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RESEARCH ARTICLE

Transactions and legal institutionalism: part II – contracts, money, applications

Geoffrey M. Hodgson

Emeritus, Loughborough University London, London, UK
Email: g.hodgson2@lboro.ac.uk

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Abstract

Part I of this article reviews major differences in definitions of the transaction concept by leading authors and some of the difficulties involved in its usage. Part II takes steps towards a new approach, starting with the legal notion of a contract. This identifies a narrower and more specific type of transaction, empowered by both legal forces and non-legal or cultural norms or rules. The sharper and more specific concept of *contracting cost* is derived. *Contracting costs* are the costs of obtaining, formulating, negotiating, and administering legal contracts. They do not include the costs of the work and other inputs required to fulfil a specific contractual agreement. Legal contracts are historically specific phenomena, applying only to modern societies with developed legal institutions. By making the analysis more specific, we emphasise factors of greater relevance in modern market economies. In addition to legal sanctions, the law engenders other forms of motivation based on what is perceived to be legitimate legal authority.

Keywords: contracts; contracting costs; formal institutions; legal institutionalism; money; moral motivation; transaction costs

JEL classifications: B52; K42; O17

The legal nature of a contract

Part I of this article revealed a range of definitions of the transaction concept, including several that focused on the protection of 'property rights', with varying attention to legal contracts (Hodgson, 2025b).[1] Definitions of transaction cost range from 'the cost of exchanging ownership titles' (Demsetz, 1968, p. 35) to the (more vague) 'costs of running/operating the economic system' (Arrow, 1970, p. 48; North and Thomas, 1970, p. 5) and to the distinctive 'costs of strengthening property rights' (Barzel and Allen, 2023, p. 40), where the latter is defined fundamentally in terms of possession or control and not primarily by legal title. Among several other presumptions about transaction costs, Douglass North, Yoram Barzel, and Douglas Allen considered some security, policing, and defence costs as transactional. John R. Commons, Ronald H. Coase, and Oliver E. Williamson did not.

This article sketches a different approach. The concept of *contracting costs* relies heavily on the legal nature of the contract. *Contracting costs* are the costs of obtaining, formulating, negotiating, and administering legal contracts. They do not include the costs of the work and other inputs required to

[1]This two-part article has greatly benefitted from discussions with and helpful comments from Douglas Allen, Richard Carter, David Gindis, Eva Micheler, Ramesh Rao, Mehrdad Vahabi, Massimiliano Vatiero, and five anonymous referees.

fulfil a specific contractual agreement. We need to understand how specific contracts function in real-world economies and the contracting costs they incur. Alternative contracting arrangements can then be compared. What matters is how the law is interpreted and enforced and how it guides dispositions and behaviours.

A focus on legal phenomena does not imply that other (informal) rules and institutions are unimportant. On the contrary, they are vital to ensure economic cooperation and sustain social order, in systems with or without (state) legal institutions. Informal rules are also stressed in the analysis that follows.[2]

Much work in economics mentions contracts. But discussion of the legal nature of a contract is less common. For example, in an essay on 'the structure of a contract', Steven Cheung (1970, p. 68) wrote: 'In modern societies, private property rights require the recognition and enforcement of law'. But there is no substantial discussion in the paper of contract law or the legal nature of property rights. In 2016, Oliver Hart and Bengt Holmström won the Nobel Prize in economics for their contributions to contract theory. They addressed the optimal design of incentives for contracting parties, particularly with imperfect information and incomplete contracts (Hart and Holmström, 1987; Hart and Moore, 1990; Schmidt, 2017). Their question was different from the one tackled here, which concerns the legal nature of the contract itself. It is notable, however, that Hart and Holmström made frequent references to law and the courts, implying they were relevant to the analysis. Consequently, while the role of law needs to be explored further, these cited analyses may be compatible with the approach developed here.

Subsequent sections consider money, contingent contracts, contracting costs, and the motivational importance of law. For good reasons, state money and debt play a significant role in many contracts. Yet so far, and apart from the work of Commons, the role of money has been given insufficient emphasis in transactional analysis.

In English law, the term 'contract' has changed in meaning since medieval times. Originally, it referred to any legal transfer of property titles. It did not necessarily imply an agreement. The term 'covenant' signalled a legally binding arrangement. In the early 17th century, the meaning of the word 'contract' widened to cover legal agreements involving exchanges of promises or obligations, including purchases and sales of property (Baker, 2007, pp. 317–18). It moved closer to its meaning today.

A legal contract is a voluntary agreement by two or more parties with the shared intention of creating legally binding obligations. The *Oxford Dictionary of Law* (Law, 2022, pp. 166–7) defines a contract as a legally binding agreement, resulting from an offer from one party and its acceptance by another, subject to the following requirements:

(1) There must be some 'consideration', legally meaning an agreed act or payment in return for the completion of the promise of the other party (Law, 2022, pp. 156–7).[3]
(2) The parties must each have an intention to create legal relations, under a single legal authority.
(3) The parties must have the legal capacity to contract, thus excluding minors and those suffering from severe mental disorders, alcohol, or drugs (Law, 2022, p. 96).
(4) The agreement must take an acceptable legal form. Depending on circumstances and precedents, it may be verbal, written, or a mixture of both.
(5) The agreement must itself be legal and not rendered void in law.

These stipulations are found in English common law. Although there are variations from state to state in US common law, the principles are broadly similar. The US-based *Merriam-Webster Dictionary of Law* defines a contract briefly as 'an agreement between two or more parties that creates in each party a duty to do or not do something and a right to performance of the other's duty or a remedy for the

[2]See Ellickson (1991) and Ostrom (1990) for examples of 'order without law'.

[3]Modern law covers a deed, which often does not involve reciprocal obligations. But some deeds comply with the five criteria here. Such deeds are regarded here as contracts, even though some legal systems do not describe them as such.

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breach of the other's duty' (Merriam-Webster, 2016, p. 101).[4] Napoleonic systems of civil law also see contracts as resting on voluntary, legally binding agreements. They provide legal criteria to determine the validity of contracts and mechanisms for enforcing them (Picot, 1854, pp. 170 ff.).

