relatively low level of individualistic self-assertion. I am reminded of the Japanese scholar and publicist, Nitobe. In his lectures in the USA in the 1930s he used to tell the national character story about the international prize competition for an essay about the elephant. In his version the Japanese entry was entitled 'The duties and domestication of the elephant'.

But there is, it seems to me, a third element in the Japanese preference for relational contracting besides risk sharing and long-term advantage on the one hand and dutifulness on the other. That is the element, to go back to Parsons' variables again, best analysed in his affectivity/affective-neutrality dimension. People born and
brought up in Japanese society do not much like openly adversarial bargaining relationships—which are inevitably low-trust relationships because information is hoarded for bargaining advantage and each tries to manipulate the responses of the other in his own interest. Poker is not a favourite Japanese game. Most Japanese feel more comfortable in high-trust relations of friendly give-and-take in which each side recognizes that he also has some stake in the satisfaction of the other.

All of which, of course, is not necessarily to say that the affect is genuine. Pecksniffs can do rather well in exploiting these relationships when they are in a stronger bargaining position—the point made earlier about the ambiguities of these relationships.

EMPLOYMENT PRACTICES AND RELATIONAL CONTRACTS

The discussion so far has centred on markets in intermediates and capital goods, and about relational contracting between enterprises. I have not so far mentioned labour markets, though the predominance of relational contracting in Japanese labour markets is, of course, much more widely known than its predominance in inter-firm trading. By now every television viewer has heard of the life-time commitment pattern—the transformation of the employment contract from a short-term spot contract agreement to provide specific services for a specific wage (termination by one week or one month's notice on either side), into a long-term commitment to serve as needs may from time-to-time dictate, with wages negotiated according to criteria of fairness which have precious little to do with any notion of a market rate-for-the-job. The contract is seen, in fact, less as any kind of bilateral bargain, than as an act of admission to an enterprise community wherein benevolence, goodwill and sincerity are explicitly expected to temper the pursuit of self-interest. The parallel between relational contracting in the intermediates market and in the labour market is obvious. There can be little doubt that the same cultural values explain the preferred patterns in both fields.

RELATIONAL CONTRACTING AND EFFICIENCY

But anyone looking at the competitive strength of the Japanese economy today must also wonder whether this institutionalization of relational contracting, as well as serving the values of risk-sharing security, dutifulness and friendliness also conduces to a fourth valued end—namely economic efficiency. Any economist, at least any economist worth his neo-classical salt, would be likely to scoff
at the idea. Just think, he would say, of the market imperfections, of
the misallocation and loss of efficiency involved. Think how many
inefficient producers are kept out of the bankruptcy courts by all
this give-and-take at the expense of the consuming public. Think of
the additional barriers to entry against new, more efficient, pro-
ducers. Gary Becker, in a lecture at the LSE a couple of years ago,
claimed that give-and-take trading was even an inefficient way of
being altruistic. In the end, he said, through greater survival power,
you get more dollars-worth of altruism by playing the market game
and then using the profits to endow a charitable foundation like
Rockefeller — which I suppose is true and would even be significant.
if ‘altruism’ were a homogeneous commodity indifferently produced
either by being friendly to your suppliers or by posthumously
endowing scholarship.20

But that apart, the main point about sub-optimality is well-taken.
The Japanese economy is riddled with misallocation. A lot of the
international dispute about non-tariff barriers, for example, has its
origin in relational contracting. Take the market for steel which I
mentioned earlier. Brazil and Korea can now land some kinds of
steel in Japan more cheaply than Japanese producers can supply
it. But very little of it is sold. Japan can remain as pure as the driven
snow in GATT terms — no trigger prices, minimal tariffs, no quotas
— and still have a kind of natural immunity to steel imports which
Mr. MacGregor would envy. None of the major trading companies
would touch Brazilian or Korean steel, especially now that things
are going so badly for their customers, the Japanese steel com-
panies. Small importers are willing to handle modest lots. But they
will insist on their being landed at backwater warehouses away from
where any domestic steel is going out, so that the incoming steel is
not seen by a steel company employee. If that happens, the lorries
taking the steel out might be followed to their destination. And the
purchaser, if he turned out to be a disloyal customer, would be
marked down for less than friendly treatment next time a boom
brings a seller’s market. What distortions, an economist would say.
What a conspiracy against the consumer! What a welfare loss involved
in sacrificing the benefits of comparative advantage! If the Japanese
economy has a good growth record, that can only be in spite of
relational contracting and the consequent loss of efficiency.

