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1 Post-Walrasian political economy

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1 Introduction: new light on an old debate

What rules of the game render an economy participatory, fair, and democratically accountable without compromising efficiency and other valued social goals? The chapters in this volume explore this question from the vantage point of the revolution currently under way in microeconomic theory constituted by the abandonment of the simple world of Walrasian general equilibrium in favor of a richer world of imperfect information, incomplete markets, unenforceable contracts, costly transactions, and strategic interaction. In this new world people do not always do what they are supposed to do, nor do they always know all that they would like to know.¹

By the “Walrasian model” we mean the strand of neoclassical economics that proceeds from the assumptions that preferences are exogenously determined, contracts are exogenously enforced, and economic agents have infinite information-processing capacity (Arrow and Debreu, 1954). Post-Walrasian economics, as we will see in this Introduction, departs from one or more of these assumptions, asserting instead the implications of bounded rationality (Heiner, Chapter 5 in this volume), the importance of incomplete or incompletely-enforceable contracts and the social origin of tastes, values, and commitments.

These new developments in microeconomic theory provide the basis for a rethinking of the old debate that pits economic planning against the market. Post-Walrasian microeconomic theory also allows us to add an essential missing term to the economists’ “socialism versus capitalism” debate: namely, democracy (Weitzman, Chapter 18 in this volume). The last great round of this debate took place during the 1930s, with Oscar Lange and other advocates of socialist planning contesting the claims of Friedrich Hayek and other advocates of capitalist market allocations (Hayek, 1935; Lange and Taylor, 1938). The upshot of that debate, at least with the hindsight made possible by modern general equilibrium economics (Ortuño-Ortín, Roemer and Silvestre, Chapter 17 in this volume), was that in a world of fully informed and well-motivated agents a socialist planner could allocate resources as well as the market in the absence of market failures, and could do better in the presence of market failures arising from externalities and increasing returns to scale.

The socialist’s victory in that round was ironic, for the debate was waged and won entirely on the terrain of the then-standard Walrasian model, often thought to be little more than an apologia for capitalism. Not surprisingly, the victory was

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short-lived. The advocates of capitalism quickly challenged the Walrasian model in favor of more plausible assumptions about information and motivation. Starting with Hayek's essay on information (Hayek, 1945) and extending through contemporary developments in the theory of public choice, mechanism design, and rent-seeking, the critics of socialism forged a compelling counter-argument: in a world of imperfect information and opportunistic agents, markets and private property provide advantageous if second-best solutions to problems of allocation.

But this conservative counter-attack has been only partly successful. For one thing, the problems of externalities and non-convexities raised in criticism of unregulated market allocations half a century ago are if anything even more pressing today, as environmental problems and global income inequality command increasing attention. For another, the new theoretical tools deployed in the defense of the free market reveal with microanalytic clarity what non-neoclassical economists have long maintained: pervasive market failures operate in the labor and financial markets of capitalist economies. The possibilities for a new economic order lie in understanding, exploiting, and correcting these market failures.

2 Post-Walrasian democratic theory

Just as the Walrasian model proved to be an inadequate framework for analysis of problems of allocation and distribution in the 1930s and subsequent decades, it is increasingly recognized as an impoverished approach to the questions of liberty and democratic accountability, especially as these are now raised in the context of economic organizations.

To see why this is true it is well to note the chasm that separates democratic concerns from the assumptions of the Walrasian model. First, the most influential advocates of economic democracy, from J. S. Mill to C. B. MacPherson and Robert Dahl, have seen democracy not only as a decision-making process but as a type of society fostering particular paths of human development. In *Representative Government*, Mill asserted that:

The most important point of excellence which any form of government can possess is to promote the virtue and intelligence of the people themselves. The first question in respect to any political institutions is how far they tend to foster in the members of the community the various desirable qualities, moral and intellectual. (Mill, 1958:25)

Yet the Walrasian assumption of exogenous preferences, and indeed the limited concept of human agents captured in the notion of the utility function, precludes any such inquiry. A viable theory of democratic governance must encompass, or at least not exclude, questions surrounding the process of human development.