The five criteria depend on legal interpretation and precedent. They are subject to adjustment and clarification, as well as statutory legislation (McKendrick, 2023). The five stipulations imply that not all agreements are contracts. For instance, the law does not recognise an agreement to commit an illegal act as a contract. There may be mutual agreement to binding obligations, without any intention to create legal relations. Consider the commonplace daily phenomena of informal swaps, deals, and reciprocity, in families, workplaces, and communities. Often, they are not contracts.

A legal contract can be enforced without resorting to the state legal system, but that may be called upon if private enforcement fails. However, laws can be ineffective. Law is far from everything. Consequently, we must also consider non-legal factors.

It is useful to compare a contract with a gift. The legal definition of a gift does not require prior mutual agreement, and it lacks a 'consideration' (payment) in return for the donation. Points (1) to (5) above do not strictly apply. Instead, a gift is defined in law as an intentional transfer of property rights to another, by a donor with legal capacity. It is a voluntary transfer without legal compensation (Law, 2022, p. 327; Merriam-Webster, 2016, pp. 211–12).

Is this legal definition of a gift adequate for social science? Basically no. Gifts that transferred assets long preceded (state) legal institutions. Marcel Mauss (1954) and others argued that gifts are ancient and enduring social mechanisms, typically driven by custom, that strengthen trust and other social ties, via social norms that encourage reciprocal gift-giving by others. But these important points do not necessarily have to be incorporated into the definition of a gift. Definitions here serve taxonomic purposes. They are neither theories nor adequate descriptions (Hodgson, 2019). In line with this understanding of a taxonomic definition, David Elder-Vass (2020, pp. 675, 681) rejected '*definitional* associations of giving with obligation, reciprocity and the development of social relationships' (emphasis added), and he defined a gift 'as a voluntary transfer of goods or services from one party (the donor) to another (the recipient) that does not require a compulsory transfer in return' (emphasis removed). This definition successfully demarcates gifts from contracts and from other transactions. As a taxonomic definition, it does not negate the vital additional observations that gifts can strengthen social ties. But Elder-Vass's definition is not a legal one. He rightly removed legal considerations in this case. His definition can apply to all human existence. A non-legal definition of a gift is necessary because gifts pervade societies without developed legal systems.

By contrast, contracts are historically specific phenomena, where legal recognition and enforcement are crucial. This gives the contract a legal core, which does not universally apply to the gift. In this manner, legal institutionalism successfully distinguishes a gift from a contract.

Definitions cannot tell us everything. The legal aspects of contracts exist alongside vital non-legal features and relations. As Émile Durkheim ([1893] 1984, p. 158) famously noted: 'in a contract not everything is contractual'. Every contract depends on social relations and other factors beyond full deliberation, appraisal, or agreement. There are also areas where it is difficult, costly, or counterproductive to resort to the law (Hodgson, 2015a, pp. 112–20). But these key issues need not appear in the definition of a contract. Taxonomic definitions cannot include everything that is important (Hodgson, 2019). Unlike most gifts, contracts are expected to be legally enforceable. While many contractual disputes are settled out of court, *potential* legal enforceability is often crucial.

Contracts are voluntary agreements by two or more parties to establish legal relations and mutual obligations. Referring to the five-point legal definition of a contract above, for our analytical purposes here, points (1) and (2) are the most important. The law recognises that details in the 'promise' specified in (1) can be a matter of dispute. These may result from the limitations of language, the flexibility of interpretation, the impossibility of specifying all conditions or circumstances, and so on.

[4]See also the stipulations on contract in the US Uniform Commercial Code (Braucher, 1967). Contracting rights are different from property rights (Arruñada, 2012).

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There are also 'implied terms' that are unspecified in the agreement, which the law finds good reason to add. All contracts are subject to some imprecision, incompleteness, and uncertainty.

Point (2) excludes some other (including domestic or amicable) agreements from being contracts because there may not be an intention to resort to law. The contractual agreement by each party to make obligations under the law brings legal forces to bear upon their relationship. Expectations of contractual fulfilment are raised. Point (2) is important in international trade. A party exporting goods or services from one country to another must agree on a single legal authority with the importer, or they must agree upon rules that determine that authority. That authority will impose trading regulations and standards, and it will adjudicate in the case of a dispute.

Business contracts can be made by fictional legal persons, such as corporations, as well as by human individuals. The standard legal category of *contract* includes employment contracts and leases. Such subcategories are subject to additional legal rules. Modern marriage contracts often omit a 'consideration' (1). Whether marriages are contracts does not matter here. This analysis concerns contracts for goods or services. Marriage contracts are henceforth omitted.[5]

Employment contracts are of particular interest. They involve an agreement to work under the direction of an employer concerning, within legal limits, the nature and manner of the work. Employers have legal rights of control or interference in the work of their employees (Simon, 1951; Brown *et al.*, 2000; Deakin, 2001; Hodgson, 2015a, pp. 235–9; Law, 2022, pp. 167, 251–3).

What is the difference between an *exchange* and a *contract*? Some sociologists have developed a universal 'exchange theory' that refers to any form of reciprocal social interaction (Homans, 1961; Blau, 1964). By this very broad definition, gifts are also exchanges. When using the term *exchange,* it should be made clear whether it implies a legal contract or not.

As argued elsewhere (Hodgson, 2025a), the distinction between *formal* and *informal* institutions advisedly refers to rule systems that are, respectively, subject to, or not subject to, legal enforcement. Accordingly, we may make a distinction between *formal* and *informal* agreements. Some legal contracts can be oral: they do not always have to be written down. *Formal* agreements are enforceable in law and are sometimes contracts. Informal agreements are non-legal in nature and unenforceable in law. Some informal agreements may be illegal.

Figure 1 lays out some of the basic issues in the formation of a legal contract for a good or service. First, the mutual agreement (A) to create legal obligations between the two parties instigates potential pressures on them both to conform to its terms. These pressures are both formal (C) and informal (B). If the agreement were not in law and involved no intention to create legal relations, then formal inducements would not exist and the pressures to comply would be entirely informal. In any case, on this informal side, there are additional demands to maintain social reputation and standing, to act with integrity, and keep one's promises, as well as feelings of duty and honour. Sanctions might include criticism, shunning, or social exclusion. See the two yellow downward arrows (B) in Figure 1.

