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Norms and Networks in Economic and Organizational Performance

By VICTOR NEE*

Analyzing institutions and the part they play in governing economic action has comprised the central problem addressed by the new institutional economics. This paradigm has made impressive progress in explaining a wide array of economic activity by extending the tools of standard economic theory to examine institutions. Thus far, new institutional economics has emphasized understanding the part played by formal institutional arrangements: contracts, property rights, laws, regulations, and the state. In recent years, new institutionalists have also incorporated a focus on informal constraints, principally norms and networks. These studies examine how informal constraints provide a framework for collective action and furnish an alternative mechanism in enforcing the rules of the game and facilitating transactions between economic actors (e.g., Robert Ellickson, 1991). But they do not examine the manner in which informal and formal constraints *combine* to shape the performance of organizations and economies.

The economics of organizations pioneered by Ronald Coase (1937) and Oliver Williamson (1975) proffers predictive hypotheses as to the forms of organization and governance structure likely to emerge. On a larger canvass, Douglass North (1981) extended his theory of the state to explain the political conditions that give rise to efficient property rights favorable to economic growth. These theories emphasize the causal significance of formal constraints in making predictions about economic and organizational performance.

However, explanations by reference to institutional effects are problematic without a theory of the nature of the relationship between formal and informal constraints. What is the nature of the relationship between informal and formal constraints in explaining variation in performance? Informal constraints embedded in norms and networks, operating in the shadows of formal organizational rules, can both limit and facilitate economic action. Informal constraints can give rise to inefficient allocation of resources when private entrepreneurial networks collude to secure resources from government for their group, resulting in structural rigidities and economic stagnation (Mancur Olson, 1982). They can also facilitate the growth of a new industry by providing a framework for trust and collective action, as documented in a case study of Thomas Edison and the rise of the electric utility industry (Patrick McGuire et al., 1993).

Unless the nature of the relationship between informal and formal constraints is better specified, the inclusion of informal constraints by new institutionalists contributes to a problem of indeterminacy. Transaction-cost reasoning based on analysis of formal constraints may identify the optimal institutional arrangement from the vantage point of the corporate actor, but this may be abraded by informal norms and networks operating to realize interests and preferences of individuals in subgroups. Uncertainty about whether informal constraints in a particular institutional environment will function in opposition or in harmony with the formal rules accentuates a difficulty of prediction in the new institutional economics. How is it possible to extend the same transaction-cost reasoning to the domain of ongoing social relationships, where economic theory runs into predictable trouble in accounting for something as elusive as sentiment and identities?

I. Informal Norms and Networks: Examples

In transition economics, rulers implemented far-reaching transformation of formal rules of the game to institute market economies.

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Economic analyses of transition economies tend to focus on the changes in the institutional framework resulting in (and from) the dismantling of state control over economic activity—for good reason, as those changes shift incentives away from bargaining with bureaucrats in political markets toward seeking profit and gain in economic markets. But whether rulers followed blueprints of capitalist transition provided by Western economists or pursued a trial-and-error evolutionary approach, the behavior of economic actors frequently bears little resemblance to the legitimate courses of action stipulated by the formal rules. Instead, networks based on personal connections serve to organize market-oriented economic behavior according to informal norms reflecting the private expectations of entrepreneurs and politicians. They act in the shadow of the state, often at odds with the goals formulated by rulers. In China, informal privatization and local arrangements have contributed to a remarkable two decades of sustained economic growth. But in Russia, mafia-like business networks have operated to obstruct Boris Yeltsin's efforts at building a modern market economy. What accounts for the difference in results? One thing is certain: a one-sided focus on either formal or informal constraints would miss the boat in understanding economic behavior in transition economies.

