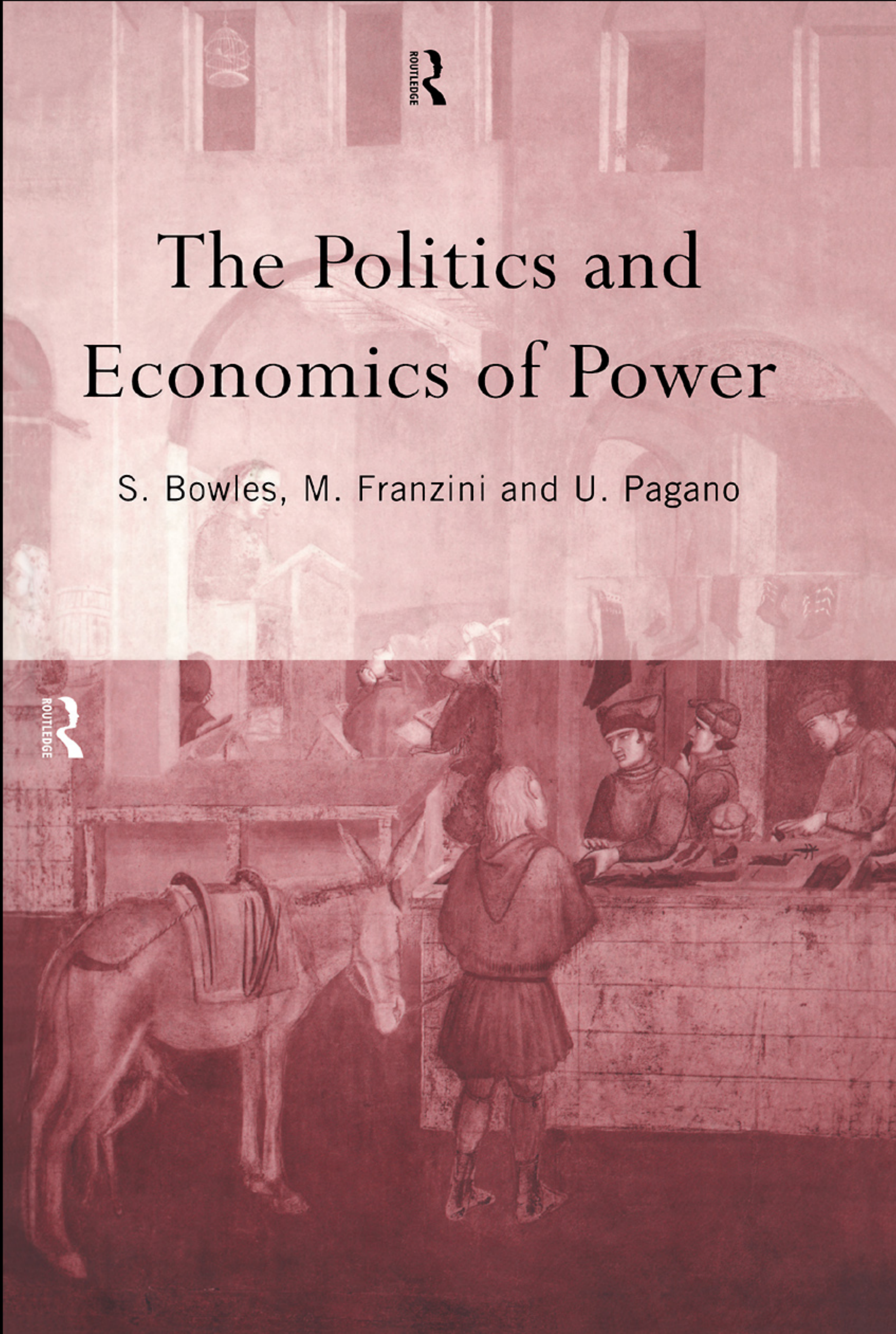
The Politics and Economics of Power

S. Bowles, M. Franzini and U. Pagano



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The Politics and Economics of Power

This edited collection looks at the emerging relationship between politics and economics. The analysis of power relations—traditionally the focus of political science—is becoming increasingly important in enabling economists to understand concepts such as the 'contested nature' of market exchanges. These papers examine power relations in the firm and the market-place and offer an economic perspective on political relations. The book is divided into three sections:

- politics and power in economic organizations
- the economic analysis of political organizations
- politics, economics and social change

The final section considers how a combination of economic and political tools can be used effectively to analyse social change. Presenting some original and thought-provoking views on important issues, this volume will be of great interest to students and researchers in political economy and related areas.

