Economic theory

Governance and coordination in economic theory

The subject matter of economics is the study of how individuals, firms and governments make choices. The overall purpose is to guide society in relation to the effective allocation of scarce means of production toward the satisfaction of human wants. In other words, the underlying normative rationale of economics is to provide guidance as to how a multitude of decisions can be coordinated in a way that secures efficiency. Economists tend to give prominence to the effectiveness of market processes in this respect and the normative implication of an economic analysis of a specific problem is often to set market processes free. However, the effectiveness of the market is premised by a set of institutional preconditions such as freedom of enterprise and ensured property rights. In addition, economic theory identifies situations where the market mechanism does not function effectively. The normative implication is to supplement or complement the market with other mechanisms of coordination.

In other words, economic theory is about coordination of decision making. Markets, corporate hierarchies and governments are seen as the most important governance mechanisms, and economics is about the proper role and scope of each mechanism. Decision making is coordinated by means of a proper division of labour between each mechanism. Some tasks are seen as best accomplished by the market, others by corporate hierarchies, and others again by the government. Some economic theories also stress the importance of proper institutions for effective coordination of the decision making. In sum, coordination takes the form of institutional framing and division of labour between governance mechanisms that are mostly seen as functioning in isolation and according to their own respective rationales. On the other hand, discursive framing of decentralized decision making and mixture of governance mechanisms as a result of direct interaction, joint decision making and negotiations between actors are beyond the theoretical perspective of economics.

Governance is seldom being analysed explicitly in economics. It is even hard to find texts where it is used explicitly as a concept. Actually, the concept does not figure at all in the list of contents in the most used handbooks, encyclopedia and dictionaries of economics. Even so, economics has contributed theories which have been highly influential in the literature of governance if this is understood in a generic sense as coordination of social and economic life. The introduction to this Handbook outlines a generic and a more narrow definition of governance. The generic definition understands governance as *the process of steering society and the economy through collective action and in accordance with common goals*. This understanding of governance fits well with the focus of much economic theory on the coordination of different modes of governance. Economic theories of markets, corporate hierarchies and the role of the state provide much of the rationale behind the traditional way of understanding the tasks and limits of government. Mainstream economics has contributed theories that underpin the rationale of the predominant steering of society and the economy through collective action.

However, this does not resonate with the overall approach of this volume as expressed in the narrow definition of governance. This definition understands governance as *the interactive processes through which society and the economy are steered towards collectively negotiated objectives*. The narrow definition stresses horizontal interactive processes between private and public actors in which objectives are negotiated collectively. Whereas such processes are in focus in a few specific areas within economics and in contributions from heterodox economic theories they are largely ignored in mainstream economic theory.

One of the metaphors being used for such forms of governance is the handshake. In this contribution the handshake will be used as a metaphor to represent contributions with important common elements even if only a few of them use the concept themselves. Instead of coordination directed by either the invisible hand of market forces or the visible hand of superiors in hierarchies handshakes represent coordination by agreement, bending of will and/or consensus. Handshakes can be visible or invisible. Visible handshakes are formal whereas invisible handshakes are informal. Visible handshakes are being fleshed out through direct interaction within institutional frameworks established for formal coordination and aiming for compromise. Invisible handshakes are informal coordination through means such as trust, social relationships, affinity and a common frame of meaning aiming for consensus.

Because of the important role of mainstream economics in relation to the traditional forms of coordination this contribution starts off by specifying in more detail how mainstream economic theory has contributed to this traditional understanding. First, the rationale of the *invisible hand* with no need for interactive coordination is presented. The economic rationale of the diametrically opposite approach in the form of central state planning (*the clinched fist*) is presented next. Then follows an outline of micro- and macroeconomic theories that suggest the need for supplementing the invisible hand with a *helping hand* in order to counteract market failure, stabilize the macro economy and redistribute income. Then the focus shifts to the governance of the firm starting with the *visible hand* of managerial coordination followed by economizing on transaction costs, and the trends of globalization and outsourcing (*the vanishing hand*). Whereas the preceding sections concern theories with a focus on coordination of governance mechanisms in accordance with the generic definition of governance, the concluding sections give a more detailed account of economic theories that contribute important insight to the understanding of governance more narrowly understood as societal steering toward collectively negotiated objectives though interactive processes. A review of contributions that provide an economic theoretical rationale for formal interaction between market actors, governments and associations (*visible handshakes*) is presented first, followed by an outline of contributions about informal coordination in networks, by means of social capital and through discursive interaction (*invisible handshakes*). Finally, economic theory of the governance of common pool resources is presented as a combination of visible and invisible handshakes followed by a conclusion.

