

2.1 — Constituting a Group

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Recap: The Story So Far



- Markets face problems with:
 - Externalities (Coase, Demsetz)
 - Public goods, common resources (Olson, Ostrom)
 - High transaction costs
- There are situations where we may want to act collectively
 - Providing public goods, club goods, common pool resources
 - Defining property rights
 - Achieving justice



Choosing in Groups, Creating Politics



- **Methodological individualism:**
individuals have their own preferences, make choices, and bear the costs and benefits of any action
- **A group must make a choice to determine a single outcome that affects all individuals**



Choosing in Groups, Creating Politics



- Easy when each member has the same preference for an outcome, then “we” prefer that outcome
 - e.g. I prefer $A \succ B$,
 - you prefer $A \succ B$,
 - she prefers $A \succ B$,
 - so “we” prefer $A \succ B$



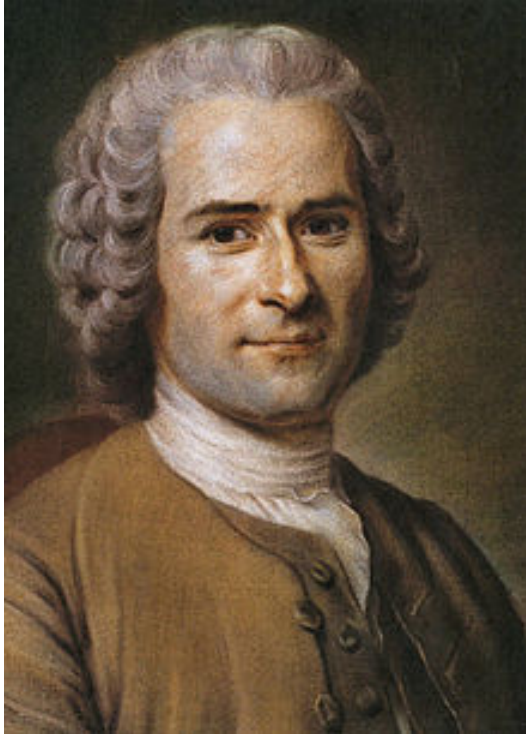
Choosing in Groups, Creating Politics



- But what if we (likely) disagree?
 - Need some procedure to aggregate our individual preferences into a single group preference
- In this case, **many (perhaps even most) members will disagree with the outcome chosen by the group**
- **How/why are individuals members of a group obliged to accept the choice of the group, even when they disagree with it**



A Puzzle



Jean-Jacques Rousseau

1712-1778

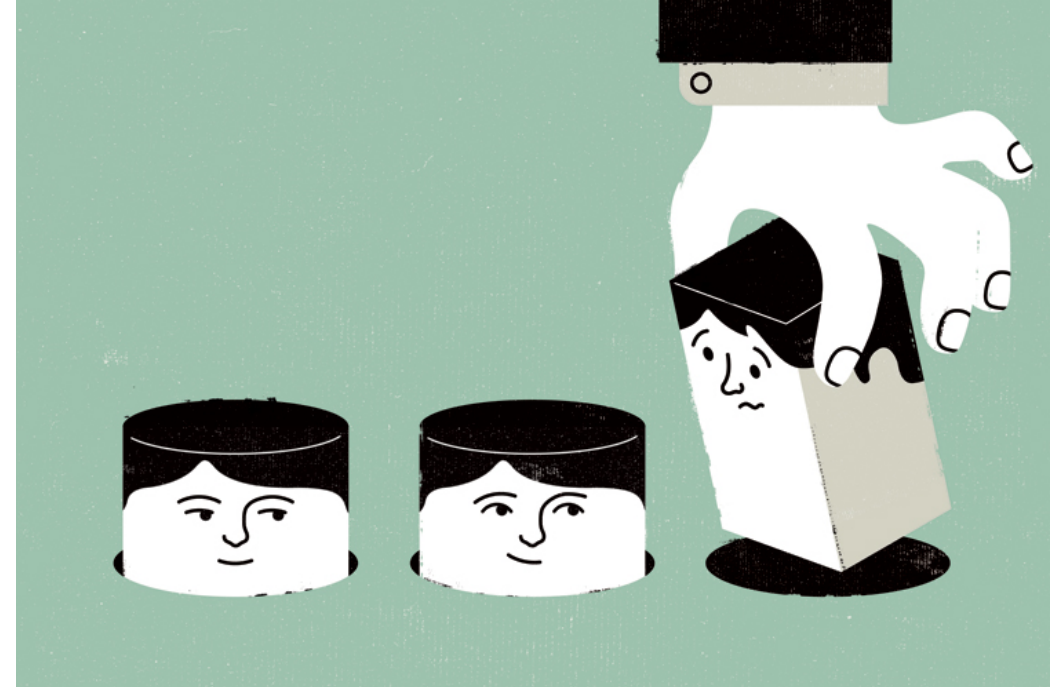
“[H]ow can a man be both free and subject to wills not his own[?]” (Book IV, Ch. 2, “Voting”),