Samuel Bowles is Professor of Economics at the University of Massachusetts at Amherst. **Maurizio Franzini** and **Ugo Pagano** are both Professors of Economics at Siena University.

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Edited by Samuel Bowles, Maurizio Franzini and Ugo Pagano

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1
Introduction
Trespassing the boundaries of politics and economics[1]

Samuel Bowles, Maurizio Franzini, and Ugo Pagano

The traditional division between economics and politics is collapsing. The analysis of power relations, which used to be the focus of political science, is becoming very important to understand the 'contested nature' of market exchanges; moreover, opening the 'black boxes' by which firms used to be characterized in economic theory has focussed the attention of economists on the internal politics of the firm. At the same time politics has been increasingly characterized as an exchange between utility-maximizing voters and vote-maximizing politicians.

This book is divided into three parts that focus on these stimulating developments of the relationship between economics and politics. The essays contained in the first part examine the internal politics characterizing such traditional economic organizations as firms and the power relations existing in the most classic economic institution: the marketplace. The second part considers the 'market exchange' and, in general, the economic view of political relations; the working of democracy and the rationale for constitutional constraints are examined within this framework. Finally, the last part shows that the analysis of social change can successfully exploit the two-way 'contamination processes' that have been examined in the first two parts. Nationalism, exclusion of minorities, the rise of dictatorship, and in general social change require a joint and interrelated analysis of economic and political factors.

We will briefly consider in the final three sections of this introduction how each paper contained in this book contributes to overcoming the traditional fences that used to separate economics and politics. In the next section we will give a brief account of the reasons that motivated the erection of those protective fences and the factors that made the social scientists feel increasingly uncomfortable about the fields they intended to enclose.

The demise and rebirth of political economy

Social scientists and political philosophers commonly represent human interactions as exchanges; the terms social contract, electoral marketplace, exchange of favors, marriage contract, marketplace of ideas, and linguistic exchange attest to the ample scope of the market metaphor. 'Interaction between persons is an exchange of goods, material and non-material,' wrote the sociologist George Homans (1958:597), a founder of the theory of social exchange. But if economic analogies have been widely used in the contemporary social sciences and in political philosophy since Hobbes, modern economists have seen little need for cross-disciplinary boundaries in order to understand the economy.

John Stuart Mill famously sought to distinguish between allocational matters, the subject of economic analysis, on the one hand, and distribution, the province of politics and ethics on the other. A generation later, Leon Walras (1954), in laying out the precepts of the then-young neoclassical paradigm, sharply distinguished his contributions from the social economics of the classical founders of the discipline and from his contemporaries in the German historical school and Marxian political economy. He sought a 'pure science' of economics as 'a relationship among things,' not 'people.' The flourishing of theoretical work during the century following him did much to realize this objective. Significantly, political economy dropped the adjective, becoming simply economics. Thus, the neoclassical paradigm at its zenith borrowed its metaphors from the physical sciences, particularly physics: the exchange of goods is more like a heat exchange than an exchange of greetings.

And so when Abba Lerner (1972:259) told the American Economics Association over a quarter of a century ago that 'An economic transaction is a solved political problem. Economics has gained the title Queen of the Social Sciences by choosing solved political problems as its domain,' it was the prose that caught one's attention; the substantive claim was uncontroversial. Economists happily interpreted Mill's separation of the allocative from the distributional aspects of economics as a prescription to leave to someone else the analysis of politics, the structure of government, and the etiology of economic policy.

