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Rethinking the Individual-Society Nexus: !

The Commitment Problem of the Powerful !

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Paper prepared for the *The New Economics as 'Mainstream' Economics* Conference -
Thursday 28 January / Friday 29 January 2010 - Murray Edwards College, Cambridge, United Kingdom

The renewed interest in *institutions* promises a much needed overhaul of economics as a discipline. Developments that broadly go under the heading, "Post Walrasian or neo-institutionalist have carried issues of contract and property right *enforcement* to the very center of economic theory in the last couple decades. The rise of behavioral economics with its focus on real behavior appears to have strengthened this reorientation. The same can also be said of the evolutionary game theory that examines how agents make *rational* decisions under realistic conditions.

Enforcement issues are of import at a general level for they relate to rational behavior under less than ideal conditions, say, where one cannot count on the government to enforce effectively property rights and contractual obligations. They also arguably have much greater real world relevance than standard economic analysis. Think of issues that gained currency with globalization. Whether it is through the much talked about weakening of the nation state, market reform chipping away at the developmental or the welfare state as the case might be, or the shock therapy transition economies had gone through, or, yet, the proliferation of failed states and now the wars of preemption and choice, it is not farfetched to think that problems of enforcement and provisioning of public goods – whether globally or locally - have become endemic in the neoliberal era.

At the level of theory, renewed interest in enforcement issues poses anew the intriguing question as to what would market exchange and rational behavior be like in the absence of effective exogenous political order that can efficiently enforce property rights and contractual obligations of individuals towards one another. What would give order to a *Hobbesian* state of nature without the *Leviathan*? Would peaceable exchange result from the interaction of self-seeking individuals who have to rely on their own devices to enforce contracts and fend for themselves to protect their claims on property?

It is possible that older non-Walrasian economists, who usually go under the heading heterodox, might have a contribution to make here. For their emphasis on power relations might be a crucial part of the answer to these questions. Think about what makes a mutually beneficial trade viable among drug dealers who by the very nature of their trade cannot rely on the legal enforcement of their property claims. Exchange between them is potentially peaceable and mutually beneficial only when both parties can deter each other effectively from predation. That in turn requires that both parties find the other's implicit threat of retaliation credible, which in turn presupposes a rough balance of power.

The interesting question of course is what happens with market exchange among agents with asymmetric power under conditions of less than effective exogenous enforcement? Consider an unskilled migrant laborer who is cheated of his daily wages by his employer. If stuck on the long side of the market, what recourse would he have if seeking redress through the legal system is not a realistic option? Clearly, he would have to credibly project a perceived capability to retaliate that is credible enough to dissuade his employer from cheating by lowering his expected gain from doing so. For instance, enlisting the support of others – whose allegiance he might enjoy on the basis of non-economic primordial ties – can possibly give our laborer a leg to stand on. Clearly, whether he benefits from exchange depends on his success in deterring his employer from violating his contractual obligations towards him. There is of course the other side of the bargain as well. Once the employer finds it in his best interest to abide by the contract, it is not a foregone conclusion that he will benefit from exchange either. He still has to see to it that the laborer does not shirk once gainfully employed.

In the absence of effective means of exogenous enforcement, the potential mutual benefit from trading which economists like to take for granted presupposes that transacting agents are in a position to deal effectively with a set of game theoretic challenges that differ respectively when power is asymmetric among them. Together, these challenges define a collective action problem that is inherent in market exchange. In a nutshell, the powerful agents face what is in essence the "principal-agent" problem, while the weak agents have to find a way to redress the power imbalance to deter the powerful from taking advantage of their weakness before exchange can be mutually beneficial and in fact viable. While the "principal-agent" problem is well-recognized among economists, the same cannot be said for neither the game theoretic problem faced by "weak" agents nor how that relates to the viability of market exchange - though they are discussed at length among earlier non-Walrasian economists in different contexts at least since Marx.

Market Exchange as a Collective Action Problem

Unlike his modern followers, Adam Smith was well aware that the viability of his *invisible hand* rests on a high degree of self-restraint on the part of individuals. For instance, the individuals as they sought to further their self-interest would have to restrain themselves from theft, fraud or force - what we would today call *opportunistic* behavior - even if they knew they could expect to get away with such behavior. He was well aware that exogenous means of enforcement (legal sanctions) could be relied on to prevent opportunistic behavior only up to a point. Especially in a democracy, it would be impossible to rely solely on the threat of punishment. A viable liberal society he held requires that individuals self-restrain voluntarily by recognizing that to be in their own *enlightened* self-interest.