Once the agreement becomes a legal contract, then legal pressures come into play. These may include fear of punishment by legal authorities for non-compliance with the contract. Legal pressures are represented within the two red downward arrows (C). In addition, informal pressures may be enhanced. If the law is broadly regarded as stemming from legitimate authority, then that could add to the informal social demands to conform to its rules. Informal pressures can be boosted by cultural norms of legal compliance. The law, norms of legal compliance, and notions of duty to fulfil obligations are moulded by historically and geographically specific cultures and institutions.[6]

Formal and informal pressures interact. And the distinction between them is sometimes fuzzy. The law can rely on customary rules or practices as evidence. It is also possible that formal and informal

[5]Some legal scholars do not regard leases or marriages as contracts. But reputable law texts by Shears and Stephenson (1996, pp. 361–2, 433, 435), McKendrick (2023, p. 1), and (regarding US law) Merriam-Webster (2016, pp. 280, 304) all describe marriages and leases as contracts. Also, Law (2022, pp. 167, 413) treats leases as contracts.

[6]Enhanced informal effects resulting from legal agreements may be included within (B) or (C) in the figure.

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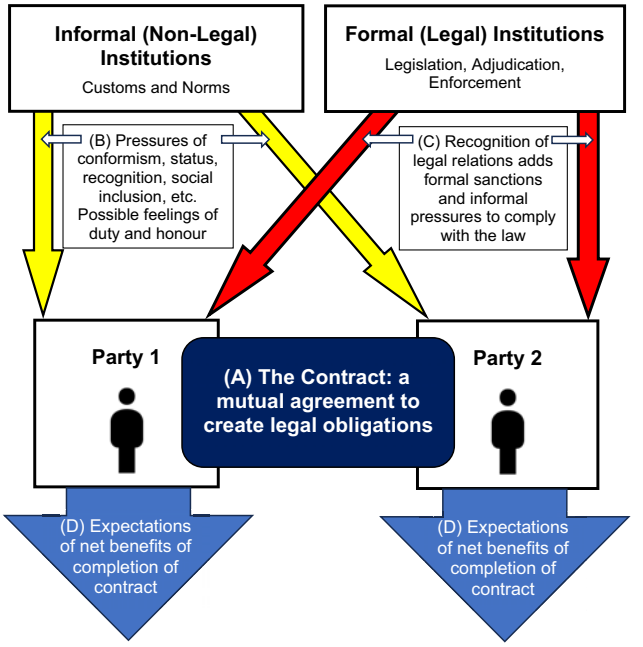

Figure 1. The instigation of a contract for a good or service.

pressures may act against one another.[7] But in reaching a contract, each party has incentives to consider the formal and informal pressures expected to act upon the other party and lead to the delivery of what is promised. Some conflicting pressures may be unforeseen. The downward pressures in (B) and (C) may interact in different ways, involving possible mutual reinforcement and possible interference. A key point is that the formation of a legal contract creates various top-down pressures on both parties to fulfil their agreed obligations. This does not mean that the contract is always fulfilled.

Finally, each party has some expectation of (net) benefit from the contract. This creates (net) positive expectations of contract fulfilment, as noted by the large arrows (D) in Figure 1.

The analytical procedure here is to take the ideal type of economy dominated by legal contracts. Considerations of illegality require some modification of the analysis, but this task must be postponed to another work. The current paper applies to economic systems where the rule of law is largely effective. Any existence of illegal markets at their margins does not undermine the value of focusing on legal institutions and forces. The analysis of economic systems with weak or failing legal institutions is a matter for another study.[8]

Robert Lee Hale (1952) and others saw contracts as potentially and circumstantially coercive (Vatiero, 2013). Hale suggested that some degree of (acceptable or unacceptable) coercion was present in all contracts, most obviously with monopolies and monopsonies. Hale's view has its supporters and critics, but for our immediate purposes, we need not go into this further. A contract is defined in legal terms. Important questions, like coercion, efficiency, and the morality of a contract, are beyond the scope of this essay.

[7]In a controlled laboratory experiment with mandatory mask-wearing (as legislated in several countries during the COVID-19 pandemic), Cardella *et al.* (2024) showed that face covering reduced altruistic and cooperative behaviour. Consequently, formal regulations can inhibit informal interactions. This reveals possible conflicts between the benefits of (formal) laws that mandate masking and reduced informal efficacy.

[8]See Boettke *et al.* (2004), Dixit (2004), Becker *et al.* (2006), Beckert and Wehinger (2013), and Beckert and Dewey (2017) on illegal markets.

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Money and futurity

Neither the definition of a contract above nor Figure 1 makes the use of money explicit, despite it being normal in business contracts. This omission is definitionally acceptable because some modern legislatures recognise barter as contractual. Yet a monetary 'consideration' is typical in modern trade. Public money grew in importance in civilisations with states, legal systems, and legally codified notions of ownership and exchange. The state, plus informal rules and private exchange networks, help to sustain public money. As Perry Mehrling (2013, p. 355) put it: money is 'essentially a hybrid entity, part market and part state'.[9] The legal notion of what we now call a contract began to develop at around the same time as state money. Although there are contracts without money, the histories of states, contracts, money, and debt are entwined (Mitchell Innes, 1913; Knapp, 1924; Keynes, 1930; Ingham, 2004; Graeber, 2011; Wray, 2012).