A methodological schizophrenia thus emerged: economists assumed that economic actors pursued the self-regarding and outcome-based preferences of the textbook *Homo economicus,* while naïvely trusting civil servants and politicians to implement faithfully the wills of the citizenry in conformance to the dictates of an idealized *Homo civicus.* Economists trained their sights on market failures, while exempting public-policy and governmental structure from any sustained investigation of possible discrepancies between individual incentives and social objectives. Whence the hubris of mid-century welfare economics: many economists came to advocate governmental interventions to correct market failures as a kind of *deus ex machina.*

The result was a double hiatus between economic and political reasoning: political analysis had nothing to say about the functioning of the economy, while economic analysis was rarely deployed to understand politics in its recognized domain, the state. This hiatus has provided the conceptual foundation for the disciplinary boundaries which came to divide economics from the other social and behavioral sciences. At its simplest, the underlying conception of society is one characterized by a remarkable degree of specialization among institutions: governments govern and economic institutions allocate resources, while families and religious institutions transmit culture and yet other institutions carry out other specialized functions.

Of course nobody believes this literally: historians, anthropologists, political scientists, and sociologists, often borrowing extensively from economics, routinely recognize the political consequences of economic organization.

The historian E.P.Thompson (1971) described markets more as politically charged meeting places than as the anonymous interactions of neoclassical economic theory:

> In eighteenth-century Britain or France…the market remained a social as well as an economic nexus. It was the place where one hundred and one social and personal transactions went on; where news was passed, rumor and gossip flew around, politics was (if ever) discussed in the inns or wine shops round the market square. The market was the place where the people, because they were numerous, felt for a moment that they were strong.
>
> (134–5)

For anthropologists, the exchange process, whether deemed a market or not, underpins the entire social structure. Bronislaw Malinowski, writing of the Trobriand Islanders early in this century, found that:

> the whole tribal life is permeated by a constant give and take; that every ceremony; every legal and customary act is done to the accompaniment of material gift and counter gift; that wealth, given and taken is one of the main instruments of social organization, of the power of the chief, of the bonds of kinship, and of relationships in law.
>
> (1922:167)

According to Marshall Sahlins (1974:186–7) the allocational role of what he calls primitive exchange is secondary to providing social cohesion in a society in which politics cannot be confined to the state for the simple reason that there is none:

> The indicative condition of primitive society is the absence of a public and sovereign power: persons and (especially) groups confront each other not merely as distinct interests but with the possible inclination and certain right to physically prosecute these interests. Force is decentralized…the social compact has yet to be drawn, the state non-existent. So peacemaking is not a sporadic intersocietal event, it is a continuous process going on within society itself.

And Gayle Rubin's 'traffic in women' (1975:174), based on the work of Claude Levi-Straus (1969), suggests that the exchange process has political as well as allocational consequences:

> The marriage ceremonies recorded in the ethnographic literature are moments in a ceaseless and ordered procession in which women, children, shells, words, cattle, names, fish, ancestors, whales teeth, pigs, yams, spells, dances, mats, etc. pass from hand to hand leaving as their tracks the ties that bind.

Nor are these assessments confined to the primitive and the past: Charles E.Lindblom (1977:171–2) describes capitalism as a system in which significant powers little different in kind from those exercised by governments are delegated to owners and exercised at least in part through competitive markets:

> Corporate executives…decide a nation's industrial technology, the pattern of work organization, the location of industry, market structure, resource allocation, and, of course, executive compensation and status…. In short in any private enterprise system, a large category of major decisions is turned over to business men both small and large.

Not surprisingly, legal theorists have found it difficult to draw coherent boundaries between state and economy, finding little grounds for restricting law to state-enforced commands. H.L.Hart (1961) refers to:

> the original conception of law as consisting of orders backed by threats of sanctions which are to be exacted when the orders are disobeyed.
>
> (36)

> Within the territory of each country there may be many different persons or bodies of persons giving general orders backed by threats and receiving habitual obedience.
>
> (24)

Relatedly L.L.Fuller's celebrated *The morality of law* (1969:129) asserts the broad dispersal throughout society of the 'authority to enact rules and to reach decisions that will be regarded as properly binding on those affected by them,' going on to comment that 'the intellectual climate of the late eighteenth century was such as to obscure a recognition of the centers of authority created when men form voluntary associations.'