And yet there are some good reasons for thinking that it might
be because of, and not in spite of relational contracting that Japan
has a better growth performance than the rest of us. There is un-
doubtedly a loss of allocative efficiency. But the countervailing
forces which more than outweigh that loss can also be traced to
relational contracting. Those countervailing forces are those which
conduce to, not allocative efficiency, but what Harvey Leibenstein
calls X-efficiency — those abilities to plan and programme, to
cooperate without bitchiness in production, to avoid waste of time or of materials, capacities which Leibenstein tries systematically to resolve into the constituent elements of selective degrees of rationality and of effort.\textsuperscript{21} We have recently been told by a solemn defender of the neo-classical paradigm that we need not bother about Leibenstein and X-efficiency because he is only reformulating the utility-maximizing paradigm of the generalized equilibrium theory as developed by the Williamson school (i.e. that which incorporates transaction costs, property-right constraints, etc.).\textsuperscript{22} To argue thus is not only to destroy the usefulness of ‘utility-maximization’ for any precise calculations, it is also to ignore the achievement of Leibenstein in actually noticing (a) that individuals, firms and nations differ greatly in degrees of generalized sloppiness, and (b) that other kinds of sloppiness are far more important for output growth and welfare than that involved in failing to fine-tune economic behaviour in response to changes in price signals — or even in failing to calculate the relative transaction costs of internal and external procurement.

In his book Leibenstein tries a rough comparison between the estimated welfare loss from tariffs and price distortions in a number of empirical cases, and that implied by the ‘inefficiency’ of business firms inferrable from the range in outputs with similar inputs as between ‘best practice’ and ‘worst practice’ firms. His evidence that for most economies for most of the time the latter vastly exceeds the former is of crucial policy importance, and any theory which succeeds in assimilating both phenomena within the same umbrella framework is, like unisex fashions, less an achievement than a distraction. The distinction between allocative efficiency which has to do with rational responses to price signals and all those other kinds of efficiency which raise the productivity of inputs in a business organization is an extremely useful one, and X-efficiency is as good a catch-all term for the second bundle of qualities as any other.

It is in the second dimension, in its effect in making ‘best practice’ better and more widely diffused, that the Japanese system of relational contracting has merits which, I suggest, more than compensate for its price-distorting consequences. To take the case of employment and the life-time commitment first, the compensatory advantages which go with the disadvantage of inflexible wage costs, are reasonably well known. In a career employment system people accept that they have continually to be learning new jobs; there can be great flexibility, it makes more sense for firms to invest in training, the organization generally is more likely to be a learning environment open to new ideas. If a firm’s market is declining, it is less likely to respond simply by cutting costs to keep profits up, more likely to search desperately for new product lines to keep busy the workers it is committed to employing anyway. Hence a strong growth dynamism. And so on.
As for relational contracting between enterprises, there are three things to be said. First, the relative security of such relations encourages investment in supplying firms. The spread of robots has been especially rapid in Japan's engineering sub-contracting firms in recent years, for example. Second, the relationships of trust and mutual dependency make for a more rapid flow of information. In the textile industry, for example, news of impending changes in final consumer markets is passed more rapidly upstream to weavers and yarn dyers; technical information about the appropriate sizing or finishing for new chemical fibres is passed down more systematically from the fibre firms to the beamers and dyers. Third, a by-product of the system is a general emphasis on quality. What holds the relation together is the sense of mutual obligation. The butcher shows his benevolence by never taking advantage of the fact that the customer doesn't know rump from sirloin. If one side fails to live up to his obligations, the other side is released from his. According to the relational contract ethic, it may be difficult to ditch a supplier because, for circumstances for the moment beyond his control, he is not giving you the best buy. It is perfectly proper to ditch him if he is not giving the best buy and not even trying to match the best buy. The single most obvious indicator of effort is product quality. A supplier who consistently fails to meet quality requirements is in danger of losing even an established relational contract. I know that even sociologists should beware of anecdotal evidence, but single incidents can often illustrate national norms and I make no apology for offering two.