Leading economists have sometimes treated money as 'veil' that obscures the alleged reality of barter beneath (Patinkin and Steiger, 1989). As Paul Samuelson (1961, pp. 52–3) put it in his canonical textbook: 'if we strip down exchange to its barest essentials and peel off the obscuring layer of money, we find that trade between individuals or nations really boils down to barter – transforming one good into another by exchange'. But if we focus on the legal details, commodity–money–commodity (C–M–C) exchanges typically involve two separate and independently enforceable contracts, not one. An imaginary world of equilibrium and universally resolved contracts allows money to be stripped away. Bringing back legal contracts helps to reinsert money.[10]

Economics textbooks argue that barter is inconvenient because it requires at least a 'double coincidence of wants' by the two parties to the transaction. Some add the problem of the indivisibility of many commodities. There are additional but neglected reasons for the use of money in modern economies. A contract without monetary commitments would have greater negotiation, measurement, and enforcement costs than a contract involving some payment of (state) money. When a contract involves the mutual exchange of (wholly non-monetary) goods or services, more disputes can arise over whether a party has complied with the contract. But if one party fulfils its obligations with a money payment, then the possibility of such disputes is reduced. Money is often used in contracts partly because it reduces the cost of negotiating and enforcing them (if there is sufficient confidence in the coins, notes, credit, or bank transfers being offered). The state legal system will endorse its own part-creation. Law, property, and public money are entwined together.

Some contracts involve monetary commitments on both sides of the bargain. Consider a loan or a mortgage contract. One party lends money to the other. The other party agrees to repay the loan, typically with interest, and sometimes offering some property as collateral. The contract involves different monetary commitments over time. Present money is traded for a greater amount of future money.

This leads us to Commons's (1934, pp. 390 ff.) important concept of *futurity*. Once a legal contract is established, each party has (future) obligations to the other. For a while, at least one has a (monetary or non-monetary) debt to the other. Each is pressured, by the formal and informal forces mentioned above, into fulfilling their obligations. Much real-world economic endeavour is energised by contracts. Contracts trigger bursts of activity. As the lawyers Peter Shears and Graham Stephenson (1996, p. 220) noted: 'When one enters into a contractual obligation … one binds oneself for the future: either for a short or for a long … period of time'. At any point in time, many existing contracts have not yet been fulfilled. Much current economic activity is driven by unfilled debts or obligations, guided by forces including custom and law.

[9]See also Salter and Luther (2014) and Hodgson (2015a, p. 154).

[10]Marx (1971, p. 87; 1976, pp. 200 ff.) introduced the C–M–C and M–C–M formulations in 1859 and 1876. For Marx (1976, p. 238), money 'becomes the commodity that is the universal subject-matter of all contracts'. Marx (1976, p. 178) also wrote that 'the contract … is a relation between two wills which mirrors the economic relation'. He regarded the contract as a reflection of the 'economic relation', without defining that term (Hodgson, 2023, pp. 45–48). Barzel and Allen (2023, p. 248) treated money as 'an intermediate medium to an exchange'. This is a common, misleading, single-exchange rendering of a process that involves at least two contracts. See Mitchell Innes (1913, p. 393) and Ingham (2004, p. 73).

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These are familiar events, but the account differs from standard versions of economic theory. We are never in a general equilibrium. At the macro level, fluctuations can sometimes be less apparent. But the micro-world of contracts is one of multiple, unsynchronised beginnings, followed by bursts of activity and unsynchronised completions. There is staccato disruption and discontinuity. The difference between the macro and the micro is like the difference between the steady warmth of an electric fire and the wave-particle micro-disorder of its electromagnetic emissions. In mainstream economics, contracting is oversimplified or neglected, partly because of a habitual focus on static equilibria.

Commons (1934, pp. 696–7) argued that economics needed to be aligned with the legal realities of contracts and other transactions, where time is real and ongoing. This reconciliation between 'law and economics ... can only be done when the factor of time and especially of futurity and expectation are introduced into the relationship'. For Commons, much of economic theory 'has no time nor futurity'. Instead, it invokes 'a pure static relation, without activity and expectation'. This criticism remains relevant today.

Walrasian general equilibrium models typically prohibit individuals from directly transacting with one another. All agents must transact with a central authority at equilibrium prices when announced by an auctioneer. It is not simply that contracts are generally incomplete (Hart and Holmström, 1987). General equilibrium models cannot adequately accommodate money, debt, innovation, chronological time, legal contracts, or bankruptcy (Hahn, 1980, 1988). Contracting requires a set of institutions to enable contract negotiation and enforcement. These institutional features are too often downplayed. Contrary to a view shared by many of its proponents and critics, neoclassical economics does not adequately represent a market economy. It has problems in dealing with ownership, contracts, and money. Without these, there can be no real markets.

There are further complications. Many legal contracts are contingent, meaning that the commitment of one or both parties is altered under specific, previously agreed conditions, which are typically beyond the control of any party. For example, insurance contracts depend on contingent events. The insurers promise to pay an agreed amount of money in the event of an accident, sickness, theft, or whatever. Employment contracts typically have contingent elements, as they allow for specific events, such as sickness leave, or they may specify rewards for good performance. Businesses may agree to build contingency into their contracts so that their commitments can be adjusted when circumstances change (favourably or unfavourably). Contingent contracts require legal expertise and are often costly to negotiate and establish – unless a suitable prior template is available. In modern developed economies, contingent contracting is widespread. This adds a particular kind of cost to the contracting process. This is one of the issues raised in the following section.

Contracting costs

By agreeing to a contract, the buyer of a good or service assumes that the seller is, or shall become, capable of fulfilling the contract. *Contracting costs* include the costs of obtaining, formulating, negotiating, and administering contracts. They do not include the costs of the *work and other inputs* required to fulfil a specific contractual agreement. Production requires labour, management, capital goods, raw materials, technical information, and so on. Obtaining these inputs themselves may require further contracts and contracting costs. But production can only begin after needed inputs are obtained. *Production costs* include the costs of anything required to produce a good or service. Production costs would apply if a good or service were (partly or wholly) produced without a current contract for its sale. For example, a motor car manufacturer may build up a stock of motor cars for eventual sale, without a contract currently in existence for their purchase. Hence *production costs* are different from *contracting costs*.

The following inclusions seem sensible. Invitations to tender are contracting costs. Some advertising might be classified as contracting costs, particularly advertising that announces features of the good or service that is being offered. Litigation costs in the event of a breach of contract are contracting costs. Insurances against breach of contract are contracting costs. Costs of checking contract completion, of

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billing the customer, and of any contracted transfer of ownership titles are contracting costs. Those accounting costs that would be unnecessary if there were no contract, are contracting costs. A key test is whether a cost would exist if the production of the goods or services took place without a contract. Production costs in the absence of contracts are not contracting costs.