A second major concern in democratic theory is the legitimacy of institutions and the obedience to laws. Indeed it seemed obvious to nineteenth- and early twentieth-century democratic thinkers that adherence to law in a society of autonomous citizens was problematic and that democratic participation in the

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making of laws might enhance voluntary compliance and reduce enforcement costs. In what is perhaps the most frequently cited nineteenth-century text on democracy, *Democracy in America*, Alexis de Tocqueville wrote:

The American man of the people has conceived a high idea of political rights because he has some . . . Whereas the corresponding man in Europe would be prejudiced against all authority, even the highest, the American uncomplainingly obeys the lowest of his officials. (Tocqueville, 1969:238)

While Tocqueville's description of the law-abiding citizen may be overdrawn, his conclusion is difficult to fault:

In a country with universal suffrage . . . the moral strength of the government is greatly increased. (Tocqueville, 1969:238)

Tocqueville is not alone in asserting the superiority of democratic rule from the standpoint of *voluntary compliance to and enforcement of laws and regulations*. But the Walrasian paradigm provides no tools for the analysis of enforcement when compliance is contingent. Indeed, even the standard theoretical treatments of the democratic firm are flawed in this respect, taking no account of the possibly superior ability of a democratic system of firm governance to foster voluntary compliance and to reduce enforcement costs in the face of such common problems as free-riding. The underlying issue here is one of agency: what contribution can democracy make to the solution of problems that arise in social interactions in the presence of incentive incompatibilities that generate market failures or their analogues in the realm of governance?

A third concern of democratic theory that escapes scrutiny within the Walrasian paradigm is the stability and evolutionary viability of systems of democratic governance in a competitive environment. It has long been recognized that democratic organizations or states might be superior in a number of respects, but yet be unable to survive in military or economic competition with despotic organizations. Tocqueville, for example, thought that

For a democratic republic to survive without trouble in a European nation, it would be necessary for republics to be established in all the others at the same time. (Tocqueville, 1969:224)

Issues of evolutionary viability and stability are essential to the analysis not only of states but also of democratic firms in a competitive environment (Levine, Chapter 10 in this volume). But on these and related questions, the Walrasian paradigm is silent, for adequate treatment requires the analysis of multiple equilibria, the resulting path dependency of social outcomes and the evolutionary consequences of strong environmental effects (Dow; Moene and Wallerstein, Chapters 11 and 9 in this volume). These are excluded from the Walrasian paradigm, by practice if not by logic.

These deficiencies of the Walrasian approach have not, of course, deterred political scientists and economists from constructing what might be called a neoclassical economic theory of democracy. But if we are correct, it is precisely the abstraction from issues of human development, agency, and evolutionary

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dynamics – shortcomings endemic to the Walrasian model – that has sharply limited the major contributions in this area by Mancur Olson (1965), Anthony Downs (1957), and others. The same might be said of the neoclassical theory of economic democracy developed by Evsey Domar (1966), Benjamin Ward (1958), Jaroslav Vanek (1970), James Meade (1972a, 1972b, 1979), and subsequent writers.

In the remainder of this Introduction we will survey some of the central characteristics of the Walrasian model that have been challenged by the emerging post-Walrasian approach.

3 **Walras' fiction**

The Walrasian general equilibrium model is based on an artificially truncated concept of self-interested behavior, depicting a charming but utopian world in which conflicts abound but a promise is a promise. Abandoning this world will redirect economists to an older conception of our profession: political economy. Adam Smith and Karl Marx alike knew that a promise is not always a promise. The broad compass of their political economy embraced not only the analysis of simple acts of exchange, but issues of opportunism, changes in tastes and sentiments, collusion among agents, reciprocity, and altruism as well.

The formal codification of Smith's "invisible hand" in the economics of Leon Walras, and later of Kenneth Arrow and Gerard Debreu, was the result of a progressive paring away of what seemed extraneous or excessively complex. During the process, political economy became economics, and the analysis of the evolution of economic institutions fell to those operating on the periphery of the discipline.

The resulting model achieved a rigor that is at once its greatest appeal and the basis of the doubts now being raised concerning its adequacy. Indeed, not a decade after the Arrow–Debreu analysis swept the profession it had become clear that human actors with capacities and opportunities for strategic action were unrecognizable in the model. The *Homo economicus* of classical political economy had all but disappeared.

Adam Smith had exemplified the liberal philosophical tradition in his lively concern with human agency and its ramifications in economic theory. Walras, by contrast, had defined the pure science to which he aspired as the study of relationships among things, not people, and sought, with notable success, to eliminate the problem of agency from his purview. His device for accomplishing this – Walras' fiction – was the notion that human relationships in economics might be represented as if they were relationships among inputs and outputs:

Assuming equilibrium, we may even go so far as to abstract from entrepreneurs and simply consider the productive services as being, in a certain sense, exchanged directly for one another . . . (Walras, 1954:225)

Beginning in the 1970s, with some notable precursors, economists in a variety of fields introduced a new *Homo economicus* to the profession. The new economic man is uncompromisingly thorough, and often less benign, in pursuing his