But, why would self-seeking individuals refrain from opportunistic behavior if they thought that they could get away with it? Would being conscious of one's enlightened self-interest in itself be sufficient for individuals to restrain themselves? For even if all individuals realized that they benefit when everyone refrains from violating the rules of the game, it does not follow that it is necessarily rational for them to act on that realization. Behind this of course lurks a classic collective action problem. Everyone might realize quite well that it is in their enlightened self-interest to obey the rules and self-restrain, but, whether it is actually rational for them to do so very much depends upon the extent to which they expect others will do the same.

In the context of repeated *prisoners dilemma* games, the simple canonical example of collective action problems, whether the mutually beneficial outcome emerges or not crucially depends on the ability of agents to punish *defectors* (Axelrod 1984). The ability to punish defectors, in turn, rests on whether defectors are easy to recognize, on the one hand, and, on a symmetric capacity to punish, on the other. In other words, for retaliation to be feasible even if defectors could be easily identified transacting agents have to have a rough balance of power. In a similar vein, Gintis' (2007) account of how *de-facto* property "rights" might emerge in a game theoretic context also crucially depends on a rough balance of power among agents competing for possessions. He shows that the incumbency of an agent in some indivisible resource (or terrain) would translate to a de-facto property right over it if agents value things more when they posses it (i.e., the *endowment* effect) provided that the incumbent is of roughly equal fighting ability as are his potential challengers. In both cases, the suggestion is that some form of a *spontaneous order* can possibly emerge to underpin market exchange as long as interacting agents are not completely anonymous and symmetrically endowed in their capacity to retaliate against defection by others. This is clearly congruous with a more traditional economy where at least some vital conditions of market activity rest on a given web of social relations such as kinship. Polanyi calls these *embedded* markets.

Indeed, enforcement of market rules in traditional societies seldom takes the form of legal sanctions enforced by formal institutions, but is instead based on informal norms that are commonly shared and practiced. Thus, self-restraint drives either directly from a credible threat of retaliation by others or is based on the force of sanctions that are internalized by the individual. The social norms that these sanctions draw from are codified in traditional or religious/ethical values and the individual takes it for granted that they are commonly shared by others in his community.

A multitude of coordination problems in practice, as we now know much better, are solved by drawing on commonly shared practices, beliefs and conventions. Consider what one would *normally* do when faced with a car coming from the opposite direction on a narrow English countryside lane: veer to the left assuming implicitly that the other driver will also do the same, likewise assuming the same about the first driver because everyone knows that traffic runs on the left in England. Relying solely on what economists call substantive rationality would have turned the occasion into a game of chicken - the solution of which oddly defies rules of formal rationality. While rationality can be used to deduce what the best course of action for both the chicken and the hawk, it cannot tell us who is to be which.

The broader interesting question of course is what happens when the common stock of shared conventions, values and norms dwindle in the course of modernization as individuals are increasingly uprooted from their places of origin and find themselves interacting with others who come from very diverse backgrounds and simply do not share similar beliefs and conventions?

This is a world reminiscent of what Polanyi calls *disembedded* markets. Now, market activity is no longer regulated by social norms and transactions are increasingly arms-length, taking place as a rule among anonymous agents who are likely to be total strangers. This means that market exchange in large measure ceases to have the structure of repeated games. The inescapable conclusion that follows from this is that if market transactions begin to increasingly resemble a one-shot prisoners' dilemma game, it becomes much harder for individuals to act on their enlightened self-interest for it becomes rational to defect, i.e., cheat when one can. Or, to put it the other way, it becomes more and more costly to be ethical for the enlightened individual who chooses not to defect. This might explain in part why the free rider problem is so much more a pervasive occurrence in modern economies as opposed to in those that are more traditional. Likewise, it is no accident that many of the well-known information problems beset modern economies more, and why product brands (reputational rents) in them acquire heightened importance, etc.

An obvious implication of this is that institutions must matter so much more in a modern economy. Clearly, if *spontaneous order* cannot be relied upon to emerge then the effectiveness of institutions on which exogenous enforcement relies on becomes all the more important. That means that a whole set of well functioning formal institutions - the most important of which are perhaps the legal system and law enforcement – becomes indispensable if a modern market system is to be functional. No doubt, the World Bank's belated discovery of *governance* as an issue of decisive importance after having pushed for market reform can be understood in this light.

Yet, to say that exogenous enforcement is all that can be relied upon to restrain opportunistic behavior in a modern economy is bleak prognosis. As Adam Smith recognized long before our time, it does not bode well for a democratic society. Thus, one would hope that institutions matter at yet a deeper level than the need to have an effective legal system or efficient governance, etc. Are there institutions that might be capable of bolstering endogenous forms of enforcement which would at one and the same time improve the quality of civic life and reduce the costs of exogenous enforcement?

Endogenous Enforcement in *Disembedded* Markets?

