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# Contested Exchange: Political Economy and Modern Economic Theory

By SAMUEL BOWLES AND HERBERT GINTIS\*

Contemporary liberal writers share a fundamental assumption: societal rule-making concerns not the political structure of the economy, but rather the political structure of the state. As we shall see, an outmoded variant of microeconomic theory has played no small part in suppressing the acute question of economic power and its accountability.

Concerns of class and power, which have occupied a major position in the thought of Marxists, institutionalists, and historians, thus find no echo in modern liberal orthodoxy. Indeed, in the twentieth century we have seen the ascendancy of a social theory that makes politics and the state co-extensive. This is evident in the identification of the public sphere of society with relations of citizens to the state and the private sphere with familial and contractual relationships; the social relationships in the public sphere are deemed political and the just realm of democratic claims, while the remaining social relations, called private, are seen as lying beyond the limits of political discourse. Thus what is transparent to the unschooled—that the capitalist economy confers power upon those who occupy leading positions in the business world—is denied by the sophisticated.

Neoclassical economics supplies an elegant argument precisely to this effect. The only form of power that this theory recognizes is the command over goods and services, called purchasing power, that is summarized by the location of the relevant budget constraint. The price-taking economic agent enshrined in our texts has infinite power over quantities and none over price. In competitive

equilibrium all markets clear, no agent is quantity constrained, and as a result, all agents are equally powerful or powerless as the case may be. Even the apparent power of the boss is an illusion, for as Schumpeter pointed out long ago, competitive pressures will force bosses (or one might add worker-elected factory councils) to do whatever is cost minimizing given available technologies and factor prices.

Our claim that the capitalist economy has a political structure, one which is undemocratic and on democratic grounds ought to be replaced by a set of rules assuring both liberty and popular accountability of power, will thus strike those with the benefit of training in economics as not so much wrong as nonsensical. Not by ideological inclination alone will most contemporary economists be more at home discussing the Pareto-inferior properties of the U.S. Department of Transportation than the undemocratic political structure of General Motors.

But the silence of economists on the political structure of the economy is unwarranted; perhaps surprisingly, a consistent application of the axioms of rational self-interested individual action does not support the neoclassical view of the apolitical economy but rather, as we shall see, provides the microeconomic basis for the study of economic power.

## I. Contested Exchange: Political Structure and Competitive Markets

By the political structure of the economy, we mean the ensemble of rules governing investment, production, and distribution in economic institutions. An actor who holds decision-making authority within the political structure of the economy is said to have *economic power*. We call decision-making

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authority *substantive* if its exercise has non-trivial allocative or distributive effects.

The political theory implicit in the neoclassical model may then be neatly summarized: in the competitive equilibrium of a capitalist economy, where there is power (in the firm), authority is nonsubstantive and where decision-making authority is substantive (in markets), there is no power.

This treatment of economic power in neoclassical theory flows from three central commitments. The first, which we may term the *neutrality of property assignments* asserts that the distribution of ownership rights has no substantive allocative implications: any Pareto-efficient equilibrium can be supported by some initial assignment of property titles followed by competitive exchange; its most celebrated version is the Coase Theorem, according to which, even in the case of market failures, the initial assignments of titles to property among competitive agents has purely distributional effects in equilibrium.

The second commitment is the *irrelevance of command*, according to which the political structure of firms has neither allocative nor distributive effects in competitive equilibrium. Organizational forms may be more or less efficient, of course, but among efficient forms, the source of decision-making authority or, more formally, the location of sovereignty, is irrelevant: how the quarterback is selected does not alter the way the game is played. The third, the *efficiency of market exchange*, asserts that in the absence of market failures, a competitive market equilibrium is Pareto efficient.

Taken together, these three neoclassical propositions imply a radical separation of distributional, political, and allocational concerns. Were these propositions correct, a wide range of normative objectives, whether egalitarian or democratic, could be implemented simply through a reassignment of either property titles or decision-making rights without direct intervention in the allocational process and, indeed, without allocational effects. Thus while Paul Samuelson's commonplace remark that in a competitive model it makes no difference whether capital hires labor or the other way might

tax the credulity of sophisticated students of social life, it raises no eyebrows among contemporary neoclassical economists—it should.