The invisible hand

Governance as it is understood in the more narrow definition in this book was out of focus in mainstream economic theory from its very inception. Often, the contribution of Adam Smith is seen as the starting point of modern economics. Even if Smith only used the phrase a few times and in more specific contexts (Slater and Tonkiss, 2001), the invisible, or hidden, hand has since been generalized and interpreted as a powerful metaphor for his economic theory.

The idea that trade and market exchange automatically channels self-interest toward socially desirable ends, as if led by an invisible hand, is the foundational idea of modern mainstream economics. The invisible hand of the market coordinates the activities of atomistic actors who are assumed to make decisions in splendid isolation. Even if everybody acts only in their own interest in total disregard of their fellow human beings and of the overall impact of their behaviour, the wonders of the market will ensure the best possible societal outcome. This is the classical rationale of economic theory: the best possible allocation of resources will be the unintended outcome of a multitude of uncoordinated self-interested decisions by consumers and producers. There is a direct line from Adam Smith through the marginal theory of value and modern general equilibrium theory to current neoclassical orthodoxy. In spite of the evidence of grand scale market failure, development and poverty traps, and economic and financial crises, the assumed superiority of the unregulated market as allocation mechanism is a constant in mainstream economic theory. The ideal market with an effective invisible hand provides a central justification for laissez faire economics. There is no positive role for direct interaction between actors which may interfere with the efficient functioning of the invisible hand.

Adam Smith was a proponent for limited government and his economic theory is closely linked to classical political liberalism. However, he stressed that government provision of the fundamental framework for free markets was crucial. He also pointed at the necessity of other form of intervention in the market such as raising wages of the poor, supporting infant industries and tariffs under certain conditions. However, the most distinct divergence from laissez fair follows from his clear diagnosis of the failure of the invisible hand in case of collusion of market actors in order to manipulate prices and restrict supply. Smith's epic work *The Wealth of Nations* (1776) is a radical condemnation of business monopolies sustained and protected by the state which legitimizes countervailing action to secure an optimal outcome for society in terms of allocation of resources..

The invisible hand has had a huge influence on the thinking of all mainstream economists since Adam Smith. The central disagreement between economic ideologies can be viewed as disagreement as far as the strength of the 'invisible hand' is concerned. Phenomena such as large-scale industry, finance, and advertising were only nascent when Smith was alive, and some mainstream economists argue that this seriously decreases the effectiveness of the invisible hand. Some economists even argue that the reason why the invisible hand often seems invisible is that it is often not there (Stiglitz, 2003). Such views provide a rationale for coordination mechanisms different from the invisible hand.

The clinched fist

Neoclassical economics has certainly been the predominant paradigm in the last century. However, alternative competing paradigms have always co-existed with the dominant one. Until the 1990s the one with the strongest following was Marxist economics which provides an alternative approach which is totally incompatible with mainstream economics with its emphasis on accumulation, exploitation and class struggle. Marxist economics has various strands and leads by no means to unified policy prescriptions. However, alternative modes of coordination of economic and social life were definitely nurtured by its fundamental critique of capitalism, and in communist regimes central planning was seen as the alternative.