The following exclusions would also apply. The costs of protecting property rights are not contracting costs. Neither national defence expenditures nor protections against theft or sequestration are contracting costs. Contracting costs focus not on property rights *per se* but more broadly on contractual processes and obligations, including for their establishment, formulation, and verification but excluding the costs of producing the good or service.

The term *contract costs* is employed by some tax authorities, but these sometimes include (incremental) production costs as well. The addition of *-ing* demarcates *contracting* from (tax authority) *contract* costs.

Contingencies in contracts create additional costs. For example, insurers with contracts to pay compensation for (say) sickness, damage, or theft will require some evidence that the insured contingent outcomes have occurred. Obtaining and processing this information can be regarded as a *contracting cost* involving *contingency investigation and accounting*. Contingency investigation and accounting costs are widespread and extend beyond insurance. For researchers, they may be estimated partly by examining the accounts of insurers or others who make payouts for contingent events.

Should contract monitoring or enforcement costs be regarded as a part of contracting costs? Monitoring is often directed at performance in production, rather than the formation or verification of a contract. A firm's managers have legal rights of interference and monitoring of employees. Such monitoring is partly to ensure performance in production, using agreed powers conceded by employees to managers, according to the employment contract. When contract monitoring or enforcement is largely concerned with production, then it is a production cost and not a contracting cost. The possibilities and costs of monitoring will often be of concern when contracts are drawn up and negotiated. In which case, the extra costs involved in considering and negotiating monitoring arrangements in the contract will be added to the contracting costs. The additional costs of performing the monitoring during production are not contracting costs. But sometimes the line will be difficult to draw.

Although there are difficulties involved, the empirical estimation of contracting costs seems to be more straightforward than the estimation of transaction costs by several prominent measures. There are economy-level and firm-level data on advertising expenditures. Tax records show *contract costs:* these may be adjusted to estimate contracting costs. Data on costs of insurance and litigation are also available. Refining these data to estimate contracting costs may prove less difficult, and less subject to discretionary variation, than estimating transaction costs.

Law and motivation

Legal institutionalism has implications for the analysis of contractual motivations.[11] Most economists see individuals as utility maximisers. It is sometimes claimed that this 'explains' human behaviour. But it offers no substantial explanation of individual motives. Some mainstream economists have admitted this. Richard Posner (1980, pp. 5, 53 n.), for example, saw rational utility maximisation as about outcomes, not intentions or motives. This does not help us to reach a better understanding of human motivation (Hodgson, 2013). Such explanations are important, partly because legal and other state institutions create mechanisms of power and legitimation that go beyond utilitarian or other instrumental motives.[12]

Looking again at Figure 1, most social scientists would accept both kinds of pressure on agents – informal (B) and formal (C). But Barzel (2002, p. 16) made another specific claim: 'What individuals

[11]This section uses some material from Hodgson (2015b), which offers a fuller account.

[12]This point is often neglected by economists. For an exception, see Miceli and Mungan (2021).

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maximize (subject to their personal safety) is the value of their *economic rights*'. Similarly, Barzel and Allen (2023, p. 66) wrote that 'individuals maximize the value of their economic rights'. These are different from 'legal rights', which are defined by Barzel (2002, p. 157) as '*claims over assets delineated by the state*'. In other words, ultimately individuals act solely to maximise their 'enjoyment' of assets under their control. People are indifferent to 'legal rights', unless these legal rights help them to access or control desired goods or services and thereby increase their enjoyment. Enjoyment or utility is the ultimate end. Legal rights are seen as possible instrumental means to that end. Legality is not a goal in itself.

But there is empirical evidence that suggests otherwise. Surveys show that many people place some normative value on obeying the law, in addition to any instrumental consideration of expected personal costs or benefits (including enjoyment). Tom Tyler (2006, p. 3), who is the leading authority in this area, contrasted the 'instrumental perspective' where 'people are viewed as shaping their behavior to respond to changes in the tangible, immediate incentives and penalties associated with following the law' with the 'normative perspective' concerned with 'what people regard as just and moral as opposed to what is in their self-interest'. The survey evidence of Tyler (2006, 2017) and others (Bachman *et al.* 1992; Jackson *et al.*, 2012; Friedman, 2016) suggests that instrumental calculations only have a partial effect on compliance with the law. Often, moral considerations by individuals are equally or more important.

People sometimes comply with a law because they believe it to be moral or they believe in a wider duty to obey the law. This does not necessarily mean that their moral assessment of a law is valid or that all laws are obeyed for moral reasons. It means that moral feelings can be motivational forces, as Adam Smith (1759) made clear in his *Theory of Moral Sentiments*. People can have moral feelings, and make moral claims, about obeying a law. It does not mean that we must agree with their moral code. But these sentiments have motivational significance.

Moral feelings often endorse laws against violence, murder, or rape. It may not be so with some other laws, such as those concerning taxes or driving on roads. Feelings of legal obligation may be diminished with private contracts. But they are not necessarily absent. Tyler argued that moral feelings sometimes help to sustain laws, but they can also lead to legal non-compliance when people believe that a particular law lacks sufficient moral force. He cited evidence that while deterrence has effects, they can be relatively minor when compared with moral motivations. These include feelings of moral obligation or responsibility to act appropriately.

For millennia, religions have provided moral imperatives to obey laws (Norenzayan, 2013; Johnson, 2016). Today, the perceived secular legitimacy of authority is also important. Compliance with the law is enhanced when people regard the legal authority as having a legitimate right to impose rules. Max Weber ([1922] 1968, p. 215) saw legal authority and legitimation as 'resting on a belief in the legality of enacted rules and the right of those elevated to authority under such rules to issue commands'. Perceptions of legitimacy have different sources. In modern liberal democracies, it often derives from the belief that the popular election of a government makes its authority legitimate (Beetham, 2013). Tyler (2017, p. 407) referred to substantial research on this issue:

> These findings show that people cooperate when they believe that agents of the law are rightful holders of authority, and when they view the legal system as conferring upon them an appropriate and reasonable duty to obey.