The intellectual climate of late twentieth century made the politics of voluntary exchange more difficult to ignore; the rise of the large firm attracted the attention of Edward Hastings Chamberlain (1933), Joan Robinson (1933), and others and introduced market power to the economists' lexicon. But of more lasting importance was the representation of the internal organization of the firm as a mini command economy developed by Ronald Coase (1937). According to Coase allocation by authoritative fiat within the firm has efficiency advantages over the use of markets, and the balance between the costs of each mode of allocation —exchange and command—determines the boundaries of the firm. These ideas were subsequently developed and extended by Herbert Simon (1951), Armen Alchian and Harold Demsetz (1972), Stephen Marglin (1974), Richard Edwards (1979), Herbert Gintis (1976), Harry Braverman (1974), Oliver Williamson (1985), Karl Shapiro and Joseph Stiglitz (1984), and others.

The politics of exchange

The key theoretical development that allowed economists to extend the reasoning of Coase is the recognition that contracts are frequently either incomplete—failing to specify in full the terms of the exchange, as in most employment contracts—or unenforceable—as is the promise to repay a loan by a borrower who may be bankrupt when the loan is due. By contrast to the incomplete contracting situation which Coase investigated, where contracts are complete there is nothing for power to be about, as the entire content of the exchange is fully determined at the moment of signing. 'What does it mean,' Oliver Hart (1995) asks rhetorically, 'to put someone "in charge" of an action or decision if all actions can be specified in a contract?' Moreover, suppose (whatever it means) someone was 'in charge' of a 'subordinate': what would motivate obedience if markets cleared and thus all parties to transaction could opt for their next best transaction at zero cost?

Transaction cost theory and the theory of incomplete contracts had asked questions that could only be answered by allowing some exercise of power within markets and firms. While the economic paradigm and the theory of political exchanges had already allowed economists to jump rather easily into the political field, the fence had also been broken to allow traffic in the opposite way: the analysis power, which was supposed to be enclosed in the political field, was bound to penetrate the very roots of the analysis blossoming in the economic field.

The theory of incomplete contracts provided not only a motive for power —enforcement of non-contractual aspects of an exchange—but as we will see in the essay below by Bowles and Gintis, a means to exercise power, that is to secure obedience to commands. Incomplete contracting and the resulting bargaining costs and possibilities for opportunistic behavior also form the basis of the contributions of Maurizio Franzini, and Paul Milgrom and John Roberts.

The latter paper makes the political structure of the firm an endogenous response to the problem of influence seeking and influences costs. Franzini's analysis of the structure of economic organizations, drawing on Albert Hirschman's trilogy—exit, loyalty, and voice—introduces the trade-off between an organization's capacity to adapt to exogenous changes and to address the problem of opportunism on the part of its members.

Ugo Pagano analyzes power as a positional good in his essay, again drawing attention to the implications of contractual incompleteness. However, in this case the analysis refers to the welfare consequences of power. In contrast to Bowles and Gintis, who find that the exercise of power is Pareto efficiency enhancing, however, Pagano's analysis makes power a case polar to that of public goods: one may well experience being subjected to the power of another as a welfare loss. Indeed, goods like power and status entail that some individual must suffer the 'negative consumption' of these goods when somebody is consuming positive amounts of them. Thus, while in the case of public goods the typical free-rider problem arises from the impossibility of excluding others from their consumption, in the case of power and other positional goods the externality problems arise from the unavoidable inclusion of others in the consumption of 'negative' amounts of the good.

The economics of power

If the first aspect of the double hiatus between politics and economics to come under attack was the apolitical conception of the economy, doubts about the schizophrenic assumptions underpinning the government servant as *Homo civicus* soon followed. Less than a decade after Coase's essay on the firm as a command economy, Frederich Hayek's (1945) attack on the informational foundations of the theory of state intervention captured the attention of economists. Optimism concerning government intervention to attenuate market failures had been unduly fostered, Hayek wrote, by the assumption that the appropriate government servants possessed, or could possess, the information necessary to implement allocations improving on those provided by markets.

Before another decade was through Kenneth Arrow (1951) had demonstrated the impossibility of a democratic aggregation of preferences consistent with a set of axioms apparently reflecting a minimalist version of the philosophical commitments of liberalism. The result was to throw into question the presumption that the state could implement citizen preferences where these conflicted with market outcomes, even if the information problems raised by Hayek were not decisive.