The still widely accepted model by which the apparent power of economic elites is dismissed as illusory in competitive equilibrium is based on what is now increasingly recognized as an outmoded Walrasian conception of contractual exchange. With the aid of new developments in the theory of moral hazard, principal-agent relations, transactions costs, and radical political economy, the Walrasian conception of exchange may be shown to be a limiting case of rather questionable importance. (Some of the relevant literature is cited in Joseph Stiglitz, 1987; Oliver Williamson, 1984; Gintis, 1976; and Bowles, 1987.)

James Buchanan has clearly identified a critical assumption of the underlying Walrasian model. Describing a prototypical exchange at his local roadside stand, Buchanan writes: "I do not know the fruit salesman personally, and I have no particular interest in his well-being. He reciprocates this attitude... Yet the two of us are able to complete an exchange expeditiously... We transact exchanges efficiently because both parties agree on the property rights relevant to them" (1975, p. 17).

When there is agreement between the parties to exchange concerning the relevant property rights, and when this agreement can be costlessly enforced, the neoclassical commitments follow. But, what if exchange must take place in the absence of (or under conditions precluding the enforceability of) such an agreement? In such cases we have a political problem. However, as Abba Lerner has observed, for neoclassical economics: "An economic transaction is a solved political problem. Economics has gained the title of queen of the social sciences by choosing solved political problems as its domain" (1972, p. 259).

Yet two of the exchanges most fundamental to the functioning of the capitalist economy have precisely the character of unsolved political problems. These are exchanges involving labor and financial capital. An employer offers a wage in exchange for which

the employee offers not some fully specifiable *pro quo*, but rather at best an unenforceable promise to perform at an adequate level of intensity, care, and initiative. The employer must develop a monitoring system to determine whether this level has been achieved in any particular case and must have means to discipline an employee whose performance is deemed unsatisfactory.

Similarly, a financial investor makes funds available to an enterprise, receiving *ex ante* neither a determinate return, nor even a specific probability distribution of returns, but rather the promise that the fiduciary obligations of the recipient will be dutifully carried out. The financial investor's interest is in this case protected only by instituting a costly array of rewards and constraints. The structure of financial intermediation, the legal regulation of securities markets, as well as customary economic practices specifying the conditions of creditworthiness, must be drawn upon to monitor the use of funds and to induce borrowers (such as the managers of firms) to act in the interest of financial investors.

Labor and finance capital are only the most important of a general category of goods that are subject to what we term *contested exchange*. An exchange is contested when some aspect of the good exchanged possesses an attribute that is valuable to the buyer, is costly to provide, and is at the same time difficult to measure or otherwise not subject to determinate contractual specification. In such cases, the *ex post* terms of exchange are determined by the monitoring, sanctioning, and incentive mechanisms instituted by the buyer to induce proper seller behavior. These systems for the endogenous enforcement of competing claims in the case of contested exchange are recognizable as elements of the economy's political structure.

In liberal societies, where the legitimate exercise of physical coercion is monopolized by the state, the instruments available to private economic agents for the endogenous enforcement of contracts are severely circumscribed. Among these instruments *contingent renewal* holds a central position: the buyer induces seller compliance by prom-

ising to renew the contract only if satisfied with the seller's performance. In Albert Hirschman's insightful terms, contingent renewal power is based on exit rather than on voice.

Nonrenewal of exchange is a threat, however, only if the buyer offers terms better than the seller's next best alternative. To render contingent renewal effective, then, the buyer must offer the seller what we term an *enforcement rent*. This rent persists in a competitive equilibrium for the simple reason that it results from the competitive optimizing behavior of the agents on the short side of the market. Those with the power to change the terms of the exchange have no incentive to do so; quantity constrained agents on the long-side of the market—the unemployed, the credit constrained—thus cannot compete away the rent.

