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Asymmetric Power and the Commitment Problem of the Powerful

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Introduction

Recent developments that broadly go under the heading, "Post Walrasian or neo-Institutionalist Economics have carried contract and property right enforcement to the very center of economic analysis. Enforcement issues as they relate to rational behavior under less than ideal conditions, where the government can be counted on to enforce effectively neither property rights nor contractual obligations, have had increasing real world relevance in recent decades as well. Think of issues that gained currency with globalization. Whether it is 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 to go through, or, yet, the proliferation of failed states and the wars of preemption, in all, efficient government enforcement (along with provisioning of public goods) could hardly be taken for granted.

At the level of abstract theory, renewed interest in enforcement issues poses anew the intriguing question as to what would rational behavior and market exchange entail in the absence of effective and costless enforcement of property rights and contractual obligations of individuals towards one another. What would give order to a *Hobbesian* 'state of nature' with a *Leviathan* who has fallen asleep? For instance, would peaceable exchange result from the interaction of self-seeking individuals who have to rely on their own devices to enforce contracts and protect their claims on property?[1] Under such conditions, how would market relations affect asymmetric power and be affected by it?

It is possible that older non-Walrasian economists' emphasis on power and power relations can make a contribution to our understanding of enforcement problems.[2] 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. Agents respect each other's

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[1] A bourgeoning new literature that goes under the heading, "conflict economics" examines how peaceable exchange can emerge in a decentralized market economy in the absence of a government that can protect individuals' property rights. See, among others, Anderton (2000, 2003), Skaperdas 2002 and Rider (1999).

[2] Albeit in other contexts, similar issues are taken up in the writings of earlier non-Walrasian economists at least since Marx, some of the insights of which the discussion in the paper implicitly draws from.

property claims to the extent they find the other's implicit threat of retaliation if they don't credible, which often presupposes a rough balance of power.

The question has much broader import than hitherto thought for it involves how market exchange might work 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. Stuck on the long side of the market, what is his rational course of action if seeking redress through the legal system is not realistic? One would think that his fortunes would rise or fall with his ability to project a perceived capability to retaliate that is credible enough to dissuade his employer from cheating by lowering his expected gain if he is so inclined. For instance, enlisting the support of others – whose allegiance he might have on the basis of primordial kinship ties – can possibly give our laborer a leg to stand on.

In this example, whether our laborer realizes the potential benefit from exchange depends on his success in deterring his employer from violating his contractual obligations. There is of course the other side of the trade as well. Once the employer finds it in his best interest to abide by his contractual obligations, it is not a foregone conclusion that he will benefit from exchange to its full potential unless he can see to it that the laborer does not shirk once gainfully employed. The challenge faced by the powerful agent is the well-known "principal-agent" problem, while that of the weak agent is to redress the power imbalance so that the powerful side cannot "takes advantage" of his weakness. The important implication is that exchange is mutually beneficial only when both sides successfully deal with their respective challenge. While the "principal-agent" problem has been explored in depth in its multifaceted manifestations, the same cannot be said for the problem the *weak* agent faces. Nor, is it often recognized that the failure of the weak agents to address the power imbalance can threaten the viability of and potential benefits from market exchange and thus have repercussions that go beyond their own wellbeing. More specifically, the paper argues that the ability of the weak to redress the power imbalance they face in exchange makes it easier for the powerful agents to resist the temptation of short term windfall profits at the expense of their long term interests.

The argument is laid out in a couple of stages for the game theoretic nature of the problem the agents face on both side changes when the structure of interactions among them is transformed. Whether it is a pre-modern, traditional economy where the interacting agents as a rule are embedded within a given web of social ties *versus* a modern economy where the norm becomes arms-length, anonymous exchange makes a difference.

The sections below discuss if and how endogenous enforcement might emerge and how asymmetric power is checked in the context of exchange that is, respectively, (i) among agents who repeatedly encounter each other and (ii) those who are anonymous. The discussion then focuses on the commitment problem of the powerful in the latter, and ends with a few concluding remarks.