In the conceptual context of this chapter the mode of governing economic behaviour and relations in communist regime can be seen as a clinched fist. The power of state is unlimited as an instrument for the will of the people, or at least the proletariat, as represented and defined by the Communist Party, in its efforts to allocate resources and distribute proceeds in accordance with socialist principles. In this context, central planning is as dominant as the market in the ideal laissez faire economy. Economic theories inspired by Marxism guided the planners in their authoritative decisions about resource allocation and price setting (Kantorovich, 1939). The decisions of the planners worked as a clinched fist. No alternatives and no opposition were permitted.

The clinched fist worked well in periods when mobilization of resources for industrialization, war, or reconstruction was of utmost importance. Later, when concerns shifted to efficiency in production and satisfaction of varied consumer needs the limits of the clinched fist became obvious. Marxist economists developed proposals for market socialism (Lange, 1936). The intention of the subsequent market socialist reforms was to establish incentives for efficiency improving economic behaviour within the framework of a planned economy. However, the reforms did not achieve their objectives and other Marxist economists criticized the emergent bargaining structure where powerful state enterprises were able to extract disproportional resources from the state. Consequently, a highly inefficient 'economics of shortage' dominated by 'soft budget constraints' emerged (Kornai , 1980). In other words, the efforts to integrate markets in the planning model resulted in interactive processes of steering toward collectively negotiated objectives, in effect, governance in accordance with the narrow definition. However, the allocative outcome was highly inefficient and the policy impact was a worsening of power inequality.

The helping hand

Economic theories stress both the wonders of the (ideal) market mechanism and the multitude of market failures in practice. The failure of the market in allocating resources optimally, steering the macro economy and distributing income fairly makes it necessary to help the invisible hand by means of other governance mechanisms. Microeconomic theory points at a number of market failures. Following in the footsteps of Adam Smith, monopoly or more broadly economic power are seen to restrict supply and raise prices. In addition, externalities, public goods and information problems also result in suboptimal allocation of resources which all require correction by a helping hand. Further, the contribution of Keynes established macroeconomics as a separate field of study. He challenged the belief in the healing powers of the invisible hand by stressing the inability of the market to create full employment and the need for a helping hand in the form of demand management by the state. In addition, the distributive outcome of the market process is the blind spot in mainstream economic theory which addresses efficiency concerns but has nothing to contribute in relation to fairness of distribution. If distribution is considered unfairly unequal, a helping hand is needed here as well.

The need for a helping hand to correct the failures of the invisible hand of the market has traditionally resulted in a call for government intervention. Economic theory provides guidance as far as not only the need but also the form and scale of such intervention. Microeconomic theories of industrial regulation (Sugden, 1993) and macroeconomic theories of income formation and economic policy (Snowdon and Vane, 2002) show how the state can counteract the inefficient and unjust outcome of the invisible hand. This is a way of governing the economy by means of supplementing or complementing markets through government intervention.

The increasing role of the helping hand resulted in the emergence of a mixed economy (Schiller, 2010, 15) characterized by private ownership of the means of production and the dominance of markets for economic coordination but also indirect influence of the government over the economy through regulatory oversight, governmental provision of public goods and macroeconomic steering. Mostly, no need for direct interaction and coordination was envisaged. Market processes and government activities were seen as two isolated domains to be coordinated through a suitable division of labour. However, some mixed economies expanded in scope to include a role for indicative economic planning (see later) and large public enterprises which represent handshakes and direct government market interference respectively.

The prevailing economic theories stressing the need for a helping hand led to state intervention across the board and generally legitimized the growth of the state from the end of WW II until the 1970s. However, this orthodoxy was not unchallenged. Friedrich Hayek stressed the incapability and undesirability of what he called the collectivist rationalism of government interventionism. Milton Friedman developed a thorough criticism of Keynesian macroeconomics and recipes for alternative economic policies. From the 1970s and onwards such heresy on the fringes was brought into the mainstream of economic theory as the prevailing theories of the helping hand crumbled. The resulting neoliberal challenge questioned not only the efficiency but also the necessity of government intervention (Nielsen, 1991).