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objectives, although he may not conform to the classical axioms of choice under uncertainty, his objectives need not be purely self-regarding, and he may lack infinite information-processing ability. Not satisfied with calculating marginal rates of substitution while shopping for groceries, he now optimizes while deciding how hard to work for his employer, how truthfully to transmit information to others, and whether the benefits exceed the costs of defaulting on a loan. These troublesome activities of the new *Homo economicus* that, Oliver Williamson notes, include “the full set of *ex ante* and *ex post* efforts to lie, cheat, steal, mislead, disguise, obfuscate, feign, distort and confuse,” (Williamson, 1985:51) are no less examples of sophisticated self-interest than buying cheap and selling dear, the bedrock behaviors of neoclassical economics.

Post-Walrasian approaches, including several chapters in this book, often deploy the tools of constrained optimization. This apparent continuity with the past has allowed the new models to be assimilated into the discipline with only token resistance. But in the process it has become clear that the Walrasian model is not premised on the informed fully rational optimizer that we had imagined, but rather on a stripped-down version of the rational agent. By taking optimizing more seriously, post-Walrasian approaches have inspired a revolution in economic thought fostering both new theoretical departures and alternative visions of capitalism.

The post-Walrasian approach differs from previous critiques of neoclassical economics by being an inside job. Earlier critics have largely questioned either its methodological precepts, such as the concept of instrumental action or of competitive equilibrium, or the empirical relevance of its standard assumptions concerning convexities and the absence of externalities. By contrast the post-Walrasian revival of political economy is based not on a rejection of neoclassical methodological precepts but rather on the systematic unravelling of their implications, and particularly on a relentless exploration of the concept of instrumental action.

4 Walrasian economics and post-Walrasian political economy

Let us review the representation of exchange relationships and economic institutions in the textbook neoclassical model. James Buchanan describes the *anonymity* of the market and the *uncontested nature of claims* by reference to “a roadside stand outside Blacksburg”:

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 ... transact exchanges efficiently because both parties agree on the property rights relevant to them. (Buchanan, 1975:17)

Armen Alchian and Harold Demsetz capture the *absence of substantive hierarchy* in their provocative observation that 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 ... [The firm] can fire or

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sue, just as I can fire my grocer by stopping purchases from him, or sue him for delivering faulty products. (Alchian and Demsetz, 1972a:777)

Indeed, there is nothing in a Walrasian model suggesting that capital has even *formal* power over labor. As Paul Samuelson (1957:894) has noted, “in a perfectly competitive market it really doesn’t matter who hires whom; so let labor hire capital.” The result, noted long ago by Joseph Schumpeter, is a *decentralization of effective power to consumers*:

The people who direct business firms only execute what is prescribed for them by wants . . . Individuals have influence only in so far as they are consumers. (Schumpeter, 1911, 1942:21)

These views taken together imply an *apolitical conception of the economy*, as noted by Abba Lerner:

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. (Lerner, 1972:259)

Through the post-Walrasian lens the economy looks considerably different.

4.1 *Markets are disciplining mechanisms*

Markets are both allocative, promoting movements to and along an exogenously defined production possibility frontier, and disciplinary, providing mechanisms for altering the supplies of inputs and production functions alike and thus shifting the production possibility frontier. Thus the labor market not only allocates workers to jobs, it also provides an environment governing the extraction of work from workers (Marglin, 1974; Gintis, 1976; Shapiro and Stiglitz, 1984; Bowles, 1985). Credit markets also exhibit non-Walrasian features: money is borrowed against a promise to repay that is not third-party-enforceable. Thus capital markets provide analogous disciplinary effects on the provision of risk-taking and other non-contractible behavior by borrowers (Stiglitz and Weiss, 1981; Gintis, 1989a, 1989b). Similar observations apply to goods markets (Telser, 1980; Klein and Leffler, 1981; Holmstrom, 1982; Gintis, 1989c). Just as allocative efficiency is a sensible normative standard for economic institutions, we may ask under what conditions markets will provide effective disciplining mechanisms.

4.2 *Enforcement capacities are a determinant of institutional evolution*

Like markets, all institutions of economic importance have consequences for the enforcement of claims arising from exchange. The evolution of institutions responds to the changing tasks and techniques of enforcement no less than to the changing techniques of production and demographic shifts stressed in standard neoclassical economic history.² Economic institutions may likewise have a

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substantial impact on endogenous enforcement environments (Skillman and Ryder, Chapter 13 in this volume). The effect of the welfare state on the distribution of income, for example, operates in part on the way in which it alters the functioning of the labor market as a worker-disciplining mechanism and not simply through the direct tax and transfer effects generally studied (Bowles and Gintis, 1982). These causal relations suggest that a major task of post-Walrasian theory is to develop a theory of institutional stability (Pagano, Chapter 6 in this volume) and institutional change (Hurwicz, Chapter 4 in this volume) where all outcomes diverge systematically from the Pareto-efficiency frontier of Walrasian economics.