Enlightened Self-Interest in embedded markets

Unlike many of his modern followers, Adam Smith was well aware that his *invisible hand* requires individuals to show self-restraint in the pursuit of their self-interest. He knew that the invisible hand could not possibly work unless individuals restrained from theft, fraud or force – not just unlawful but also what we would today call *opportunistic* behavior - when they knew they could realistically expect to get away with it. He was well aware that legal sanctions and the threat of punishment could only go so far in dealing with the problem. Especially, in a liberal society, he believed, individuals would need to refrain from opportunistic behavior out of their own volition, and that required them to act on their enlightened rather than short term self-interest.

But, the problem is that awareness of enlightened self-interest in itself need not be sufficient for individuals to show self-restraint. For even all individuals fully realize that they benefit when everyone refrains from violating the rules and otherwise acting opportunistically, it still might not be 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 other words, whether individuals act on their enlightened self-interest or not depends not just on their own commitment but also on their assessment of others' level of commitment as well.

We know well how the individual utility calculus can change in the repeated *prisoners' dilemma*. The gain from opportunistic behavior (defection) in the current period is weighed against future benefits from continued cooperation. When the latter is high enough mutually beneficial cooperation can emerge provided that agents have the ability to punish *defectors* by withholding future cooperation (Axelrod 1984). The ability to punish defectors, in turn, rests on the ability to recognize defectors in repeated future encounters on the one hand, and, on a symmetric capacity to punish, on the other. In other words, even if defectors are easily identifiable, a credible threat of punishment requires that transacting agents have a rough balance of power, i.e., ability to punish the other.

In a similar vein, balance of power again plays a crucial role in Gintis' (2007) account of how *de-facto* property rights might emerge in a game theoretic context. Gintis shows how incumbency in some indivisible resource (or terrain) can translate to a de-facto property right over it if agents value things more when they posses it (i.e., the *endowment* effect) and are of roughly equal fighting ability. The intuition is that the incumbent is likely to fight much harder for the resource that his potential challengers are contesting. Clearly, the advantage incumbency confers would not amount to much if the power asymmetry is large enough.

It might not be too much of a stretch to suggest that in both the emergence of *cooperation* as well as *de facto* property rights, some *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*. In pre-modern, traditional economies where relations of kinship undergird at least some vital enforcement functions in market activity, in what Polanyi (1944) calls *embedded* markets, repeated encounters are of course the norm. In addition, the same kinship ties might also provide commonly shared notions of "fairness" that can provide the *weak* with a mechanism of power balancing to prevent opportunistic behavior on the part of the powerful.

Indeed, enforcement of property rights, rules and contracts in traditional societies seldom relies on legal sanctions enforced by formal institutions, but rather on informal networks whose members share common norms, values, etc.. Enforcement can take place at the level of the community because self-restraint derives either directly from a credible threat of ostracism or sanctions that are internalized by the individual. The norms that these sanctions are based on are often codified in religious/ethical values which the individual assumes are commonly shared by others in his community. To put it differently, such norms and sanctions function as *commitment devices*, enabling Individuals to commit to acting on their enlightened self-interest on account of them because they can reasonably expect that others will do so as well.[3]

Of course, the broader question that is of interest here is what happens when the common stock of shared conventions, values and norms dwindle in the course of social processes such as modernization and globalization, when the norm becomes exchange among individuals who are from diverse backgrounds with little in common? This is the world of what Polanyi calls *disembedded* markets, where transactions are arms-length and take place among anonymous others.[4] In this case, market exchange in large measure ceases to have the structure of repeated games, and comes to resemble a disconnected series of one-shot games. The worrisome implication is that a slippery slope can then

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[3] In fact, a multitude of simple coordination problems are in practice solved by individuals drawing on what they assume are commonly shared practices, information and conventions with other individuals, what Schelling (1960) calls "focal points". For instance, when faced with a car coming from the opposite direction on a narrow countryside lane, we normally steer to the side of the road from which traffic flows in that particular country, assuming implicitly that the other driver will also do the same. We thus rely on a social convention and the expectation that it is commonly shared, rather than turning the occasion into a game of chicken. The latter would be more consistent with what economists call substantive or instrumental rationality, yet fail to solve our problem since postulates of rationality could only tell us what is the best thing to do respectively for the chicken and the hawk, but not who is to be which (Sugden 1989).