Microeconomic regulation of industry was seen as inefficient because of government failure. Bureaucrats lack not only the capacity but also the incentives for regulating in accordance with the prescriptions of the helping hand. Public choice theory show how regulation fails because of the self-interested behaviour of politicians and bureaucrats (Tullock, 1987). Economic theory was applied in an attempt to better understand policy making and implementation which had previously been assumed to be automatically efficient responses to the need for microeconomic public intervention prescribed by economic theory. Macroeconomic steering was seen as similarly inefficient as a result of inherent failures in relation to targeting, implementing and timing of macroeconomic policies, in particular fiscal policies which were considered central in the Keynesian repertoire of policy intervention (Mankiw, 2013). Further, redistributive policies to counteract unwanted distributive outcomes were seen as having negative impacts on efficiency. Especially, the assumed neutrality of redistribution in relation to allocative efficiency was questioned. In particular, the rising tax burden was seen as distorting resource allocation and as a drag on the economy (Lind and Granquist, 2010).

The negative critique of the theories of the helping hand was complemented by a positive restatement of the wonders of the market. Market solutions were not only propagated as second best solutions when government failures exceed the market failures that led the government to intervene in the first place. The inherent efficiency of market mechanisms was reinstated. The need for wholesale macroeconomic policies was seen as limited because of the self-correcting mechanisms of the market. In addition, market-led alternatives to microeconomic regulation by politicians and bureaucrats, such as trade in pollution permits instead of administrative regulation, were developed. Neoliberal economic analysis also led to New Public Management that resulted in delegation of public service production and delivery to private contractors and special-purpose agencies, on the basis of contracts and incentive governance. This represents a totalization of market competition as a universal steering principle in the public sector. The neoliberal turn in economic theory led to re-establishing the boundaries between the market and the state and as such it implied new modes of coordinating economic and social life.

The governance of the firm – from the visible hand to the vanishing hand

Above, only two forms of coordination have been mentioned. The economic theoretical debates have concerned the boundaries and division of labour between the market and the state. This is indeed the main focus of coordination or governance within economic theory. However, also the role of corporate hierarchies has been covered in the economic theory of the firm. In economic theory, firms have traditionally been seen as profit maximizers. Apart from this function it was treated as a black box. What goes on inside the firm was perceived as irrelevant. This has changed in the last 3-4 decades.

The focus of economic theories on market relations between small producers and buyers who cannot influence prices corresponded relatively well with the economic reality until the late 19th Century. However, it became increasingly obvious that this theoretical emphasis was no longer a suitable representation of the emerging *managerial capitalism* dominated by big corporations. Berle and Means (1932) identified the separation between ownership and control as a crucial characteristic of managerial capitalism. Dispersed ownership associated with the concentration of power in the hands of top management is a defining characteristic of the managerial revolution. The most emphatic contribution to the literature on managerial capitalism was Chandler (1973) who argued that the visible hand of the modern managerial enterprise has replaced the invisible hand of the market in coordinating activities and allocating resources of the U.S. economy. The modern multi-unit business has replaced small traditional enterprise, because the volume of economic activities had reached a level that made administrative coordination more efficient than market coordination He argued that an increasingly powerful managerial hierarchy had been created for this multi-unit business enterprise. As the business enterprise grew in size and diversity and as its managers became more professional, the management of the enterprise became separated from its ownership. Managerial capitalism underscores the problem of controlling managers, who were shown to have a preference for growth and stability rather than maximization of shareholder profit.

Managerial capitalism, dominated by big firms, prevailed until the 1970s. Since then, there has been an opposite trend. Administrative coordination by managerial hierarchies have been largely replaced by market relations but also by mechanisms such as horizontal networking and social capital akin to governance as defined in this book. Langlois (2002) has coined this process the *vanishing hand*. A combination of technological and institutional changes has the effect of increasing the benefits of specialization and the division of labor relative to the costs of contracting, leading to vertical disintegration. Outsourcing and subcontracting have supplanted the vanishing administrative coordination by managerial hierarchies.