The intuitive idea here is simple. Institutions can perhaps be discussed in terms of whether they help or hinder agents with asymmetric power deal with the game theoretic problem they need to address before they can benefit from trading. If institutions are effective in this sense, it is more likely that agents will self-restrain out of their own volition and thus at least in part the burden on exogenous enforcement will be lessened. In what follows, I define what these problems are and the role power plays in how they work. But, first, what *power* is needs to be defined.

For our purposes here we can define minimally – following Bowles and Gintis (1993) – whether agents are *powerful* or *powerless* as to whether they happen to be on the long or short side of the market. Clearly, this presupposes that markets do not clear in equilibrium for all the reasons in *efficiency wage* type arguments (Shapiro & Stiglitz 1984) and thus a segment of the agents on the long side of the market don't get to make a trade. Thus, those who are on the short side are in a powerful position in relation to the agents on the long side whose numbers well-exceed what is in offer for exchange. They are *powerful* because they are in a position to pick and choose, while the others on the long side are *powerless* because they have to compete among themselves to make a trade. Thus, the employer who is in a position to choose from a long list of applicants for hire, or the multinational corporation whose investment a large number of developing countries are competing among themselves to attract are the typical examples of the powerful agents on the short side of the market.

An evocative example from Schelling (1980) captures well the essence of the problem the powerful agent has to deal with, which goes something like this. Think of a contrite kidnapper who would like to let go his victim but cannot on fear of his going to the police and having him arrested. The victim's remonstrations that he would never do that if only he is let go are not credible because the *time-variance* of what is in his interest to do is patently obvious. While still a captive he would want to *commit* anyway he could to not going to the police when released. But after being freed it would be a different story altogether as nothing would keep him from going to the police. The position of someone unemployed vying for a coveted job resembles that of the kidnapper's victim in Schelling's example. While before being hired the prospective worker would want to *commit* to work "exceptionally" hard if hired, but it would not necessarily be in his interest to do so after actually getting the job. Thus, just like the kidnapper *vis a vis* his victim, the employer has to deal with the challenge posed by the predictable *time-variance* in what is in workers' interest and has to find a way that would make his employees stick to their initial *commitment*.

Thus the challenge the powerful agent faces is in essence a variant of the *principal-agent* problem with the added twist of *dynamic time-variance* on the part of the *agent*'s preferences. Though usually it comes up in different contexts, the problem and its possible solutions are extensively discussed in the literature. It is well recognized that contracting, even when enforceable at low cost, need not be sufficient to solve the problem at hand for the *principal*. The general challenge is to find a way to align the interests of the *agent* with that of the *principal*. A generally workable strategy for the principal is to see to it that the employment contract is made contingent on employee performance. This obviously only works if the wage exceeds what it would be under market clearing conditions, the difference being equal to what Bowles and Gintis call, the "enforcement rent." The worker must have something to lose, something better than what his second best alternative offers, for him to care about not losing his job and thus willing to perform to renew his contract.

The issue can also be looked at from the point of view of globalization of investment where safeguarding of investors' property rights is a perennial issue. For just like the case with Schelling's kidnapping victim or the worker above, a similar kind of a *dynamic time-variance* might characterize the shifting interests of host countries *vis a vis* foreign investors. A part of the foreign investors' (multinationals) challenge is to be prepared for the fact that the incentive structure can potentially shift drastically once they sink fixed costs in the country they invest in. Again, *contingent renewal* can be seen to give the outline of a potentially workable strategy, which here takes the form of making continued foreign investment contingent on the "good behavior" of the host country. Obviously, this can work better if the country is vulnerable to financial sentiment in international markets and have limited policy autonomy - the very attributes given boost to by market reform and financial liberalization in recent decades. Moreover, if agents on the short side of the market are *footloose* and the rest *footstuck*, another salient characteristic of globalization in our era, then clearly the long side of the market gets much longer, increasing the power imbalance.

But, the problem is that the increasing power imbalance can also end up being too much of a good thing for the powerful agents who clearly benefit from it in the short run. For the intensity of competition on the long side might rise to such a level that the return from trading can become exceedingly lopsided and thus no longer perceived as "beneficial" by the powerless agents, thus threatening its long term viability. That these agents' second best alternative is inferior to trading need not be taken as *prime facie* evidence of its desirability, since the very lopsidedness of its rewards might make the individual consider endeavors at a much higher risk/return spectrum than he would normally prefer. Such are often "transformative" of the *givens* in his underlying cost-benefit calculus. One would think that these might take very diverse forms - conventional risk taking dynamically blending into crime or political radicalization - but equally come back to hurt the interests of powerful agents once sufficiently pervasive. The warnings many authors issue today against the growing danger of a political backlash against globalization around the world can be looked at in this light. Put simply, what is in principle involved here is perhaps not much different than the plight of the store owner who charges extra for his umbrellas during a rain storm. He makes windfall profits in the short run but ends up losing the goodwill and thus the future business of his customers. His long term interest is served better if the fear of a backlash from his consumers deters him from “taking advantage” of them by exploiting his temporary monopoly position. Thus the powerful agent it turns out faces a commitment problem as well. It might be in its long term interest not to take advantage of the weakness of its trading partner by committing to the norms of exchange, but that will be harder to do if s/he thinks his/her competitors will not. But, if it were common knowledge that the weak were capable of retaliating against opportunistic behavior, the individual agents on the short side of the market would find it easier to stick to ‘fair’ exchange. In other words, the commitment problem of the powerful depends very much on the ability of the weak to redress the power imbalance.