[4] Despite his widespread influential among other social scientists, Polanyi's influence among mainstream economists has been limited and thus his terminology remained little used. However, many economists draw a distinction between formal and informal governance in various different contexts that is similar to Polanyi's embedded/disembedded dichotomy. See, among others, Fafchamps (2004), Ensminger (1992), Li (2003) and Casella & Rauch (2002).

emerge where self-restraint no longer pays off. Individuals become less likely to act on their enlightened self-interest when others begin to *cheat* when they can. Or, to put it the other way, it becomes increasingly costly to stick to one's enlightened self-interest.

This possibly explains why the free rider problem is much more pervasive in the anonymous world of modern economies. Likewise, it is no accident that many of the well-known information problems beset modern economies more, why our awareness of them is relatively recent, and why reputational capital loses its bedrock quality as it comes to rest on the cash nexus of utility calculus rather than the individual's moral traits.

Endogenous enforcement in disembedded markets?

Above, I suggested that commonly shared norms and values in traditional societies can function as *commitment devices*, instilling in individuals the mutually reinforcing expectation that those acting opportunistically will be sanctioned and thus making it sensible to assume others will be self-restrained. It is also possible that the very notion of 'fairness' embedded in the same norms and values can be effective in constraining opportunistic behaviour on the part of the powerful. This of course brings up the question if and how endogenous enforcement might be possible in modern economies, and what types of modern institutions and mechanisms might be effective in preventing the potentially adverse effect of asymmetric power on exchange.

It is clear that formal enforcement institutions are an essential prerequisite of a modern market economy – especially, given that no spontaneous order can be relied on. For a modern market system to be viable the whole battery of formal institutions - the most important of which are of course the courts and law enforcement – must be functional at least to a degree.[5] Moreover, as Russel Hardin (1995) has argued we might expect that the very effectiveness of these institutions – or, rather their reputation that

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[5] In fact, the rapid rise of *governance* as a separate sub-branch of study at a time of rapid 'modernization' around the world under the influence of globalization can be thought of a reflection of this salient fact. Again it might not be surprising that the World Bank became keenly interested in governance once it became obvious that market reform in many developing countries seriously weakened the institutions of enforcement that were frail to begin with. See, Dixit (2008) for comprehensive overview of this bourgeoning literature and Dixit (2004) for a more extensive treatment.

they are – can also work as a commitment device in the sense defined above. The expectation of swift justice against tax evaders and "cheaters" one would think would enhance individuals' willingness to contribute to public goods, at least, in instances that involve a legal obligation.[6] The cost of enforcement would thereby be lowered as well, since the more credible the threat of punitive sanctions the lower is the need to actually mete out punishment. But if we do not already have efficient institutions of enforcement how does one get there, or what happens when their effectiveness erodes over time for whatever reason, undermining their reputation?[7] It is possible that the answer depends on how asymmetric power is dealt with, or rather whether and how its potentially adverse effect on exchange is checked.

For our purposes here we can define minimally – along Bowles and Gintis (1993) – whether agents are *powerful* or *weak* 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 *weak* 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 vying to attract are the typical examples of the powerful agents on the short side of the market.

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[6] Of course, civic obligations are yet another matter. As Adam Smith recognized, the credible threat of punitive sanctions might make law abiding agents, but not necessarily good citizens in a liberal society. Thus, one would think (and hope?) that institutions matter at yet a deeper level than the need to have an effective legal system in promoting endogenous forms of enforcement.

[7] For instance, think of the recent literature on 'regulation capture' in advanced countries (Dal Bo 2006, Mattli & Woods 2009) and 'state capture' following market reform in transition and developing economies (Hellman & Kaufman 2001, Hellman & Schankerman 2000, Jensen (2000).

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 release his victim, but feels cannot do so because his victim would have him arrested if let go. The victim's remonstrations that he would not go to the police are not credible because what is in his self-interest is patently *time-variant*. While still a captive he would want to be able to make a credible *commitment* not to go to the police when freed. But once he is free it would be a different story altogether, unless a way is found to make his prior commitment binding. The position of someone unemployed vying for a coveted job resembles that of the kidnapper's victim in Schelling's example. Before being hired the prospective worker would want to *commit* to work hard if hired, while it would not necessarily be in his interest to do so if he actually gets 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 the workers' self-interest and has to find a way that would make his employees stick to their *commitment*.