The reasoning of Langlois is based on transaction cost theory which provides powerful tools for the analysis of the governance structure of firm transactions. This branch of economic theory is one of the few areas in economics where governance is explicitly analyzed (Williamson, 1996). According to Williamson, governance is "an exercise in assessing the efficacy of alternative modes (or means) of organization" (ibid, 11). The transaction is seen as the basic unit of analysis. Dependent on their attributes, transactions "are aligned with governance structures that differ in their cost and competence so as to effect a discriminating – mainly a transaction cost-economizing – result" (ibid, 11). The most well-known application of transaction cost economics is as a means to decide the boundaries of the firm, i.e. which transactions to internalize ('make') and which to acquire in the market ('buy'). The shifting boundaries of the firm over time reflect changes in the relative costs of performing a task through the corporate hierarchy versus the market.

Transaction cost economics is explicitly about governance. However, there is an emphasis on a rather limited choice of organizational forms. Williamson recognizes the existence of other forms of governance but most often narrows down the perspective to a choice between market exchange and corporate hierarchy. He sees potential governance forms as being positioned on a spectrum with market and hierarchy in each end. However, he sees the spectrum as "thick in the tails". Intermediate hybrid forms are seen as inherently inferior and unstable. For instance, Williamson (1975) explicitly dismisses the relevance of trust and networks as governance mechanisms. Although the theory is explicitly about governance it appears to exclude the relevance of mechanisms of governance that correspond with the more narrow definition of governance.

The visible handshake

Formal coordination through direct interaction between market actors, bureaucrats and politicians has been visible for a long time. However, it flourished, in particular, in the Golden Age of post-war capitalism until the 1980s. The phenomenon was linked to Keynesianism and more broadly the Fordist model of accumulation (Jessop, 1992). Economic interests were organized, and interest organizations seeked and were granted formal influence on public policy. Government-business links have always flourished. Whereas business influence on government policy has mostly been informal and indirect, it has also occasionally been formalized, for instance in delegation of authority to set standards and allocate public subsidies. Formal influence of organized business is stronger in Coordinated Market Economies than in Liberal Market Economies (Hall and Soskice, 2001).

In many developed countries interest representation, which were previously pluralist, changed into corporatism, or neo-corporatism, where quasi-monopolies organizing major labour market and sectoral interest groups are granted formal rights to represent and make decisions on behalf of their members in joint decision making with other interest groups. Neo-corporatism favoured economic tripartism which involved strong labour unions, employers' unions, and governments that cooperated as "social partners" to negotiate and manage the national economy. Corporatist systems instituted in Europe post WW II include the ordoliberal system of the social market economy in Germany, the polder model in the Netherlands, and the Nordic model in Scandinavia.

When Keynesianism ran into trouble with the emergence of stagflation in the 1970s, the predominant response in neo-corporatist countries were incomes policy and tripartist social pacts which are basically attempts to control the development of macroeconomic aggregates through agreements between organized interests. The failures of such policies and the ideological assault of neo-liberalism caused a gradual erosion of such grand-scale social engineering. However, formalized joint decision making still exists in many areas.

Indicative planning is another type of visible handshake (Nielsen, 2007). Whereas central planning is the authoritative economic decision making by the state, other forms of planning consist of interactive processes and collective negotiations with private actors. When planning was popular in Western democracies in the 1960s and 1970s, this was the type of planning that took place. Non-authoritative, non-directive planning by the state exists when it engages in activities intended to reduce risk and uncertainty for private actors. This may take the form of forecasting, investment planning and signalling intentions regarding future policies, and may be particularly effective when state owned enterprises constitute a significant share of the economy and/or when government procurement constitutes a significant and growing part of demand. It could even consist of comprehensive long-term (typically five-year) plans inspired by the central planning tradition. Such planning provides a framework for formation of less uncertain expectations about the future and does not necessarily include direct interaction. However, it is often coupled with interactive processes between the government and the major private economic actors with the purpose of informal coordination of public and private decision. This is what happened in France and other European countries where policy signalling, investment planning, and an institutionalized system of long-term planning was supplemented by consultation with organized interests and other major economic actors. The most iconic example of indicative planning is the post WWII experience of Japan. Here the guiding hand of the state was highly prominent and visible. The Ministry of International Trade and Industry (MITI) effectively ran a comprehensive industrial policy, funding research, directing investment and influencing corporate strategies in accordance with long-term plans (Ihara, 1987).