Rousseau, Jean-Jacques, 1762, *The Social Contract*

Choosing in Groups, Creating Politics



- Individuals choose, but groups *do*
- Must be a single action/policy taken for the whole group
 - One speed limit for a road, one set of swimming pool club rules, one defense budget, etc.



Constituting a Group



- Very important then to consider how groups **constitute** themselves: **deciding how to decide**
- The Greek word commonly translated as “constitution” is *politea*, more like the “soul” of a group
 - self-identified identities, rights and obligations of citizens, a polis, etc.
- Difference between a bunch of individuals and a *group*



Constituting a Group



Aristotle

384 B.C.-322 B.C.

“[T]he constitution is in a figure the life of the city,” (Book IV, Part XI)

“...shall we say that while the race of inhabitants, as well as their place of abode, remain the same, the city is also the same, although the citizens are always dying and being born, as we call rivers and fountains the same, although the water is always flowing away and coming again? Or shall we say that the generations of men, like the rivers, are the same, but that the state changes? For, since the state is a partnership, and is a partnership of citizens in a constitution, when the form of government changes, and becomes different, then it may be supposed that the state is no longer the same...And if this is true it is evident that the *sameness of the state consists chiefly in the sameness of the constitution* [politeia], and it may be called or not called by the same name, whether the inhabitants are the same or entirely different,” (Book III, Part I).

Aristotle, *Politics*

Features of a Constitution



- A constitution contains rules about deciding how to decide
- Need not be formal, or written down
- **Everyone must unanimously consent to the constitution, so that you are obliged to follow the outcomes of politics that you disagree with**



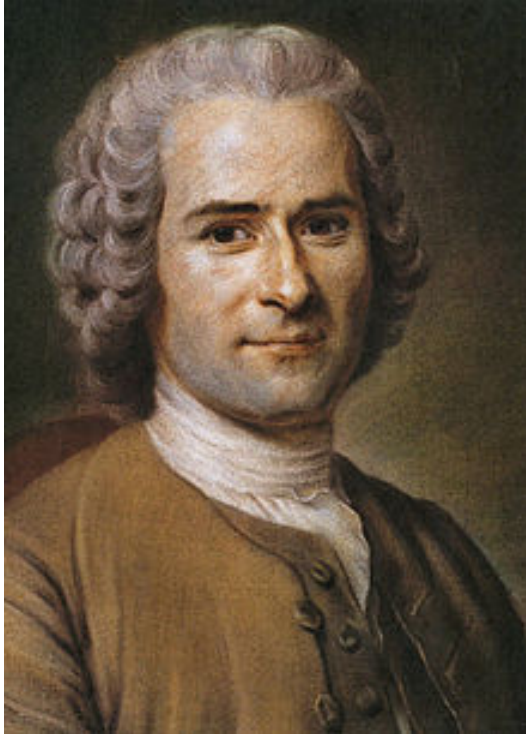
Features of a Constitution



1. **Source of sovereignty:** account of the source of the group's sovereignty, e.g. citizens' consent, a contract, or a historical event or legacy
2. **Membership:** provisions for allowing (or denying) entry into the group
3. **Collective domain:** rules to define and limit the scope of what the group may or may not demand of or do to its members (What is *mine* vs. *ours*)
4. **Decision rules:** rules for deciding how to decide normal business for the group choosing outcomes or policies
5. **Citizenship obligations:** rules to define and limit what members can demand of the group
6. **Amendment:** rules for deciding how to decide how to change the rules
7. **Exit:** rules for allowing (or denying) exit from the group



The Social Compact



Jean-Jacques Rousseau

1712-1778

“There is but one law which, from its nature, needs unanimous consent. This is the social compact; for civil association is the most voluntary of all acts...Apart from this primitive contract, the vote of the majority always binds all the rest. This follows from the contract itself. But it is asked how can a man be both free and subject to wills not his own. How are the opponents at once free and subject to laws they have not agreed to?”