Thus the challenge the powerful agent faces is in essence the *principal-agent* problem tied to *time-variance* in the weak *agent*s' self-interest. Though usually it comes up in different contexts, it is well recognized in the literature that contracting, even when enforceable at low cost, need not be sufficient to solve the problem the *principal* faces. The general challenge is to find a way to align the interests of the *agent* with that of the *principal*, whereby a generally workable strategy involves making the renewal of the employment contract contingent on the agent's performance. This obviously can only work if the wage exceeds what it would be under market clearing conditions. 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 well enough 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 *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.[8] 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 has only limited policy autonomy and thus vulnerable to financial sentiment in international markets - the very attributes given boost by market reform and financial liberalization in recent decades. Moreover, if agents on the short side of the market are *footloose* and those on the long side *footstuck*, another salient characteristic of globalization in our era, then clearly the long side of the market gets much longer, increasing further the power asymmetry.

The Commitment Problem of the Powerful

The problem with increasing power imbalance is that it makes it hard for the weaker agent deal with his challenge. Moreover, if the weak agent cannot successfully redress the power asymmetry it is likely that the exchange will be short lived and its potential mutual benefit will go unrealized, adversely affecting the powerful agent as well. Put simply, what is involved here is not in essence much different than the plight of the store owner who charges extra for umbrellas during a rainstorm, only to find out he has lost future customers. Though he makes windfall profits that day, he loses out in the long run. His long term interest might have been served better if the fear of a backlash from his consumers deterred him from taking advantage of their temporary weakness. Thus, the powerful agent has his commitment problem as well. It might be in his long term interest to commit not to take advantage of the weakness of the weak, but that might be unlikely or more difficult to do when the weak agents are incapable of projecting a credible threat of retaliation.

Another example might help think about how the weakness of the weak affects the powerful in a more general way. Think of Grief's (1992) mediaeval sovereign who would like to attract long distance merchants to his territory. Initially, it would be in his interest to respect merchants' property and contractual rights and refrain from pilfering.

[8] See Garzia Ietto-Gillies' contribution in this volume for an insightful discussion of how transnational corporations strategize to cultivate and use 'asymmetric power' to their advantage.

But, once the trade becomes well-established, he might feel that he could maraud on individual merchants with impunity. The merchants might prevent this if they can credibly threaten a collective boycott. That requires them to be ready to act in tandem in the event the sovereign harms the property or person of any one of them. If their threat is credible enough everyone benefits, including the sovereign. The collective coordinated power of the merchants makes the sovereign stick to his commitment to refrain from acting opportunistically, which is in his own long term interest as well. But when the *weak* fail to redress the power imbalance by successfully coordinating among themselves, a slippery slope can potentially result, where exchange becomes increasingly lopsided and fails to flourish if it does not die out completely. Thus, the power that emanates from coalition formation among the weak agents can help ensure the powerful agent stick to his commitment and thus work as a *commitment device*. By preventing the powerful from "taking advantage" of their weakness the weak not only help themselves but help trade remain mutually beneficial as well.[9]

But, what about market competition? In the above example the sovereign clearly faces no competition from other rulers, and the question is, if he did, would that not be an equally effective commitment device as well. It appears that the answer depends on whether competition can be relied on to close the gap between the long and short sides of the market. Note that our initial assumption was that equilibrium did not entail market clearing, and that was in fact how we could define power asymmetry.

Until recently, it was generally thought that lack of market clearing could only be a short lived disequilibrium situation, because the mutually beneficial trades that could be made between agents would propel the market towards clearing. For instance, many mainstream economists were never persuaded by Keynes' account of involuntary underemployment because they thought if each individual market but the labor market cleared, then the labor market would have to clear as well. The labor market would tend

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[9] See, Greif, Milgrom and Weingast (1994) for a discussion of how merchants used collective action to counter the rulers' tendency to violate their members' property rights in late medieval Europe. According to Acemoglu (2003) and Acemoglu & Robinson (2005) the rise of democracy can be traced to some ruling elite's recognition that making a credible commitment not to violate the property rights of their people is in their interest.

to clear because agents on both sides would exploit mutually beneficial trading opportunities.