Anthony Downs' *An economic theory of democracy* (1957), James Buchanan and Gordon Tullock's *Calculus of consent* (1962), and Mancur Olsen's *Logic of collective action* (1965) further extended the model of self-interested individual action to the political sphere. These and subsequent contributions of public choice theory by Gary Becker (1983) and others brought governments and markets under the same lens: outcomes in both spheres were now understood as manifestations of the interplay of intentional actors, both governmental and private.

Neither the rational actor view of politics nor the political interpretation of economic institutions was entirely new. The model of political behavior as intentional action goes back at least to Nicolò Machiavelli, and the representation of markets, firms, and other economic institutions as political arenas was amply developed by Karl Marx. What the recent trespassing across the boundaries of politics and economics has done, however, is not simply to rediscover old truths (or to recycle dubious claims), but rather to embed the older themes of political economy in a general model of individual interaction and generalized competition in electoral arenas no less than in markets.

Thus Donald Wittman's essay invokes the founding principle of public choice economics—that 'understanding…political organizations should be based on the same economic principles that are used to explain economic organization'—with the innovation that the key concept used—transactions costs—is one foreign to the conventional neoclassical paradigm.

Albert Breton argues for a neo-Madisonian alternative to the public choice, public economics, and welfare economics accounts of what governments actually do. Gianluigi Galeotti and Viktor Vanberg develop the analogies between political and economic competition and explore the associated dilemmas of accountability and efficiency of governmental outcomes. Building on these and related themes John Dunn argues for the development of an integrated political economy as a common field of study.

The expanding domain of economics

While the resulting work has obliterated the methodological boundary between politics and economics and has installed *Homo economicus* in the leading role among the *dramatis personae* of social science, the result has been not only an 'expansion of the domain of economies' in Armen Alchian's words, but a reconsideration of some of its usual practices. Among these two are striking.

First, as the rational actor model has been applied to the political arena the deficiencies of the standard assumption of self-regarding and outcomeoriented preferences as a behavioral model have become apparent. Forms of political behavior—even the most rudimentary such as voting—often escape explanation within the terms of the standard rational actor model. Thus understanding ethnic identity, the politics of exclusion, and nationalism requires a broadening of the notion of preferences and a more searching inquiry into their provenance.

The papers by Russell Hardin on norms of exclusion, by Ronald Wintrobe on ethnic capital, and the late Ernest Gellner on nationalism reflect these new interests. Hardin points out that 'solving' collective action problems may be undesirable where the results are exclusive or hostile towards others. Wintrobe explains why there may be an 'overinvestment' in ethnic capital, leading to high levels of ethnic identity and interethnic tensions. Gellner offers a sweeping interpretation of the interaction between the geographic extension of the division of labor, the development of modern 'exo-educational' institutions, and the rise of nationalism.

Gellner's theory of nationalism parallels and anticipates many topics typical of the new institutional literature (Pagano 1996): markets need a homogeneous culture requiring ethnic-specific investments that can be greatly enhanced by the political safeguards supplied by the national state. In an academic division of labor where economists (with few exceptions such as Albert Breton's (1964) contribution) were not concerned with such important issues, Gellner provided a famous and convincing explanation of nationalism. It is rather ironic that, whereas his theory appeared to many non-economists a brilliant economic interpretation of this phenomenon, some leading economists believed (and even told him) that his theory had little or nothing to do with economics: the proper 'economic' (and definitive) theory of nationalism was that individuals had a preference for it.

Second, the economic analysis of politics and of institutions generally has revealed the frequent coexistence of sharply contrasting institutional arrangements, even in highly competitive environments. As Ugo Pagano (1993) and Robert Boyer (1991) have shown, the organization of firms and labor relations contrasts sharply between Japan, Northern Europe, and the USA for example, with little apparent tendency for a single dominant form to emerge. Thus economists and other social scientists have begun to model social systems with multiple equilibria, thus rejecting the canonical economic practice of assuming a single equilibrium. Ulrich Witt's contribution applies this reasoning to the problem of institutional change, and the role of the *coup d'état.*

We dedicate these pages to the memory of Ernest Gellner, an artful trespasser across the boundaries of politics, history, anthropology, and economics. His essay, below, sadly is his last.