“I retort that the question is wrongly put. The citizen gives his consent to all laws, including those which are passed in spite of his opposition, and even those which punish him when he dares to break any of them,” (Book IV, Ch. 2, “Voting”),

Some Useful Definitions



- **Politics:** a set of rules that we all agree are legitimate that will determine how we decide as a group
 - Makes one collective decision for the group, even though many will disagree with the decision
- **Constitution:** set of rules for deciding how and what a group will be able to decide
 - Constitutional rules supersede politics
- **Democracy:** a *particular* decision rule where an outcome is chosen for the group if any $\frac{n}{2} + 1$ of its members agree



Freedom of Association



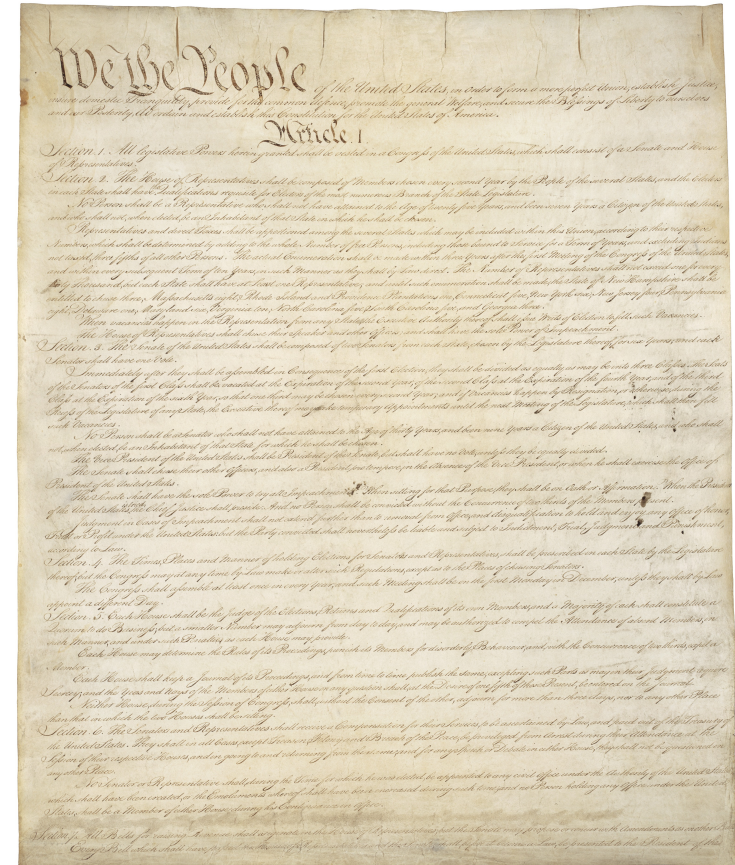
- By joining a group, you are consenting to be coerced (to follow outcomes you disagree with), so *very* important how groups are constituted:
 1. We must be able to negotiate and choose (constitutional) *rules* that we can all consent to
 2. Need to have freedom of association, to choose among many groups to join



Freedom of Association



- Difference between constitution and Constitution (a club vs. the Nation-State)
- The problem is not coercion, it's monopoly





The Credible Commitment Problem

Back to Exchange and Transaction Costs



- In a voluntary exchange, both parties expect to be made better off
- The best justification for reallocation of resources (even via coercion) is consent
- Parties would *like* to enter into binding contracts with each other, but significant transaction costs!
 - trust; enforcement



The Fundamental Transformation



Oliver Williamson

1932-

Economics Nobel 2009

- A contract between two parties constitutes a “**fundamental transformation**” from *ex ante* competitive market to an *ex post* bilateral monopoly
 - Two parties depend on one another’s performance to jointly capture the gains from exchange
 - Committing inputs into the relationship is a **specific investment**, possibly **sunk cost**
- Creates the possibility of **post-contractual opportunism** by the parties

The Fundamental Transformation



- This **bilateral dependency** creates “**quasi rents**” from cooperation that might be **appropriated** by a party
- Need to contract *ex ante* to protect *ex post* possibility of someone threatening to appropriate the rents
- Inability to prevent this may cause parties to inefficiently avoid making agreements!