Human inclinations to respect those in authority were dramatised by the famous experiments of Stanley Milgram (1974, pp. 124–5, 131), who argued that dispositions to respect authority emanate originally from the evolutionary survival advantages of cohesive social groups. This and subsequent research suggest that respect for authority has both genetic and cultural foundations (Engel, 2008; Haidt, 2012).

Instrumentalists, in general, and proponents of utility maximisation, in particular, argue that the issues of legitimacy and morality can be incorporated into the calculus of costs, benefits, enjoyment, or

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utility. Hence advocates of utility maximisation claim that when someone acts according to their perceptions of legitimacy or morality, they gain extra utility from an extra 'warm glow' of self-satisfaction. A problem with this argument is that it undermines the meaning of legitimacy and morality. Morally motivated actions do not necessarily serve self-interest (Mackie, 1977; Joyce, 2006; Hodgson, 2013, 2014, 2021). Acting morally means 'doing the right thing', even if it is costly to the actor. People obey legitimate legal authority 'because it's the law'. Such deontic motivations cannot be reduced to convenience, convention, or cost-benefit calculation, in accordance with a one-dimensional calculus of utility or desire (Searle, 2001).

This is manifestly important with public law, which upholds general rules and concerns relations with the state. Its branches include constitutional and criminal law. Contracts involve private law. But some people will still think it morally important that promises be honoured. While few outsiders might be concerned about the particularities in a contract, there is widespread concern that the legal processes are well maintained. There are cultural pressures to keep promises and to respect and obey the law. The laws of property and contract have significant moral support. For many people, property and contract are at the foundation of a liberal order and are vital aids to the creation of wealth (Oman, 2012; Gerhart, 2021). To such ends, both public and private laws can have some moral salience.

The claim that law can have motivational importance does not imply that people never break the law. It does not mean that contractual compliance is intrinsically moral. However, the establishment of legal rights, through perceptions of moral legitimacy, can affect motives and outcomes. Accordingly, as well as self-interest and cultural norms, the law is a powerful force that helps to ensure compliance with contracts. This is not about the (normative) morality of obeying (or disobeying) the law. It is about the (empirical) importance of moral sentiments and motivations to help explain some obedience to some laws.

First application: the nature and boundaries of the firm

This section shows how the legal notion of a contract can help to develop the definition and theory of the firm. From a legal institutionalist perspective, firms are defined as 'individuals or organizations with the legally recognized capacity to produce goods or services for sale' (Deakin *et al.*, 2017, p. 194). This definition applies to corporations, partnerships, and single traders. A legally recognised capacity to sell trivially implies a legal capability to make contracts. Its legal identity is essential for its capacity to make contracts under the law. A firm can sue or be sued. The addition of legal factors, including the nature of a legal contract, to the conceptualisation of the firm helps answer crucial questions concerning its nature and boundaries (Hodgson, 2002, 2015a, pp. 204–24; Gindis, 2009, 2016).

The concept of a *legal person* helps us establish the identity, nature, powers, and boundaries of modern business firms. With earlier precedents, the concept of legal personality applies to historically specific, modern business organisations. It does not apply to all kinds of organisation, past or present. Legal personality links directly to potential involvement in contracts. Parties to contracts (acting singularly or jointly) must be legal persons.[13]

Modern law recognises both 'natural persons' (i.e. human individuals) and 'artificial persons' (i.e. 'incorporated' organisations) and grants them rights, duties, and powers. These include the powers to own property and make contracts. An artificial person is a 'legal fiction': in some but not all respects, the law treats corporate entities *as if* they were natural persons. But legal fictions are not false. The term 'fiction' in law refers to the borrowing of a principle or rule from one context to be used in another. It does not mean that the rules are fake (Fuller, 1967). The borrowed rules or principles are real and endowed with the force of law.

By trading with others, a single person can constitute a firm. With a partnership, its legally deposited 'articles of partnership' bind the partners together with mutual obligations and make the partnership

[13]On the meaning and roles of legal personality, see Blair (1999, 2003), Iwai (1999), Hansmann *et al.* (2006), Iacobucci and Triantis (2007), Spulber (2009), Pagano (2010), Robé (2011), and Deakin (2012).

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firm identifiable in legal terms. With a business corporation, legal fictions help to endow it with specific rights and liabilities concerning ownership and contracting. When the law identifies a firm, it means that the law treats the firm as a point of imputation for legal rights and duties.

In contrast to a business partnership (where individual partners have legal liability), with a business corporation, there is only one legal person to litigate against. Furthermore, the fictional device of corporate personality can deal with problems concerning the death, bankruptcy, or insanity of the individuals controlling, or owning shares in, the firm. The corporation can outlive the key individuals that operate within it. The potential longevity of the corporation is a major factor in long-term contracting and business stability (North *et al.*, 2009). Finally, the corporate form 'locks in' the invested capital of its members (Blair, 1999, 2003, Hansmann *et al.*, 2006). This protects its financial capital from the whims of its shareholders.

In his famous article, Coase (1937) set out to define a firm, as well as to explain its existence. He assumed a dichotomy between the integrated organisation (the firm) and a collection of self-employed, individual producers (the market). He asked why the former would sometimes supplant the latter. The firm was defined not in terms of its contracting or other legal powers but in terms of its 'supersession of the price mechanism' (1937, p. 389). For Coase (1937, p. 393): 'A firm ... consists of the series of relationships which comes into existence when the direction of resources is dependent on the entrepreneur'. A major flaw here is that the legal constitution and role of the (individual or collective) 'entrepreneur' – who owns resources, makes contracts, and directs production – are incompletely specified.

Coase (1937) did not clearly identify the legal entity that owns the product, is able to enter into contracts, and has the right to the revenue from the goods or services that are produced. Instead of ownership rights, contracting capacity, and potential liabilities, he concentrated on the administrative functions of the entrepreneur during the production process. He did not consider who would be sued if the output of the firm proved defective or dangerous. Would it be the individual worker responsible for the defect? With a legally constituted firm, it would be impossible for an outsider to sue the culpable employee directly – the firm would be sued. The legal formation of a firm establishes the locus of legal liability in contracting with others.