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Part I

Politics and power in economic organizations

2
Power in competitive exchange

Samuel Bowles and Herbert Gintis[*]

Introduction

In the standard Walrasian model of general economic equilibrium, competitively determined allocations maximize each agent's utility subject to that agent's wealth constraint, and prices simultaneously eliminate excess demand or supply in all markets. In competitive equilibrium, moreover, conditions of unimpeded entry and exit ensure that for each commodity (including such factors of production as labor and capital) there is a selling price such that each buyer faces a large number of sellers offering this commodity at this price, and no seller offers the commodity at a lower price; similarly there is an offer price such that each seller faces a large number of buyers offering to buy at this price, and no buyer offering to buy at a higher price.

It follows that in equilibrium, if agents A and B engage in an exchange, B's gain exactly equals the gain from his or her next best alternative. Were this not the case, competition would imply that a third agent consigned to such an alternative could have offered A a contract superior to B's, in which case A's contract with B would not have been accepted. Because in equilibrium the cost to B of foregoing an exchange with A is zero, A cannot affect B's well-being by terminating the exchange, and hence has no power over B.[1] In Walrasian competitive equilibrium of non-colluding agents, sanctions cannot be imposed.

Because each economic agent can refuse any exchange at no cost, power must be absent in an equilibrium of a competitive economy. Hence political and moral questions concerning the distribution of power and the presence of coercion in exchange relations do not arise.[2] David Gauthier expresses this view with considerable clarity:

> the operation of market cannot in itself raise any evaluative issues… the presumption of free activity ensures that no one is subject to any form of compulsion or to any type of limitation not already affecting her own actions as a solitary individual.[3]

It is precisely this putative lack of compulsion in voluntary exchange which allows Robert Nozick to distinguish between taxation and profits on the grounds that the former is 'on a par with forced labor' while the latter is not.[4] Less transparently, the claimed absence of coercion in voluntary exchange motivates John Rawls' concept of justice: 'These principles presuppose that the social structure can be divided into two more or less distinct parts…those…that define and secure the equal liberties of citizenship and those that specify and establish social and economic inequalities.' In the former sphere, political liberty—meaning 'the right to vote and to be eligible for public office'—should obtain. In the latter, by contrast, 'positions of authority and offices of command need not be subject to democratic election, but rather 'must be accessible to all.'[5]

But as we will see, Gauthier's claim that compulsion is absent in the market is mistaken. Rather, the exercise of power is a characteristic of voluntary exchange under quite general conditions.[6] For agent A to have power over agent B it is sufficient that, by imposing or threatening to impose sanctions on B, A is capable of affecting B's actions in ways which further A's interests, while B lacks this capacity with respect to A.[7] While this conception of power is not exhaustive (we present a sufficient condition only) to regard the application of sanctions to further one's interests as an exercise of power is uncontroversial. Thus Harold Lasswell and Abraham Kaplan make the expectation of 'severe sanctions…to sustain a policy against opposition' a defining characteristic of a power relationship.[8] And Talcott Parsons makes 'the presumption of enforcement by negative sanctions…in case of recalcitrance…' a necessary condition for the exercise of power.[9] By a 'competitive capitalist economy' we mean one in which productive assets are privately owned, production is carried out by employees, and all markets are characterized by free entry and large numbers of buyers and sellers. We will show that in such an economy, voluntary market exchange engenders a structure of power relations among economic agents in equilibrium.

The assertion that the capitalist economy exhibits a system of power relations has typically been motivated by reference to such deviations from competitive conditions as to pervasiveness of monopoly,[10] the autonomy of management,[11] corporate influence over government policy and consumer demand,[12] and the ubiquity of disequilibrium.[13] Whatever their attractions, none of these approaches offers an adequate response to the fundamental claim of the Walrasian model: that capitalism is a system of generalized choice in which the extensive opportunities to walk away from any transaction preclude the private use of sanctions in the absence of collusion. Even where empirical deviations from the competitive ideal are admitted the presumed prescription is to restore competition, a not altogether utopian remedy in the highly competitive global economy of the late twentieth century.