4.3 *Enforcement rents persist in competitive equilibrium*

Non-Walrasian markets do not generally clear in equilibrium, since it is not generally optimal for an agent facing an endogenous enforcement problem to make an offer equivalent to a trading partner's next-best alternative. Should such an offer be accepted the partner will be indifferent to the continuation of the exchange, and there will be no means of using the threat of contract termination to enforce the *de facto* terms of exchange. As a result, some agents receive competitively determined rents that are not dissipated through the rent-seeking behavior of identical agents.

These rents include the cost of job loss in a non-clearing labor market. The cost of job loss is a rent, as it expresses the excess of the value of the worker's position over that of his or her next-best alternative. This rent is an enforcement rent, since the fear of losing it ensures the level of work intensity desired by the employer. Even where collateral is required as a condition of borrowing, credit markets may also exhibit enforcement rents: some agents would like to borrow at the going interest rate but cannot secure a loan. Identical agents who have secured loans enjoy enforcement rents, which generally afford the lender a credible threat, the termination of the loan, sufficient to induce borrower compliance with lender wishes.

4.4 *Exchange is a strategic non-anonymous relationship*

In a post-Walrasian exchange, it is often cost-minimizing to forgo the flexibility of spot contracting and to make and secure from one's trading partners long-term commitments (Goldberg, 1980; Lazear, 1981; Rebitzer, 1987). The durability of exchange relationships generally lends them a face-to-face quality involving sufficiently few actors to allow the reciprocal effects of one's actions to be taken into account in selecting a strategy. The paradigmatic form of economic action is not an agent intervening in a given external world (e.g., the behavior of a price-taking firm) but rather an interaction among two or more agents, mutually aware of the reciprocal effects of their actions.

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Because exchanges are durable and personal each agent has an interest in altering the capacities and preferences of the other, and at least one has the possibility of so doing, given the long-term and non-anonymous nature of the exchange. Agents are not “endowed” with preferences that they then take to market. Rather, the transactions are constitutive of economic agents: agents make exchanges, but exchanges also make agents.³ As a result exchanges have an evolutionary component, involving learning on the part of both agents. In this sense they are path-dependent.

These results are of course far from exhaustive. But they are suggestive of the radical shift in focus fostered by the post-Walrasian approach. Many of the contributions to this volume reflect just such a shift.

Conspicuously absent from the chapters in this volume is the traditional preoccupation with central planning versus the free market. With the unravelling of the economic systems of Eastern Europe and the Soviet Union, centrally planned non-market economies have joined unregulated laissez-faire economies as existing only in the realm of academic textbooks, and the theory of comparative economic systems must be reconceptualized accordingly (Meurs, Chapter 7 in this volume). The question, as Robert Dahl and Charles Lindblom (1953) have argued, is *how* and *when*, not *whether*, to regulate the market interactions of autonomous agents. Conspicuously present, by contrast, is the concern for participatory economic institutions, reflecting a heightened global awareness of the centrality of popular representation and civil liberties to social welfare, and the pressure to extend these from political to economic institutions.

Several chapters in this volume reflect this concern with participatory institutions by studying democracy at the lowest level of the economy: the democratic, worker-controlled, or worker-owned enterprise. The theory of enterprise democracy has been significantly deepened by the application of post-Walrasian concepts, but some of the fundamental problems remain open (Putterman, Chapter 8 in this volume). Ben-Ner (Chapter 12 in this volume) develops a general theory of cooperation and conflict in the enterprise that can be used to assess distinct distributions of control and rewards in capitalist and democratic firms. Nuti (Chapter 3 in this volume) argues that the form of worker compensation is central to the size and distribution of the firm’s net revenues. Our own Chapter 2 in this volume suggests that a key to the viability of worker ownership and control of firms in a competitive economy is the design of credit institutions and rules of ownership that overcome the failures of capitalist credit markets. Ognedal (Chapter 15 in this volume) argues that a capitalist-style stock market with extensive worker ownership is generally infeasible and unstable. Fehr (Chapter 16 in this volume) suggests that under certain conditions a membership market for labor-managed firms, with appropriate legal structures, can produce efficient outcomes. Aoki (Chapter 14 in this volume) argues that a bank-centered financial system, in which worker control in the firm is balanced by the participation of an external creditor (the bank) in the firm’s decision-

making process can produce outcomes superior to either the pure capitalist or worker-controlled firm.