The glue binding the corporation together is the power of corporate law, the adoption of its principles by the shareholders, and the legal agreement between them. Contrary to Coase, the firm is not constituted by entrepreneurial administration of a production process but by the establishment of a singular legal entity.

Like Coase, Williamson (1981, p. 1538) concentrated on 'the internal organization of the corporation' and downplayed its legal personality. Williamson (1985a, p. 199) explained: 'whereas each constituent part of the enterprise strikes a bilateral deal with the firm ... management has knowledge of and is implicated in all of the contracts'. But this formulation runs into the same problems that we have observed with Coase. What binds a corporation, together? Being 'implicated in all of the contracts' is not the same as identifying the legally recognised entity that is responsible for the contracting activity.

Like Coase, Williamson treated the firm as a group of individuals, such as partners or shareholders. But this is insufficient to establish the firm as a cohesive entity or to define its boundaries. Consequently, distinctions between the firm (or 'hierarchy') and the market faded away. Williamson (1985b, p. 83) became 'persuaded that transactions in the middle range are much more common'. For Williamson (1991, p. 271), hierarchies (firms) became 'a continuation of market relations by other means'. Instead of the firm-market dichotomy, he adopted a firm-market continuum. Both Coase and Williamson failed to establish the legal identity of the firm and its crucial capacity to enter into legal contracts.

Transaction cost analysis has made advances in other respects, but some basic questions are unanswered. Legal institutionalism with its focus on legal persons and their contracts has viable answers to some important questions. For example, the boundaries of the firm are determined by the actual scope and reach of its legal identity, particularly in contracting terms. A neglect of legal realities impairs any attempt by the social scientist to give advice on appropriate legal structures to enhance

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business performance. Furthermore, without attention to legal relations, social scientists are ill-equipped to intervene in the long debate concerning the limitations and abuses of corporate power.

Second application: contracting costs in healthcare systems

As a second example, we look at the economics of healthcare systems. Healthcare needs are complex, and there is a large literature devoted to the assessment of different systems and policies. Contracts are often used in healthcare, and there are acknowledged problems of incomplete contracting, resulting from inadequate information and other factors, which are sometimes exacerbated in a healthcare context. The aim of this section is to focus on *contracting costs* including *billing costs*. Questions concerning system efficiency and health outcomes must be postponed to another study.

While standard transaction cost economics made headway in other areas, it has been applied much less often to healthcare economics (Hodgson, 2008, 2013, ch. 8). There are a few healthcare studies where 'transaction costs' are raised explicitly, sometimes with appropriate references to their literature, but several of these articles are not in economics journals (Ashton, 1998; Allen, 2002; Donato, 2010; Sahni *et al.*, 2023). Part of the difficulty of applying the concept of transaction cost is its ambiguity. I suggest that the narrower concept of *contracting costs* avoids some of these difficulties, and it can help with comparisons of different health systems.

Several studies have found substantial differences in contract administration and billing costs between the US system, where healthcare fees are paid by multiple private insurers, and the Canadian single-payer healthcare system, where fees for many healthcare needs are paid by the state. Both systems involve largely private healthcare provision, but the cost outcomes are quite different. Antoon Spithoven (2009) found that administration accounted for 31 per cent of healthcare expenditures in the USA, as compared with 7 per cent of healthcare expenditures in Canada. Alexis Pozen and David M. Cutler (2010) found that 39 per cent of the difference in *per capita* healthcare spending, between the USA and Canada, was due to administration costs. Comparing several countries, David U. Himmelstein *et al.* (2014) found that administrative costs accounted for 25 per cent of total US hospital expenditures. The next highest country was the Netherlands at 20 per cent. These authors claimed that the contract-intensive nature of the US healthcare system was partly responsible for its greater administrative costs. Himmelstein *et al.* (2017) compared the US and Canadian healthcare systems and found that US insurers and providers spent 34.2 per cent of national health expenditures on administration, *versus* 17.0 per cent in Canada. Their analysis highlights additional costs in the US private insurance-based, multi-payer system. While administrative costs exist in any system, these studies suggest that the relatively greater use of (legal) contracts in the US system may in part be responsible for higher administrative costs.

Some studies that dig a bit deeper seem to confirm this. Barak D. Richman *et al.* (2022) compared health systems in six Organisation for Economic Coperation and Development (OECD) countries and found that billing and insurance costs were greatest in the USA. Ani Turner *et al.* (2023) compared US health spending with a peer group of other OECD countries and found that 15 per cent of US 'excess spending' was due to administrative costs of insurance. These would include costs of investigating and accounting, specifically associated with insurance contracts.

Some studies have analysed what kinds of contracting costs are responsible for the disparities between different healthcare systems. David M. Cutler and Dan P. Ly (2011) – writing in the *Journal of Economic Perspectives* but making no mention of transaction cost economics – compared health spending in several countries. They argued that the greater *per capita* healthcare expenditure in the USA results from multiple factors, including coordination failures between multiple insurers, other billing costs, generally higher administrative costs, and waste. The costs of coordination and other failures in the US system were modelled in a paper by Brigham Frandsen *et al.* (2019). Again, this is in a prominent economics journal, but with no mention of transaction cost economics. Yet the word 'contract' or its derivatives appears in its title and over 200 times in its text. Its focus is on contract inefficiencies, caused principally by (1) free-rider issues among payers (insurers) facing common

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problems, resulting in weak incentives for efficiency improvements among healthcare providers, and by (2) coordination failures that can lead to an absence of incentives for providers to make efficient investments, particularly those involving large, lumpy, fixed costs. This contracting-based model helps us to explain the prevalence of separated fee-for-service contracts, several other inefficiencies in the US system, and why single-payer systems in other countries are less costly than the multi-payer system in the USA. These contract-based studies make significant progress in understanding costs in healthcare systems. But despite being published in leading journals of economics, they make no reference to transaction cost economics.