Non-Credibility AKA “Cheap Talk”



- “Talk is cheap”
 - Low cost to making promises/threats you don’t intend to carry out
- Promises and threats **without commitment** will not change equilibrium behavior (with perfect information)
- If you try to bluff in poker, and your rivals know what cards you have, they will call your bluff



Non-Credibility AKA “Cheap Talk”



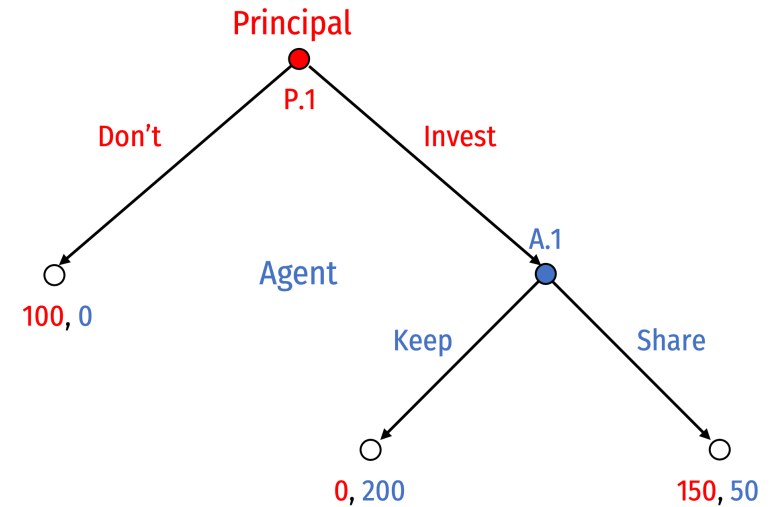
- Promises or threats must be **incentive-compatible** to work
 - Threat/promise-maker must actually stand to benefit from performing the threat/promise or suffer from not performing it
- In game theory terms: strategy must be **subgame perfect**



Promises



- Consider a **agency/investment/trust** game
- **Principal** decides to **invest** money (\$100) with **Agent**
 - Investment grows to \$200
- **Agent** can then **keep** or **share** the returns with **Principal**