Most economists have struggled to make sense of visible handshakes which goes against key assumptions in economic theory. Market exchange is supposed to guarantee appropriate relative prices which are at best simulated but typically distorted by organized interests. And in case of market failure, the granting of formal influence to interested parties is seen to result in vested interest capture. However, some mainstream economists have contributed theories built on the rationale of visible handshakes. An example is the Rehn-Meidner model developed by two trade union economists which provides the rational for the use of selective employment policy measures, a tight macroeconomic policy and a wage policy of solidarity to combine full employment and equity with price stability and economic growth (Erixon, 2008).

Outside of mainstream Economics there have been major contributions theorizing the rationale of visible handshakes. One of founders of the American tradition of institutional economics, John R. Commons, developed an analysis of collective action by the state and other institutions (Commons, 1924). According to Commons, institutions were made up of collective actions that, along with conflict of interests, defined the economy. A number of theories exploring the economic and political rationale of policy networks, bargaining, the negotiated economy and various hybrid forms of coordination were developed by political economists and political scientists in the 1980s and 1990s (Kenis and Schneider, 1996). The most generic and influential contribution was Streeck and Schmitter (1985) who develops a typology with four models of social order. In addition to the market, the state (or the bureaucracy) and the community, they add interest governance, or the associative model of social order as a fourth model.

The associative order includes informal as well the formalized aspects of cooperation, and most forms of formalized joint decision making are not only visible handshakes but invisible handshakes a swell. Whereas the analytical distinction is clear it is difficult in practice to distinguish the formal and informal parts of interactive processes. What is called the guiding hand in the next section is an example of this although it focuses of the 'hand' of the state in orchestrating and guiding the interaction.

The invisible handshake

The identification of invisible handshakes is not a straight-forward exercise. The concept is seldom used explicitly and the practices producing such agreements, social capital or consensus are informal and accordingly not immediately visible, yes, indeed invisible. However, we will argue that such forms of governance are omnipresent and are becoming increasingly applied in a variety of contexts. Only a few examples are mentioned below.

The concept has explicitly been used to characterize the development of organic relationships between producers and suppliers in the Japanese automotive parts industry. Smitka (1990s) shows how such relationships are formed partly by contractual means but mainly through social interaction. Networking built on trust develops into long-term strategic relationships that facilitate mutually beneficial management of interdependencies and strengthens incremental innovation. The argument has general relevance in many contexts with networks, partnerships and alliances.

Many economic transactions take the form of a relational contract. The explicit terms of such a contract are just an outline as there are implicit terms and understanding which determine the behaviour of the parties. Relational contracts are relations rather than discrete transactions. Relational contract theory was originally developed by legal scholars (Macauley, 1963) but has been widely adopted in economic theory. The employment contract is the archetypical relational contract but the phenomenon exists in many markets and in a wide range of economic relationships. Economic theory tends to focus on the incentive structure in such relationships (Gibbons and Roberts, 2013). However, the incompleteness of contracts necessitates negotiation, and, often, relational contracts are based upon relationships of trust.

The burgeoning literature on trust (Nooteboom, 2002) and social capital (Durlauf and Fafchamps, 2004) provides evidence that some forms and some dimensions of invisible handshakes are analysed extensively by economists although many mainstream economists have still problems with the use and status of such concepts (Solow, 2001). The analysis of the non-profit social economy, or the third sector, is another field where economic theory has been applied. However, the mainstream approach gives priority to only certain dimensions of third sector activity (Westall, 2009).

Douglass North and other institutional economists have stressed the role of mental models and ideologies in economic exchange (Denzau and North, 1994; North, 2005). Decision making is framed by social processes forming the mental models of the actors. However, apart from a few such contributions the discursive dimension of economic exchange is largely neglected by economic theory. The presumption of given preferences still permeate economic theory. It is in a sense peculiar that this dimension of visible handshakes is not given more attention in economics considering the fact that much application of economic theory is embedded in efforts to influence the way major economic actors and the public at large understand and interpret the economic reality.