For this reason, contested exchange markets do not generally clear in competitive equilibrium. Thus some agents have power over both price and quantity while others have power over neither. In general we may distinguish three types of agents: those on the short side of the market who use enforcement rents to as an instrument of control (for example, employers, financial intermediaries), those on the long side who succeed in making a transaction and thus receive the rents (the employed, the credit-worthy), and the long-siders who fail to make a transaction (the unemployed, the credit rationed). Because the short-siders are in a position to give commands which the long-siders are constrained to obey, and because some of the long-siders are quantity constrained (they cannot make a transaction), both markets and firms become arenas for the exercise of substantive economic power.

Not surprisingly, all three of the basic neoclassical propositions are false in the context of contested exchange.

## II. Property and Power: Enforcement as Market Failure

When Knut Wicksell demonstrated that in a constant returns to scale world, the results of a general competitive equilibrium would be unaltered by having agricultural workers

rent land, paying the landlords the marginal product of land and rewarding themselves with the residual rather than the converse, he assumed that the labor exchange had the usual Walrasian properties. Had he instead modeled the landlord-worker relationship as a contested exchange, it would have been perfectly clear that the location of the residual claimant status makes a very substantive difference. As has been widely recognized in the literature on hierarchical firm organization, owner-manager conflicts, and land tenure relationships, and as is confirmed by common sense, the enforcement problem arises because the agent controlling the contested variable (for example, work effort or managerial risk taking) is not the residual claimant and thus does not enjoy the full fruits and bear the full costs of his or her actions. But in the context of contested exchange, a reallocation of property rights generally involves a reallocation of residual claimant status. We thus affirm a counter-proposition, *the nonneutrality of property-assignments*: the reallocation of titles to property will generally alter the competitive equilibrium allocation, changing prices, enforcement costs, and output levels in contested exchange markets (and hence in all markets) as well as altering the distribution of income.

The nonneutrality proposition is true for yet another reason: the distribution of property rights alters the relative cost effectiveness of different endogenous enforcement mechanisms. If, for instance, workers own substantial amounts of property, they may post bonds as a condition of employment, thus reducing the costs of enforcing labor discipline. Again, if potential borrowers are wealthy, they may post collateral, thus reducing the monitoring and incentive costs of financial investors. In both cases, wealth redistributions alter competitive equilibrium allocations.

The neoclassical commitment to the irrelevance of the locus of command is also unwarranted. For in the case of contested exchange, the locus of command determines how contracts are endogenously enforced. Consider, for instance, a firm in contested exchange equilibrium in which the owner, has chosen a profit-maximizing configuration

of monitoring resources and enforcement-rents. Included in such a configuration is a profit-maximizing decision process involving an assignment of firm members to positions in the structure of command, an allocation of resources to monitor decision-making behavior, and a pattern of enforcement rents accruing to decision makers.

Now let us consider a new structure of command replicating the old in all respects save that additional firm members are permitted to participate at one or more points in the process of decision making. The owner might be able to reproduce the previously optimal decision by spreading monitoring resources across the additional decision makers, while increasing enforcement rents sufficiently to induce the original pattern of decisions. But, even assuming that the process of decision making per se does not expend real resources, this new locus of command entails an equilibrium transfer of wealth from the residual claimant to the newly empowered decision makers. The locus of command is thus not irrelevant, but has distributional effects even when the alternatives contemplated are limited to otherwise equivalent allocations.

The example can be significantly extended. Indeed, we may suggest a general *principle of induced autocracy*, that asserts that short-side agents in competitive financial markets will, under very general conditions, prefer to deal with firms controlled by a relatively small subgroup of members unaccountable to the general membership for its actions. Suppose the key operating parameters that a firm must choose have the following characteristics. First, these parameters render the relationship between the firm's decision makers and its financial investors one of contested exchange (i.e., the parameters are costly to monitor and decision makers are motivated by enforcement rents and contingent renewal). Second, the firm's performance depends upon the key parameters chosen, but not upon the process by which they were determined (i.e., the political process has no independent effect upon performance). Third, each decision maker's choice of key parameters is a function of his or her preferences and the incentives provided. Fourth, suppose the final val-

ues of the key parameters represent some convex combination (possibly degenerate) of the choices of members participating in the structure of command. Then financial investors will prefer a structure of command in which the number of participating decision makers is at most one greater than the number of key parameters to be chosen.<sup>1</sup> The irrelevance of command is thus false.