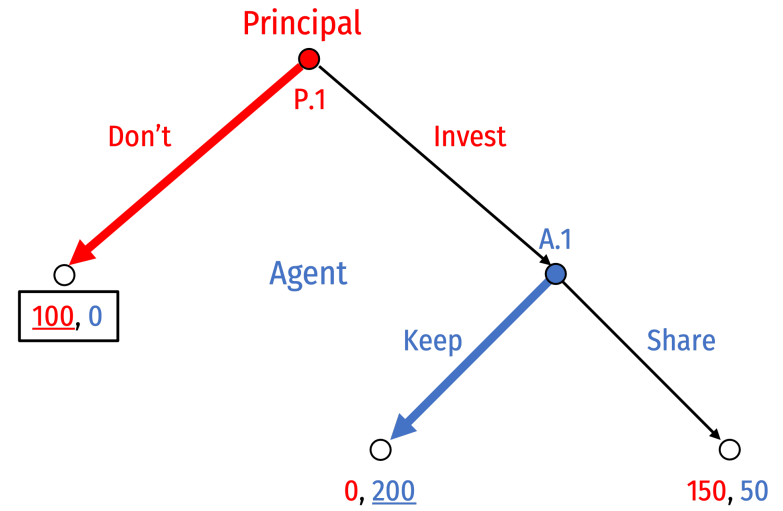


		Agent	
		Share	Keep
Principal	Don't	100 0	100 0
	Invest	150 50	0 200

Promises



- Only one Nash equilibrium: {Don't, Keep}



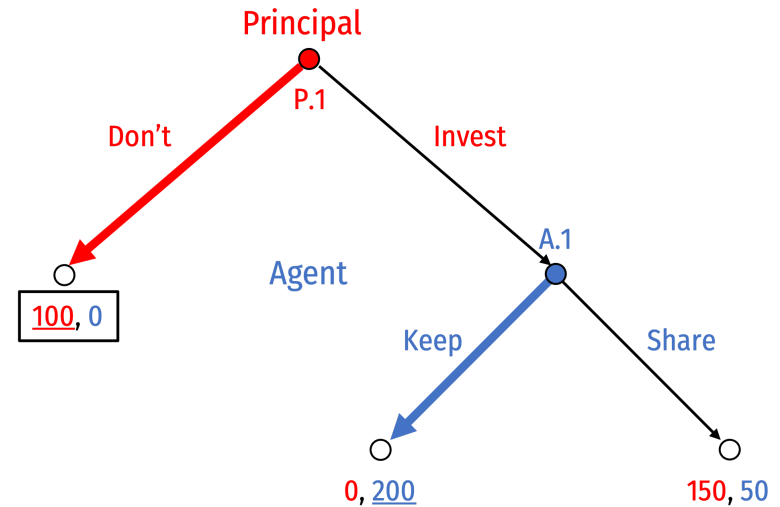
		Agent	
		Share	Keep
Principal	Don't	100 0	<u>100</u> <u>0</u>
	Invest	<u>150</u> 50	0 <u>200</u>

Promises



- Only one Nash equilibrium: {**Don't**, **Keep**}
- What if before game began, **Agent** said to **Principal**:

“If you **Invest**, I will **Share**”

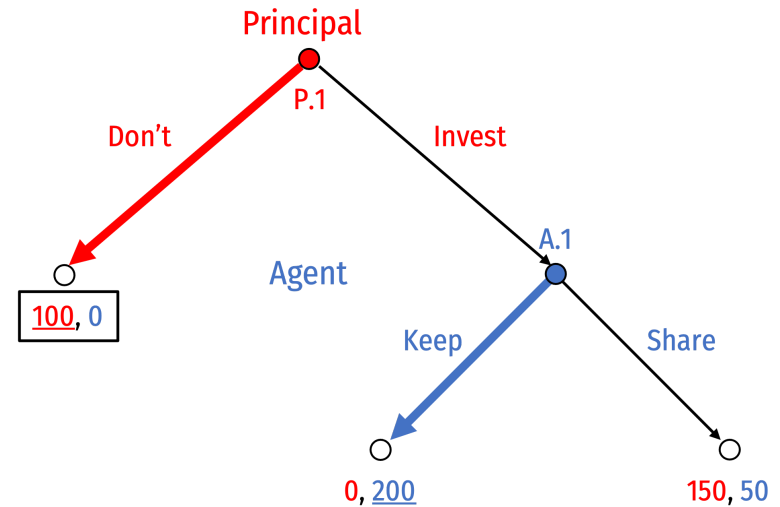


		Agent	
		Share	Keep
Principal	Don't	100 0	<u>100</u> <u>0</u>
	Invest	<u>150</u> 50	0 <u>200</u>

Promises



- Only one Nash equilibrium: {Don't, Keep}
- What if before game began, Agent said to Principal:
“If you Invest, I will Share”
- Not a credible promise



		Agent	
		Share	Keep
Principal	Don't	100 0	<u>100</u> <u>0</u>
	Invest	<u>150</u> 50	0 <u>200</u>

Appropriable Quasi-Rents



Benjamin Klein

1943-

"Coase's fundamental insight [was] that transaction, coordination, and contracting costs must be considered explicitly in explaining the extent of vertical integration...[We] explore one particular cost of using the market system-the possibility of postcontractual opportunistic behavior," (p.297)

"The particular circumstance we emphasize as likely to produce a serious threat of this type of renegeing on contracts is the presence of appropriable specialized quasi rents. After a specific investment is made and such quasi rents are created, the possibility of opportunistic behavior is very real. Following Coase's framework, this problem can be solved in two possible ways: vertical integration or contracts," (p.298)