5 Varieties of post-Walrasian economics

To speak of a post-Walrasian “school” would, of course, be misleading. We may clarify some common dimensions and distinct variants of the approach by pinpointing the two most critical abstractions of the Walrasian paradigm: the exogenous enforcement axiom and the assumption that agents are exogenously determined. We can then generate three variants of post-Walrasian economics by selectively dropping the exogenous enforcement and exogenous agent assumptions (see Figure 1.1).

Economists dropping the external enforcement axiom alone model what may be termed *instrumental contested exchange*, as the activities of the agents are explained as instruments towards pre-formed objectives. Yet the exchange is “contested” in the sense that the contract is not third-party-enforceable at zero cost to the parties to the exchange. Efficiency wage theory (Solow, 1980; Akerlof and Yellen, 1986) and principal–agent analysis (Ross, 1973; Shavell, 1979), as well as transactions cost analysis (Williamson, 1985) are generally of this type.

Conversely, economists who retain the external enforcement axiom but reject the exogeneity of preferences – one thinks of Sen (1977), for example – work with a model of *constitutive contractual exchange*. Here the exchange process constitutes the parties to the exchange, but the claims arising from the exchange need not be endogenously enforced. Lastly, those who drop both Walrasian assumptions, taking both the agents’ behavioral rules and the enforcement of claims as endogenous model a *constitutive contested exchange*.

It may be thought that the issue of the constitution of the actors in economic theory is independent of that of endogenous enforcement. As we have stressed, by accepting the Walrasian model’s methodological individualism and objecting only to its artificially truncated notion of self-interest, much of the post-Walrasian critique is indeed an “inside job.” Nonetheless the contested nature of social relations among economic agents in post-Walrasian approaches undermines the traditional asocial conception of the economic agent. Thus the

		<i>Enforcement of Claims</i>	
		Exogenous	Endogenous
<i>Constitution of Agents</i>			
Exogenous	Walrasian Exchange	Instrumental Contested Exchange	
Endogenous	Constitutive–Contractual Exchange	Constitutive–Contested Exchange	

Figure 1.1 Enforcement of claims

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introduction of action dependent on custom, commitment, conformity, collusion, fairness, regret, and a host of additional complex human behaviors, into economic calculation is permitted, indeed encouraged, by such a deepening of the concept of self-interest. We have suggested that such behaviors can often be modeled through a constitutive conception of individual action (Bowles and Gintis, 1986). But however they are conceptualized, the stress on the explanatory power of such behaviors for economic theory (notably in Akerlof, 1984; Jones, 1984) may well be the beginning of a series of successful incursions of sociological issues into microeconomic theory. Douglass North's (1981) treatment of transactions' cost economics with endogenous ideology is another example, as is the emerging game-theoretic literature on cooperation (Taylor, 1987).

Whether in its transactions' cost, contested exchange, efficiency wage, or some other version, the post-Walrasian approach does more than challenge the substance of the standard neoclassical model; it appears likely to foster some fundamental rethinking about the structure of economic theory itself and its relationship to empirical studies and to neighboring disciplines. The new approach endows economic theory with a degree of open-endedness and path-dependency more characteristic of biology and geology than of physics, to which economists of the Walrasian persuasion have turned for a model of their intellectual pursuits. Faced with this open-endedness, and the proliferation of theoretically coherent results and multiplicity of equilibria generated by complex exchanges, economic theory may restore a more symbiotic relationship with economic history, experimental studies, and econometric testing, these latter being essential to the choice of correct postulates incapable of derivation from any plausible set of axiomatic first principles. The interdisciplinary focus of the research of some of the leading contributors to post-Walrasian economics is suggestive in this respect. No less important, the post-Walrasian paradigm is likely to expand the disciplinary boundaries of economics to include, as in the nineteenth-century, the selective study of law, history, sociology, psychology, and politics.

Notes

1. Varieties of what we term post-Walrasian microeconomics are surveyed in Stiglitz (1987), Akerlof and Yellen (1986) and Bowles and Gintis (1990).
2. Here Douglass North's work (1990b) represents the post-Walrasian approach to the theory of economic evolution, while his earlier work with Thomas (1973) exemplifies the Walrasian tradition.
3. See Gintis (1972, 1974), Bowles and Gintis (1986: Chs.5, 6). In an earlier work (Bowles and Gintis, 1976) we analyzed the structural determinants of the constitution of agents.