For this reason approaches to economic power that fail to challenge the Walrasian logic can reasonably be accused of grounding what is ostensibly a fundamental aspect of economic life, power, on an ephemeral deviation of economic reality from the conditions of competitive equilibrium. It is thus not surprising that economists have traditionally banished 'power' from their lexicon in analyzing market behavior. Like other phenomena inconsistent with competitive equilibrium, the real-world exercise of economic power in the sense we have indicated is thus thought to be an anomalous and unimportant feature of modern capitalism.[14]

Among economic theorists, however, the Walrasian paradigm has come under serious criticism. Contemporary developments in microeconomic theory, particularly transactions cost analysis and the theory of principal-agent relationships, have suggested major revisions.[15] Far from representing a general analysis of informed, self-interested economic behavior, it is now clear that the Walrasian model is in fact a limiting case based on an arbitrary truncation of the concept of rational action. The Walrasian model allows agents to optimize when they shop for groceries but not, for instance, when they decide how hard to work for their employer or whether to default on a loan they have secured.[16]

We will explore the implications of what might be termed post-Walrasian microeconomic theory for the study of the competitive economy as a political entity, demonstrating in particular that even in competitive equilibrium, a market economy sustains a system of power relations.[17] We demonstrate the existence of economic power by relaxing one of the more implausible assumptions of the Walrasian model: the *exogenous enforcement axiom,* which holds that exchanges between agents in the economy can be enforced by a third party (e.g. the judicial system) at no cost to the exchanging parties. Neither the contract between employer and employee, nor that between owner and manager, nor that between lender and borrower, nor that between parties to international exchanges, is sufficiently subject to third-party enforcement to render the Walrasian account of these exchange relationships even remotely acceptable.[18]

In cases where third-party enforcement is infeasible or excessively costly, the exchanging agents must themselves enforce their agreements. In the presence of endogenous enforcement, the terms of exchange are continually subject to *de facto* respecification by the exchanging parties. The threat of coercive sanction, the defining instrument of the state as third-party enforcer, is thus but one among several stratagems invoked by economic agents in the protection of their claims. Privately imposed sanctions, we will see, are essential to the workings of the key exchanges of a capitalist economy: those involving capital and labor. The neat division of society into an arena characterized by sanction (the state), and a sphere of voluntary exchange devoid of political content (the economy), thus collapses.

The puzzle of obedience

Ronald Coase (1937) famously distinguished the firm from relationships among individual contractors by the ability of one of the parties in the labor exchange—the employer—to command the other—the employee — with the expectation of obedience. The distinction was not new. D.H. Robertson (1930) had earlier referred to firms as 'islands of conscious power in this ocean of unconscious cooperation like lumps of butter coagulating in a pail of buttermilk' (p. 85). Well before him Marx had made the distinction between the celebrated freedom of market exchange and the workplace domination of the worker by the owner a fulcrum of this theory of exploitation.

Oliver Williamson subsequently used this distinction to erect the 'markets and hierarchies' approach to the firm. The firm is thus represented as a mini-command economy, circumscribed by the market arena which is by contrast characterized by the absence of authority relationships. But this neat distinction between market and hierarchy begs a key question, one that remarkably neither Coase nor Williamson thought to ask, namely, why should the employee obey the command of the employer? Noticing the lack of a good answer, Armen Alchian and Harold Demsetz (1972) challenged the idea that the firm is a command economy, suggesting that the labor market is not different in this respect from other markets.

> The firm…has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people…. Wherein then is the relationship between a grocer and his employee different from that between a grocer and his customer?

Their well-known theory of the structure of the 'classical capitalist' firm shows how hierarchy (in the person of a monitor possessing both control rights—the right to fire—and residual claimancy rights) might emerge from the unanimous decisions of a work team of equal members seeking to advance their well-being by controlling shirking. The analogy to the Hobbesian account of the genesis of an authoritarian government from a 'free and equal' state of nature can hardly have been accidental. Their account hinges on the key but unmotivated assumption that monitoring itself is relatively difficult to monitor: otherwise it would