In advanced market economies, informal constraints influence productivity to a larger extent than has been readily acknowledged by economists. The workaday norms and network structure of workers have a decisive effect on organizational performance, as Fritz Roethlisberger and William Dickson's study (1939) of a work group in the Western Electric Company's Hawthorne Plant documents. This work group's productivity was not regulated by management, since the foreman assigned to the group chose not to enforce formal organizational rules so as not to sacrifice his good relationships with the men in the work group. Instead, he chose to side with workers and to "wink" at activities in the workshop that violated formal rules. In practice, group performance was regulated by an informal output norm, which limited production to two pieces of equipment a day. This output was considered satisfactory by management; however, it was not as great as it could have been if worker fatigue were the limiting factor. Workers enforced the "restriction of output" by submitting offenders to merciless ridicule. They called a fellow worker who exceeded the informal output norm a "rate-buster" or "speed king," while they labeled someone who fell below the norm a "chiseler," for cutting down the earnings of the group. "Binging" (hitting as hard as possible on the upper arm) was meted out to fellow workers who worked either too fast or too slow. Workers who consistently conformed to the informal output norm enjoyed higher informal rank, reflected in social approval from fellow workers and a position of centrality in the network structure, while those who regularly violated the output norm were ostracized.

Although these examples (work group and transition economies) are drawn from very different institutional environments, there is a common thread. In both kinds of contexts, the formal constraints have established the parameters of legitimate action, providing the institutional mold within which emergent norms and networks operate. This is seen in transition economies where the state still controls resources needed by entrepreneurs who must manage their firms in quasi-markets. Not surprisingly partial reform and quasi-markets result in "crony capitalism," characterized by strategic network ties between entrepreneurs and politicians. Similarly, in the Hawthorne Plant of the Western Electric Company, the informal norm emerged in response to the group piece-rate program designed by management to encourage workers to work up to the limit imposed by fatigue. Workers instead enforced the informal norm as a "satisficing" strategy in opposition to the formal rules. In both kinds of contexts, the informal overwhelmed the formal rules of the game in shaping economic action. Network ties provided the basis for trust and identity in close-knit groups, and informal norms enabled actors to engage in collective action to realize their preferences and interests.

II. The Relationship between Formal and Informal Constraints

Herein lies the problem. Formal rules are produced and enforced by organizations such as the state and firm to solve problems of collective action through third-party sanctions, while informal norms arise out of networks and are reinforced by means of ongoing social relationships. To the extent that members of networks have interests and preferences independent of what rulers and entrepreneurs want, the respective contents of informal norms and formal organizational rules are likely to reflect opposing aims and values.

Unlike formal rules, the monitoring of informal norms is intrinsic to the social relationship, and enforcement occurs informally as a by-product of social interaction. Norms are implicit or explicit rules of expected behavior that embody the interests and preferences of members of a close-knit group or a community. The norm of "publish or perish," for example, articulates the preference of senior faculty and administrators in research universities where the ranking of a department and university is based on the research productivity of its faculty. The formal procedures of promotion review, providing an institutionalized mechanism to enforce a high standard of faculty quality, preceded the emergence of the "publish or perish" norm. The formal rules emphasize teaching and research. But according to the norm of "publish or perish," individual faculty members are expected to devote their best effort to research and writing. Although teaching and department citizenship are valued, the norm makes the priority clear. Faculties strive to maintain a high standard of research productivity because it is in their collective interest to secure a high national ranking for their departments. But the everyday interactions of faculty members enforce the informal norm of "publish or perish" to the extent that those who are "active" enjoy social approval and higher social rank, and those who are unproductive are marginalized. Insofar as norms help solve the problem of coordination and collective action, they enable actors to capture the gains from cooperation, which in the case of "publish or perish" is a higher national ranking, research funding, and the capacity to attract better students.