1. The manager of an automobile parts supplier said that it was not uncommon for him to be rung up at home in the middle of the night by the night-shift supervisor of the car factory 60 miles away. He might be told that they had already found two defective parts in the latest batch, and unless he could get someone over by dawn they were sorry, but they'd have to send the whole lot back. And he would then have to find a foreman whom he could knock up and send off into the night.

2. The manager of a pump firm walking me round his factory explains that it is difficult to diagnose defects in the pump-castings before machining though the founders are often aware when things might have gone wrong. 'I suspect', he said cheerfully, 'our supplier keeps a little pile of defective castings in the corner of his workshop, and when he's got a good batch that he thinks could stand a bit of rubbish he throws one or two in'.

I leave the reader to guess which is the Japanese and which the British story.
HOW UNIQUELY JAPANESE?

So if it is the case that relational contracting has some X-efficiency advantages which compensate for allocative inefficiencies, what lessons should we draw from all this about how to run an efficient economy and build a decent society? The first thing to do is to look around at our economies and take stock of the ways in which benevolence/goodwill actually modify the workings of the profit motive in daily practice. So far I have referred to relational contracting as something the Japanese have an unusual preference for. But that is far from saying that they are uniquely susceptible to it. If we look around us we will find far more evidence of relational contracting than we think. This is so even in America where capitalism seems generally to be more hard-nosed than in Europe. In an interesting article written 20 years ago, Stewart Macaulay examined the relative importance of personal trust and enforceable legal obligation in business contracts in the USA. He found many businessmen talking of the need for give-and-take, for keeping accountants and lawyers, with their determination to press every advantage, out of direct dealings with other firms. Among those with experience of large projects in the civil construction industry it is a truism that successful work requires a bond of trust between client and contractor. Engineers, as fellow-professionals, sharing a commitment to the project’s success, can create that trust. Their firms’ lawyers can endanger it by the confrontational stance with which they approach all potential conflicts of interest. Recently I got a simple questionnaire answered by seven managers or owner-managers of weaving mills in Blackburn asking them about their trading practices, and found a strong preference for stable long-term relationships with give-and-take on the price, and a claim that, on average, two-thirds of their business already was that way. In the British textile trade, of course, Marks and Spencers is well known for its relational contracting, squeezing suppliers a bit in times of trouble but not ditching them as long as they are maintaining quality standards, and accepting some responsibility for helping them technically. In the supermarket world, Sainsbury’s have the same reputation, supposedly very different from that of Tesco’s which believes that frequent switching of suppliers encourages the others to keep the price down.

QUALITY, AFFLUENCE AND RELATIONAL CONTRACTING

There may be something very significant in the nature of these examples. Try adding together the following thoughts.

1. Marks and Spencers is well known for one thing besides
relational contracting, namely that it bases its appeal on product quality more than on price.
2. There is also an apparent relation between a quality emphasis and relational contracting in Japan.
3. Sainsburys is up-market compared with Tesco which is for keen pricers.
4. Japan’s consumer markets are generally reckoned to be more middle-class, more quality sensitive and less price sensitive than Britain’s. (Textile people, for instance, have given me rough estimates that if one divides the clothing market crudely into the AB groups, fastidious about quality and not too conscious of price, and the rest who look at price and superficial smartness rather than the neatness of the stitching, in Britain the proportions are: 25:75; in Japan 60:40.)
5. Japan of the 1920s, and again in the post-war period, was much more of a cut-throat jungle than it is today. Not the ethics of relational contracting nor the emphasis on product quality nor the life-time employment system, seem to have been at all characteristic of earlier periods of Japanese industrialization.