Some other studies of the US healthcare system drill down to micro-data and gauge the administrative and billing costs involved. They are mostly in medical journals. For example, Aliya Jiwani *et al.* (2014) tackled some of the problems in estimating billing and insurance-related (BIR) costs. They synthesised and updated available micro-costing evidence to estimate total and added BIR costs for the US healthcare system. They claimed that a simplified financing system in the USA could result in cost savings of nearly 15 per cent of its healthcare spending. Nikhil Sahni *et al.* (2023) looked closely at US healthcare administrative spending and argued that a more efficient financial transactions ecosystem could reduce this spending by about 40 per cent. Generally, although we need to probe further, the evidence we have so far suggests that a focused, *contracting costs* approach helps with the analysis of healthcare systems.

None of the cited studies in the preceding three paragraphs made any reference to 'transaction cost economics', but contracting issues were central to the cited research. Why has the work of transaction cost economists been overlooked in this area? And why have too many transaction cost economists overlooked contract-based studies? The lack of a clear consensus definition of transaction costs is a serious problem and a possible explanation. When leading economists see a transaction as happening 'when a good or service is transferred across a technologically separable interface' (Williamson, 1981, p. 552), or when transaction costs are defined in terms of the 'costs of running/operating the economic system' (Arrow, 1970, p. 48; North and Thomas, 1970, p. 5), or the 'the costs of establishing and maintaining property rights' (Allen, 1991, p. 741),[14] then the identification of both transactions and their costs, especially in complex healthcare systems, becomes far from straightforward.

The concept of *contracting cost* is different. There is a *prima facie* case for categorising some administrative costs in healthcare in these terms. An example of such contracting costs is insurance costs. These create administrative costs for insurance providers and healthcare organisations, not to mention the patients themselves. Insurance-based healthcare systems insert additional contracts into processes of healthcare provision and consumption, and they add to the administrative burdens of healthcare administrators, physicians, and nurses. Comparing one healthcare system with another, the empirical differences in contracting costs seem to have a significant impact on overall costs. There is much work to be done on this, including considerations of healthcare system performance, alongside costs. But the approach suggested here – based on contracting costs – seems worth pursuing.

Concluding remarks

Important rules and institutions considered here are historically and geographically specific. The analysis does not apply to all human societies. In 1904, Weber (1949, pp. 72–80) wrote that 'the most general laws' are 'the least valuable' because 'the more comprehensive their scope', the more they 'lead away' from the task of explaining the phenomena in question. There is a trade-off between the generality and the detailed explanatory power of a theory. By attempting to be general, much transaction cost analysis downplays vital phenomena in modern economies, such as the legal nature of the contract, the motivational powers of law, and the role of money.

[14]See Hodgson (2025b) for a fuller discussion.

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Legal institutionalism applies to large-scale societies under the rule of law (Waldron, 2023).[15] These have existed for only a few thousand years. Legal institutionalism highlights the power and ubiquity of (state) legal rules in modern society. It insists that law accounts for many of the powerful rules and structures of modern capitalist society. Consequently, law is a constitutive part of the institutionalised power structure and a major means through which control is exercised. Law is not simply epiphenomenal. It helps to constitute key economic institutions, including property and public money. It is an important motivational force, often via sanctions and punishments, but additionally when it has perceived legitimacy.

Other rules matter, but (state) legal rules are of special importance in modern societies. The power of the law is not solely due to coercion or threat of punishment. The evidence suggests that many people feel obliged to obey those laws that they perceive as legitimate and often for what they see as moral rather than instrumental reasons. People often obey laws out of respect for authority and justice and not because they calculate the advantages and disadvantages of compliance. Basic dispositions to respect authority have evolved over millions of years because they aided the cohesion and survival of primate and human groups.[16]

Legal institutionalism does not imply that informal institutions, non-legal institutions, customs, or culture are unimportant. On the contrary, they are vital. Legal institutions always depend on customs and culture to work effectively. Many things get done without recourse to the law. When a supportive culture is lacking, the law may prove moribund. For example, the caste system survives in parts of India today, despite it having been declared illegal for many years. But while it is vital to recognise the role of culture and informal institutions, it would be a mistake to ignore or downplay the power and historical specificity of law.

Contracts vary enormously in their value, range of performance outputs, and temporal scale. Parties to contracts may come from a variety of backgrounds, have one or more of many social positions, and have a range of possible skills. These factors affect the credibility of any attempted contract and the degree to which the parties rely on trust or customary normative assumptions. In any case, there is always a mixture of formal and informal rules.

The legal aspects of contracts have features that are relevant for economic analysis. The analysis sketched here shows how formal and informal forces combine in the contract. The approach provides links between contracts, debts, and money. There is also a *prima facie* case for possible and useful theoretical and empirical applications.

The embryonic approach outlined here does not overturn all preceding insights in this area. Indeed, it can be claimed that many of the positive insights of 'the economics of property rights' and 'transaction cost economics' openly or covertly depend on legal concepts and institutions. Useful work in this area often identifies rules and mechanisms that rely to a degree on legal structures and motivations. As Part I of this essay showed, this connection with legal forms and rules was made explicit by leading new institutionalists such as Coase and North, as well as original institutionalists such as Commons.

Both parts of this paper have pointed to unresolved major differences over the use of terms such as *property*, *transaction*, and *transaction cost*. By focusing on *contracting costs*, the approach outlined here offers a way forward that is rooted in the legal and other realities of modern economic systems. The analysis is no longer universal. But why should it be? Modern economies have many major features that have not endured for all human existence. Some of them have existed since the rise of large-scale states with complex legal institutions. Concepts such as *property* and *contract* are historically specific. Institutional analysis should take account of that.

[15]In addition to Commons (1924, 1934) and Samuels (1989), legal institutionalism (Deakin *et al.* 2017) draws from forerunners such as MacLeod (1872), whom Commons (1934, pp. 394, 399) described as 'the first lawyer-economist' and the 'originator' of institutional economics. Greif and Tabellini (2017) argued that the formation of state legal systems with associated moral norms was crucial in Europe's economic development.

[16]Milgram (1974), Tyler (2006, 2017), Haidt (2012), Freidman (2016).

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