The proposition that individuals jointly produce and uphold norms to capture the gains of cooperation opens the way to specifying the relationship between informal and formal constraints (Nee and Paul Ingram, 1998). It is consonant with Ellickson's (1991) welfare-maximizing hypothesis for workaday norms: "Members of a close-knit group develop and maintain norms whose content serves to maximize the aggregate welfare that members obtain in their workaday affairs with one another." Both assume that norms are ideas that arise from the problem-solving activities of human beings in their strivings to improve their chances for success (the attainment of rewards) through cooperation. Informal norms arise through trial and error and are adopted by members of a group when they result in success. Whether members of a group are individually rewarded governs the selection of a norm. The core assumption behind each proposition is that informal norms embody interests and preferences that can only be realized by means of collective action.

III. Congruent, Decoupled, and Opposition Norms

When the formal rules of an organization are perceived to be congruent with the preferences and interests of actors in subgroups, the relationship between formal and informal norms will be closely coupled. The close coupling of informal norms and formal rules is what promotes high performance in organizations and economies. When the informal and formal rules of the game are closely coupled, they are mutually reinforcing. This is illustrated in the case of research universities in the close coupling between formal review procedures gauging and rewarding research productivity and the informal norm of "publish or perish." It is also seen in the congruence between informal norms of fair play and formal rules in competitive games. When informal and formal norms are closely coupled, it is often difficult to demarcate the boundaries between informal and formal social control. Close coupling of informal and formal constraints results in lower transaction costs because monitoring and enforcement can be accomplished informally. The cost of social rewards to achieve conformity to norms is low because it is produced spontaneously in the course of social interactions in networks of personal relations. By contrast, the greater the reliance on formal sanctions, the higher the transaction costs involved in maintaining compliance.

When the formal rules are at variance with the preferences and interests of subgroups in an organization, a decoupling of the informal norms and practical activities, on the one hand, and the formal rules, on the other hand, will occur. As John Meyer and Brian Rowan (1977) observe, decoupling "enables organizations to maintain standardized, legitimating, formal structures, while their activities vary in response to practical considerations." For certain types of organizations, particularly those (such as public schools and government agencies) for whose output there is not a competitive market, formal organizational rules will be largely ceremonial, designed to satisfy external constituents that provide the organization with legitimacy. Independent of this ceremonial formal structure, informal norms arise to guide the day-to-day business of the organization.

Informal norms evolve into "opposition norms" if institutions and organizational sanctions are weak relative to contradicting group interests. Opposition norms encourage individuals to directly resist formal rules. In state socialist societies where the state-managed economy was widely perceived to be at odds with the interests of economic actors, opposition norms emerged to organize what came to be known as the illegal "second economy." Elsewhere too, when the organizational leadership and formal norms are perceived to be at odds with the interests and preferences of actors in subgroups, informal norms opposing formal rules will emerge to "bend the bars of the iron cage" of the formal organizational rules. Opposition norms have the most negative implication for performance. They give rise to organizational conflict and factionalism and often result in low morale.

IV. Concluding Remarks

Institutional design requires a combination of poetry and science. The cold rationalist view based on the extension of standard economic theory to analyze the workings of institutions is effective so far as the formal organizational rules are concerned. However, in the domain of informal norms and networks of ongoing social relationships, a poet's insight into the human condition may prove to be as useful in institutional design as science. In a recent Gallup Organization survey of 55,000 workers to match employee attitude to organizational performance, four attitudes were found to be strongly correlated with company results: that workers feel they are provided the opportunity to do their best work, that they feel their opinions matter, that they are confident that fellow workers are also committed to quality, and that they sense their effort contributes directly to the company's success (Linda Grant, 1998). All of these matters involve sentiment and identity, which confer a sense of self-worth and purpose realized in the workplace. In other words, informal norms are not always utilitarian in content as they also embody more intangible states of sentiment and identity that arise from ongoing social relationships.

Notwithstanding, to the extent that the formal rules are consonant with the preferences and interests of organizational actors, informal processes of social control largely subsume the cost of monitoring and enforcement. It is this circumstance that affords for lower transaction costs, often leading to high economic and organizational performance. When rulers and entrepreneurs ignore or ride roughshod over this principle, they are likely to confront opposition norms and networks that organize resistance to their goals.

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