Add all these fragments together and an obvious hypothesis emerges that relational contracting is a phenomenon of affluence, a product, Hobhouse would say, of moral evolution. It is when people become better off and the market-stall haggle gives way to the world of Which, where best buys are defined more by quality than by price criteria, that relational contracting comes into its own.

It does so for two reasons: first because quality assurance has to depend more on trust. You always know whether the butcher is charging you sixpence or sevenpence. But if you don’t know the difference between sirloin and rump, and you think your guests might, then you have to trust your butcher: you have to depend on his benevolence. Also, I suspect, when affluence reduces price pressures, any tendencies to prefer a relationship of friendly stability to the poker-game pleasures of adversarial bargaining – tendencies which might have been formerly suppressed by the anxious concern not to lose a precious penny – are able to assert themselves. Japan’s difference from Britain, then, is explained both by the fact that the cultural preferences, the suppressed tendencies, are stronger and by the fact that the price pressures have been more reduced by a much more rapid arrival at affluence, and consequently a greater subjective sense of affluence.

The fragmentary evidence about relational contracting in inter-firm trading relations in Britain, is much more easily complemented by evidence of its growth in the labour market. Not only Britain, but Europe in general – even the USA to a lesser extent – are no
longer countries where employers hire and fire without compunction. Statutory periods of notice gradually lengthen. National redundancy payment schemes recognize the expectation of continuance of an employment contract as a property right. In industries like steel, job tenures are valued at well over a year’s wages. More generally, labour mobility has been falling for 15 years. Factory flexibility agreements take the employment contract further away from the original rate-for-the-specific-job basis. More attention to career-promotion systems within the firm, managerial doctrines about ‘worker involvement’ in the affairs of the enterprise and, intermittently, talk of, and even occasional moves towards, enterprise-based industrial democracy all exemplify the transformation of the employment contract into a more long-term, more diffuse commitment.

RELATIONAL CONTRACTING, RIGIDITIES AND ECONOMIC POLICY

Economists have occasionally noted these trends, but have generally treated them as market imperfections, basically lag problems of the long and the short run — for in the end, habit always succumbs to the pursuit of profit. And among imperfection problems they have found them less interesting to analyse than other kinds like monopoly. And those bold souls among them who have taken aboard the new phenomenon of stagflation, and tried to explain the tendency for contraction in demand to lead to a contraction in output not a fall in price, to increased unemployment but only slow, delayed and hesitant deceleration in the rate of wage increase, have rarely recognized the importance of a general growth in relational contracting — of the effects on the effectiveness of fiscal and monetary regulators of the fact that more and more deals are being set by criteria of fairness not by market power. More commonly, they speak of the growth of oligopoly on the one hand and on the other of trade union monopoly consequent on statutory job protection and higher welfare benefits. They have explained stagflation, in other words, not as the result of creeping benevolence — the diffusion of goodwill and mutual consideration through the economy — but as the result of creeping malevolence, increasing abuse of monopoly power. And the cure which our modern believers in the supreme virtues of the market have for these ‘rigidities’, is a deflation stiff enough to restore the discipline of market forces, to make firms competitive again and force the inefficient out of business, to weaken trade union monopolies and get firms hiring and firing according to their real needs.

A few people have given relational contracting and its growth the importance it is due. Albert Hirschman, first in this as in so
many things, described the general syndrome of voice and loyalty taking over from exit and entry as the characteristic disciplining force of advanced capitalism. More recently Arthur Okun developed before his untimely death a similarly comprehensive view of relational contracting and, moreover, explained in his *Prices and Quantities* its connection to worsening stagflation. He wrote of the tendency in capital goods and intermediate markets, and to some extent in consumer markets, for what he called ‘customer markets’, to grow at the expense of ‘auction markets’, and of the corresponding growth of ‘career labour markets’—employment characterized by an implicit contract of quasi-permanence—the invisible handshake is one of his phrases—all adding up to what he called a ‘price-tag economy’ as opposed to the ‘auction economy’ of orthodox text books. What I do not think he fully took aboard is the way in which social relations in customer markets and career-labour markets take on a moral quality and become regulated by criteria of fairness. Consequently, his remedies, apart from being far more imaginatively interventionist, are not so very different in kind from the more common marketist prescriptions for dealing with the rigidities of stagflation. That is to say, he also concentrates on devices to change (a) incentives and (b) expectations under the unchanged assumption that economic behaviour will continue to be guided solely by short-run income-maximizing considerations.