Asset Specificity: Example



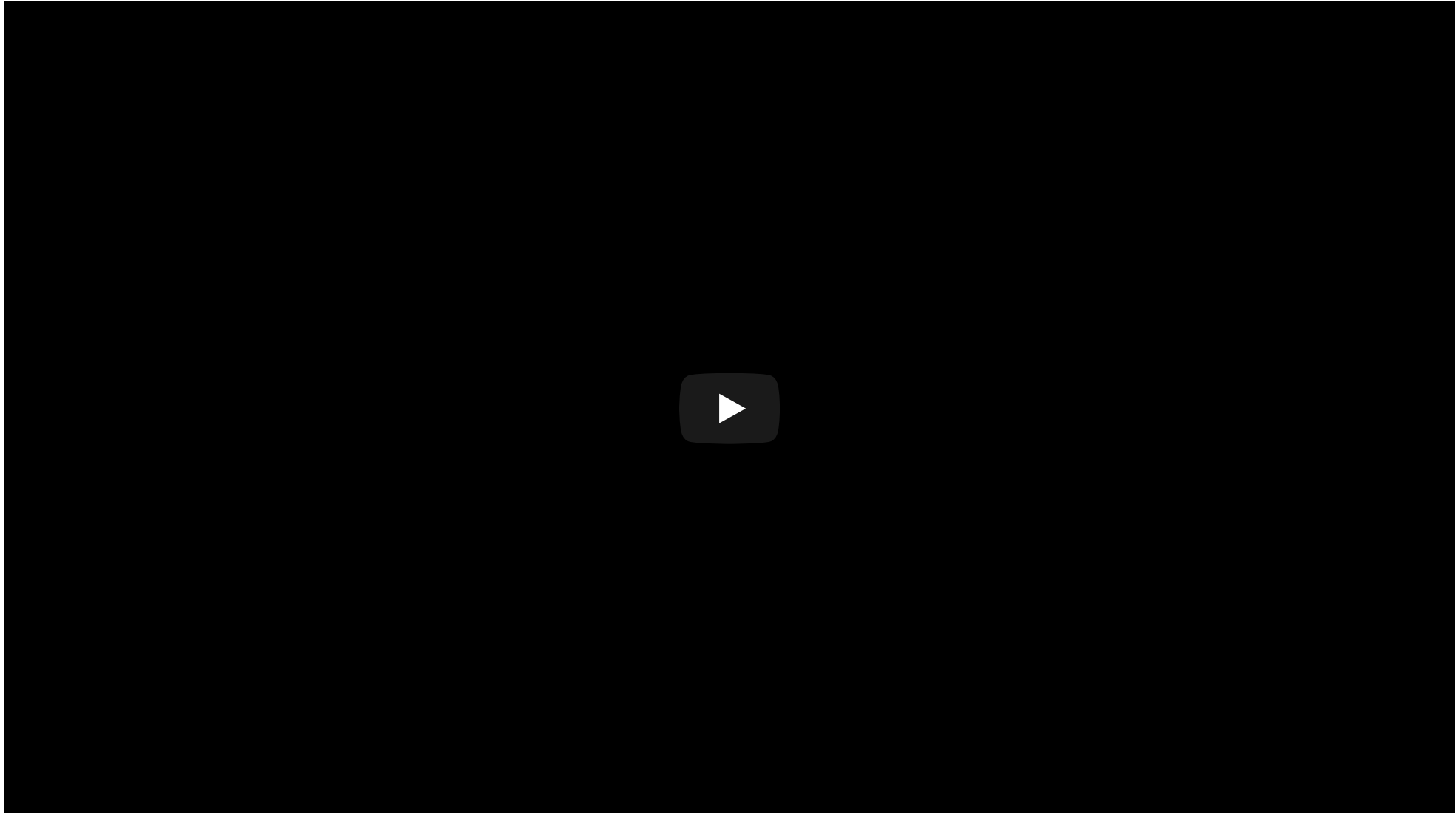
- Suppose one party owns a **generic** asset
 - trucks
 - High opportunity cost - easily resold or put to other uses
- Another party owns a **highly specific** asset - highly specialized machines
 - Next best alternative use is a boat anchor