The third neoclassical proposition, the efficiency of market exchange, fares no better. Indeed, we may demonstrate the quite general *principle of Pareto-improving redistribution*: in any contested exchange equilibrium with positive monitoring costs, there will exist a redistribution of income entailing a Pareto-superior allocation of economic resources. This is the case because every cost-minimizing enforcement strategy will involve both enforcement rents—a distribution variable, and monitoring costs—a resource-using variable. Cost-minimizing claim enforcement is not efficient because it treats the resource-using and the non-resource-using enforcement instruments equivalently despite the fact that the former has social opportunity costs and the latter does not.

To see that this is the case, suppose that, starting from a cost-minimizing contested exchange equilibrium, the buyer increases the enforcement rent offered the seller by a small amount, while at the same time reducing the real resources devoted to monitoring, so as to maintain a constant level of seller compliance. Then the same quality of the contested good has been provided at a smaller expenditure of real resources despite the fact that (by construction) buyer costs have risen. Hence there must exist some redistribution between buyer and seller which renders both better off.

The principle of Pareto-improving redistributions contrasts sharply with the widely accepted “neo-Coasean” notion that competitive firms will choose “efficient” forms of monitoring. The flaw in the neo-Coasean

argument is simple: it fails to investigate explicitly the instruments available to the firm for disciplining wayward firm members. When these means involve contingent renewal, minimizing transactions *costs* does not entail minimizing transactions *resources*, as some instruments—the enforcement rents—while costly to the enforcer, bear no social opportunity costs. In the two cases we have focused upon—financial markets and labor markets—the implications are clear: by comparison to the profit-maximizing equilibrium, a small reduction in the interest rate or increase in the wage, followed by a suitable redistribution of property titles, would be Pareto improving.

### III. Economic Democracy and Property Distribution

Would-be contemporary constitution makers may well ponder these results. For they point to the importance of economic power, not only as a problem for democratic accountability, but as challenge to the putative economic rationality of competitive equilibrium in a private ownership economy. Three implications are particularly striking.

First, the argumentation surrounding the nonneutrality of property assignments suggests that enforcement costs will be minimized by locating residual claimant status in those agents supplying the service whose monitoring is relatively difficult. The fact that residual claimant status in the modern capitalist corporation resides in owners who generally supply little more than financial assets, the monitoring costs of which strikingly approach the Walrasian ideal, is simply irrational from the perspective of minimizing enforcement cost. A redistribution of ownership to employees of the firm might yield major efficiency gains.

Second, the principle of induced hierarchy demonstrates that worker-run and worker-owned firms will be shunned by financial markets despite a cost structure which on the above reasoning may be favorable by comparison with more hierarchical firms owned by the wealthy.

Third, while the transaction costs of democratic decision making may militate against economic democracy and a generalization of

<sup>1</sup>For instance, if there is one key parameter (for example, a point on a risk/expected return schedule), financial investors will prefer either a single decision maker, or two decision makers whose choices lie on opposite sides of the investors' optimum. See Gintis (1987) for a fuller statement and proof.

property ownership, these costs may be rather small compared to the high levels of enforcement cost in a capitalist economy, for as we have seen, these costs include not only by the direct monitoring of transactions in which the effective decision makers are rarely the residual claimants, but those associated with equilibrium credit rationing and unemployment as well.

The theory of contested exchange thus does more than illuminate the undemocratic political structure of the economy; it suggests that a competitive capitalist economy of hierarchically structured firms is not simply unequal, undemocratic, and inefficient, but rather that it may be inefficient *because* it is unequal and undemocratic.

Indeed, a stronger position might be sustained: that a more egalitarian and democratic economy would support greater acceptance of the rules of the game and less contestation over the distribution of economic reward, allowing a further reduction in enforcement costs, (this argument is made in Bowles, 1985). But to support this claim would take us beyond the concerns of this essay, to issues with which we have dealt elsewhere (1986).

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