There is no mention of Japan in his index, and none that I have discovered in his book. But if we do think of Japan, a society which has far more developed forms of relational contracting than ours and glories in it, and achieves high growth and technical progress, we might think of a different prescription.

It would run something like this. First, recognize that the growth of relational contracting can provide a very real enhancement of the quality of life. Not many of us who work in a tenured job in the academic career market, for example, would relish a switch to freelance status. I hear few academics offering to surrender their basic salary for the freedom to negotiate their own price for every lecture, or even demanding personally negotiated annual salaries in exchange for tenure and incremental scales. And if you overhear a weaving mill manager on the telephone, in a relaxed friendly joking negotiation with one of his long-standing customers, you may well wonder how much more than the modest profits he expects would be required to tempt him into the more impersonal cut-and-thrust of keen auction-market-type competition.

But the second point is this. Having recognized that relational contracting is something that we cannot expect to go away, and that inevitably a lot of allocative efficiency is going to be lost, try to achieve the advantages of X-efficiency which can compensate for the loss.
This prescription has a macro-part and a micro-part. The macro-part includes, first of all, maintaining the conditions for free competition in the one set of markets which remain impersonally competitive—the markets for final consumer goods. This is necessary to provide the external stimulus for the competing chains or pyramids of relational-contract-bound producers to improve their own internal efficiency. It means on the one hand an active competition policy, and on the other, where monopoly is inevitable, the organization of countervailing consumer watchdog groups. Also included in the macro-part are first, an incomes policy, since if it is now criteria of fairness rather than the forces of supply and demand which determine wages in career labour markets, those fairness criteria had better be institutionalized. Second it means an attempt, if you like, to tip the ideology towards benevolence; in Fred Hirsch’s terms, to try to revive an ‘ethos of social obligation’ to replenish the ‘depleting moral legacy’ which capitalism inherited from an earlier more solidary age, not least by stressing the importance of quality and honest thoughtful service, the personal satisfactions of doing a good job well as a source of pride and self-respect—letting profits be their own reward, not treated as if they were a proxy measure of social worth. The Department of Industry’s recent announcement of an £8 million programme of subsidies for improvement in quality assurance systems in British factories is at least a recognition of the enhanced importance of quality in the modern world, even if there are no signs of a recognition that this might entail new attitudes and values (or a new affirmation of old ones now lost), a move away from the spirit of caveat emptor.

The micro-part of the prescription involves a better specification of the ethics of relational contracting; perhaps, as the French have been contemplating, criteria for deciding what constitutes unfair dismissal of a sub-contractor, parallel to those for employees, with protection depending on performance, including quality criteria and conscientious timing of deliveries. Second, at the enterprise level, it means taking the growth of job tenure rights not just as an unfortunate rigidity, but as an opportunity for developing a sense of community in business enterprises. It means, that is to say, reaping the production advantages which can come from a shared interest in the firm’s success, from co-operation and free flow of information and a flexible willingness not to insist on narrow occupational roles. What those advantages can be we can see in Japan, but in Britain, where attitudes to authority are very different from those of Japan, the prescription probably means not manipulative policies of worker ‘involvement’ in existing hierarchies, but some real moves towards constitutional management, industrial democracy or what you will—anything except the extension of traditional forms of collective bargaining made for, and growing out of, the era of auction markets for labour.
Goodwill and the spirit of market capitalism

I think Hobhouse would not have objected to a lecture in his honour being used as an occasion for preaching, though I am not sure that he would have approved of the contents. I am enough of an old-fashioned liberal, however, to hope that he might.

Ronald Dore

NOTES