Another example might help think about this in a more general way. Think of a mediaeval sovereign who would like to have some long distance merchants begin using one of his ports that is suitable for a stopover. Initially, it would be in his interest to keep merchants happy and refrain from pilfering. But, once his stopover becomes well-established on the trade route, he might feel that he could maraud on individual merchants with impunity. What can the merchants then do? A workable strategy short of finding an alternative route would be to be able to credibly threaten a collective boycott. Merchants would have to be ready to strike in the event the sovereign arbitrarily confiscated the property of any one of them. If the threat is credible everyone benefits, including the sovereign. The collective power of the weak makes him stick to his initial commitment to refrain from acting opportunistically, which is in his own long term interest. The inability of the weak to redress the power imbalance by contrast can start a slippery slope where exchange becomes increasingly lopsided, eventually undermining its viability.

The weak agents’ ability to redress the power imbalance in turn depends on how well they deal with, among other things, a classic cartel problem that is involved in a collective boycott. In the event of a strike, they have to be able to prevent any one of their members from breaking the boycott for personal benefit, any merchant secretly sailing into the sovereign's port in the dead of the night for extra reward the sovereign would be more than happy to bestow. In the event the boycott is successful whereby the sovereign pledges to behave and business goes back to normal, the merchants have to remain ever vigilant by maintaining their potential to act collectively. This requires that they protect the integrity of their coalition from both internal threats and merchants who are new on the scene.

A general conclusion follows. The collective power of the weak acts as a commitment device for the powerful. By preventing the powerful from "taking advantage" of their weakness the powerless not only help themselves but help trade remain mutually beneficial as well. To deter the powerful from reneging on its commitment the powerless in turn have to be able to (i) close ranks to prevent defection in their midst and (ii) deal with competition from outside, i.e, the other agents who have not made a trade on the long side of the market.

Falling short in either makes it more likely that they would be "taken advantage" of, which can take many different forms depending on the context, varying from violations of one's property rights to contract infringement, or to even having one's wages "unfairly" lowered at a time of low demand (Akerlof & Yellen 1988). Unlike the example with the medieval sovereign, whether the powerful agents are individually aware of their enlightened interest might not be decisive for they face a collective action problem of their own as well. Once it is common knowledge that the weak cannot deter one can no longer take it for granted that the next agent will be enlightened enough to refrain from acting opportunistically.

Conclusion

The suggestion is that institutional structures can perhaps be distinguished as to whether they strike a balance in accommodating the game theoretic problems of both types of agents or tilt in favor of one or the other. For instance, among others, Polanyi's account of the 1930s is an example of an era where the powerful agents felt under siege. Labor movement in many countries was powerful. Capitalists perceived a serious threat given that socialist parties were either in government or at striking distance from acquiring political power.

The welfare state that had emerged after WWII by contrast, can be seen to have bolstered the ability of both capital and labor deal more effectively with their respective game theoretic problems. The property rights of capitalists were unambiguously supported by the state and any serious source of political uncertainty removed as the Left became in large measure "domesticated." But, at the same time, many obstacles labor unions faced in collective bargaining were likewise removed and, moreover, competition from the unemployed was significantly mitigated. Finally, institutional structures that came to predominate under neoliberal globalization is an example of an era where the pendulum has swung in favor of the powerful, as the story is only too well-known to recount (Milanovic 2003).

The increasing importance of *community* in our neoliberal era that is found so much baffling can thus be tied an effort on the part of weak to redress the increased power imbalance globalization has brought about at their expense in a setting where *modern* institutions have increasingly failed to enforce adequately their property claims and contractual rights on the one hand, and provision public goods on the other. It need not be surprising that someone like the day laborer in our example above gravitates towards some social network which gives him insider privileges on account of some communal affiliation he has given his background. When looked thus, the return to the communal fold today need not be emblematic of an irrational fearful escape from, or a vengeful reaction against, modern life but a second-best response. Even the seemingly fanatical public expressions of over-politicized group sentiment, so often taken as the *prima facie* evidence of the irrationality of individuals and groups who exhibit them, might perhaps be explicable as signaling devices embattled individuals use in vying for group acceptance in competition with others.

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