It is now widely recognized that information problems, if nothing else, could prevent individual markets from clearing in equilibrium. While the potential for a mutually beneficial trade might exist, it need not be a viable option for the individual employer because of the collective action problem he faces when he does not know what other agents are likely to do. The potential benefit from hiring the unemployed worker might require that all other employers do so as well. Hiring when no one else does entails loss, and thus not hiring remains the preferred action when others cannot be counted on acting in tandem even though everyone would be better off if they did.

If no tendency exists for markets to clear in equilibrium – defined as position of rest - then competition is likely to have a pernicious effect as it would make it harder for powerful agents to act in their enlightened self-interest as a group. Note that it is in the collective interest of powerful agents not to take advantage of the weakness of the weak. But, the larger is their population the harder it is to supplant competition between them to secure a 'public good.' For each powerful agent is better off if everyone but they refrained from exploiting the opportunity offered by the weakness of the weak. Just as in any common resource problem, here, too, private gain is associated with collective cost. Those who behave opportunistically make it more costly for the others' who exercise self-restraint.

Think of a group of cab drivers at some foreign tourist destination. The foreign tourists who do not know the area are easy pickings for the cab drivers as they come off the airport. When drivers cheat by overcharging their passengers they might very well know that they are assailing their collective reputation which will eventually harm them all. Why do they do it? If they assume that other drivers are likely to cheat regardless of what they do they might conclude that self-restraint is pointless, making them think they might just as well cheat too. Those wavering might see their scruples vanish when competitive pressures intensify. In a similar vein, the financiers who engaged in the risky practices that eventually led to the financial crisis were probably not much different than the cab drivers in this example. The more scrupulous players who refrained from the riskiest practices often paid a price in terms of their competitive standing (Tett 2009; Authers 2010; Rajan 2010). As self-restraint ceased to pay, few chose to exercise it.

Note that adding competition into the mix transforms the commitment problem of the powerful into something much more formidable than simple *moral hazard*. The latter is a failing of the individual while the former that of the group. While both involve the shortsighted exploitation of an opportunity, the latter is caused when poor judgment is incentivized while in the former the failure to secure a common good makes individual good judgment and self-restraint unprofitable. For once it is common knowledge that the weak can no longer deter it becomes harder to assume that the next powerful agent will refrain from acting opportunistically, making it harder for everyone to stick to their enlightened self-interest on the short side of the market. The fair-minded store owner who refuses to hike up the price of his umbrellas in a rainstorm, the honest cab driver who does not rip off tourists and the investment bank that shuns the subprime mortgages, all, see their business suffer. Yet, the more likely the threat of a backlash, whether it is collective action on the part of customers, workers or tourists, the easier it might be for the enlightened powerful agents to deal with their commitment problem, while, by implication, anything that is detrimental to coalition building on the part of the weak is liable to make it harder.

Conclusion

The foregoing raises the question whether governance institutions' effectiveness depends on the extent to which they make it easier for the weak to redress the power imbalance they face in exchange. The weak agents' ability to form coalitions, the main mechanism by which they can balance power asymmetries, depends in turn on how well they cope with two key challenges: (i) potential free riders in their midst and (ii) competition from outside, i.e., the other agents who have not made a trade on the long side of the market. In Grief's example above, the effectiveness of merchants depends on their ability to prevent their individual members from running the embargo in the event of a boycott for extra reward. Moreover, in the event the boycott succeeds the merchants need to maintain their ability to act collectively over time, which means that in addition to thwarting free riders they need to be able to absorb and otherwise neutralize the competition of outside merchants. Arguably, a strong safety net and powerful closed-shop unions, both associated with the welfare state, were instrumental in easing both challenges, free riders and competition from outside, and thus the types of institutions that made historically collective action a more credible threat. Of course, as often remarked, neither institution - along with the welfare state - could resist the erosion caused by globalization, drastically reducing their effectiveness in bolstering the coalition building ability of the weak. But, if the weak can no longer project a credible threat of collective action, this raises the question what else can help the powerful solve their problem of commitment in the age of globalization? One also wonders if the rising importance of community around the world that is often found so baffling the last of refuge of the weak to protect themselves from "outside competition" in a world where they can no longer deter the powerful?

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