Common pool resources - a case of visible and invisible handshake

The invisible hand indicates the existence of hidden mechanisms that automatically translate self-interested individual behaviour into socially optimal results. However, economic theory identifies many situations where rational behaviour by individuals leads to irrational societal outcomes. The classical market failures and macroeconomic imbalances represent only some of those situations (Barry and Hardin, 1982). Perhaps most significantly, game theory addresses problems such as the prisoner's dilemma where isolated rational decisions by individuals lead to suboptimal outcomes. In such interaction contexts an appropriate institutional framework for strategic interaction between isolated market actors is required according to economic theory. In practice, interaction dilemmas are often solved through collective action and social mechanisms such as trust, social norms, culture and tradition.

Economic theory identifies problems with collective action, in principle. Olson (1965) shows that concentrated minor interests will be overrepresented and diffuse major interests neglected in situations of concentrated benefits and diffuse costs. He argues that free riding is a rational choice for individuals in cases where joint action is beneficial for the group as such which means that collective action is only possible in situations with significant benefits for small groups, coercion or fringe benefits unrelated to the purpose of the action itself. The consequence is that small producer interests will be overrepresented whereas broad consumer or tax payer interests are underrepresented.

Collective action problems are particularly acute in relation to common pool resources such as pastures, forests, water, fishing grounds, irrigation systems and the atmosphere where usage generally cannot be restricted. Such resources tend to degrade because of excessive use. This is the so-called 'tragedy of the commons' (Hardin, 1968). As far as remedies are concerned, economists have traditionally recommended either public ownerships or the establishment of individual property right to common pool resources. This follows the usual practice of solving interaction problems through either government intervention or market exchange. However, this is often impractical and impossible. Based on in-depth empirical studies of the management of common pool resource in various contexts, Ostrom (1990, 2000) points to a 'third way' that relies neither on central planning nor on individual property and markets. Her evidence suggests that many successful common-pool management systems are "rich mixtures of 'private-like' and 'public-like' institutions defying classification into a sterile dichotomy" (Ostrom, 1990, 14). She emphasizes the crucial role of trust and culture, arguing that that the assumption of ubiquitous opportunism leading to free riding, does not reflect the actual practices of managing common pool resources where trust and other social mechanisms substitute or complement costly monitoring to ensure compliance with the collectively negotiated rules of governance. Ostrom shows how collective action problems are solved through various forms of social interaction and negotiations. Through the conceptual prism of this article these processes constitute a combination of visible and invisible handshakes.

Conclusion

Economic theory has much to contribute and is highly influential in relation to the overall social coordination of different modes of governance. This has typically provided the rationale for allocating specific tasks to either the market or (corporate or governmental) hierarchies. The interaction processes in focus are the inherent processes of market competition and exchange, and hierarchic decision making in either firms or the state. It is still unusual among mainstream economists to pay attention to interactive processes that go beyond the specific modes of interaction characteristic of either markets (voluntary exchange) or hierarchies (command). However, some contributions, in particular from outside the mainstream provide valuable insight about interactive governance. The emergence and growth of new forms of governance characterized by interactive, negotiated processes of steering is a challenge for economic theory. Some of the paradigmatic assumptions in mainstream economics make it difficult to grasp the inherent rationality of this reality in full. Relaxation of the assumptions of given preferences and given institutions is a necessary precondition for a profound understanding of these phenomena. It is crucial to recognize fully how formal and informal institutions (North, 1985) shape decision making. In addition, the importance of discourse and informal forms of cooperation must be acknowledged and it must be better understood how the integration of economic and social forms of interaction shape preferences and decisions. More fundamentally, however, a proper understanding of the new forms of governance may require a substitution of the assumption of maximization with balancing of interests and concerns in an Aristotelian spirit (van Staveren, 2001) but this would constitute a complete paradigm shift.

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