Asset Specificity: Example

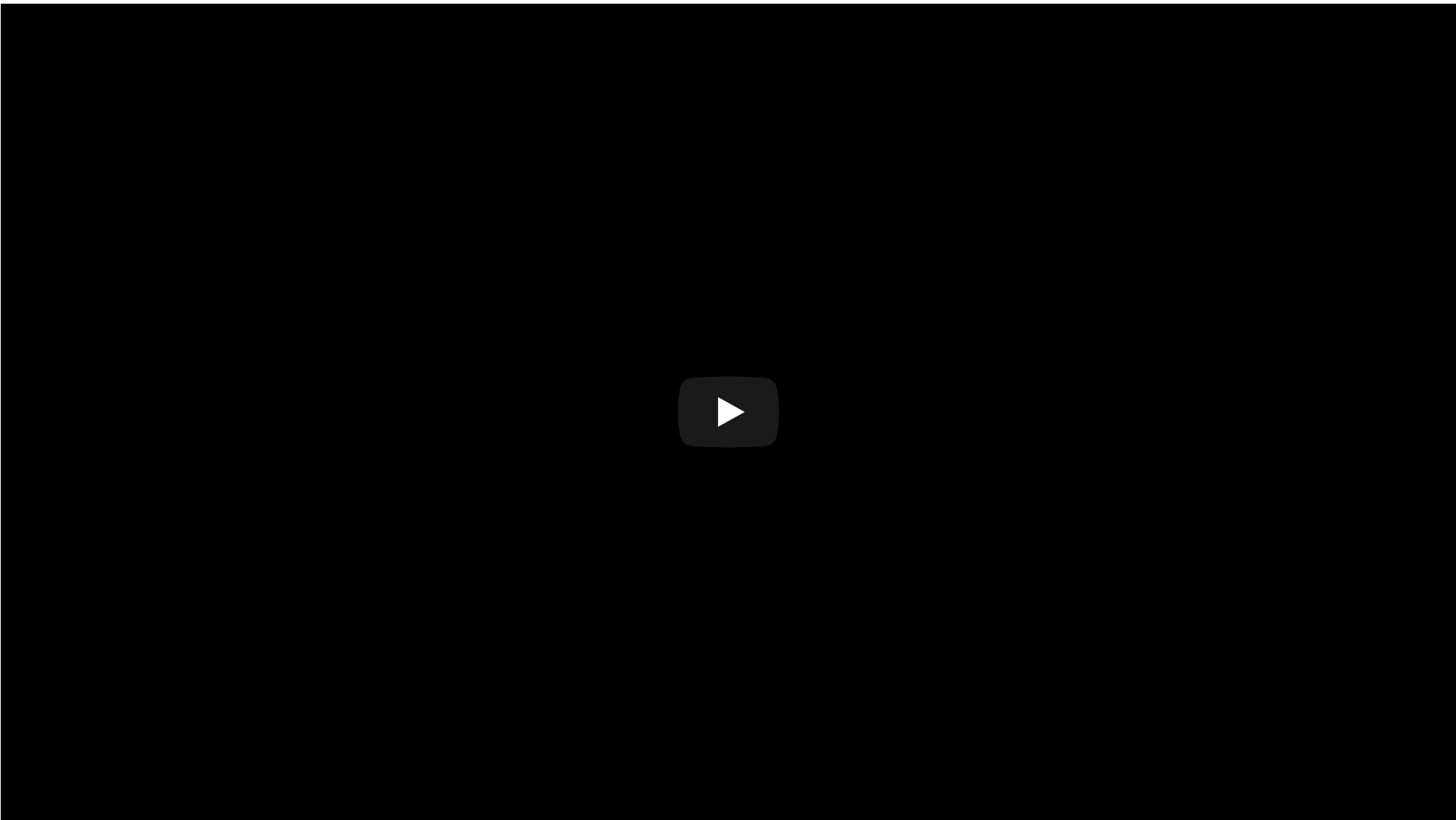


- Suppose a contract between them creates **\$50,000** of joint net value for the owner of the generic asset and the owner of the specific asset
- Can't recontract until next year
- Once the contract is signed, the owner of the generic asset threatens to pull out of the contract
 - **Demands \$49,000** of the "quasi-rents of cooperation"

They Are Altering The Deal...



...Pray They Don't Alter it Any Futher



Asset Specificity: Example



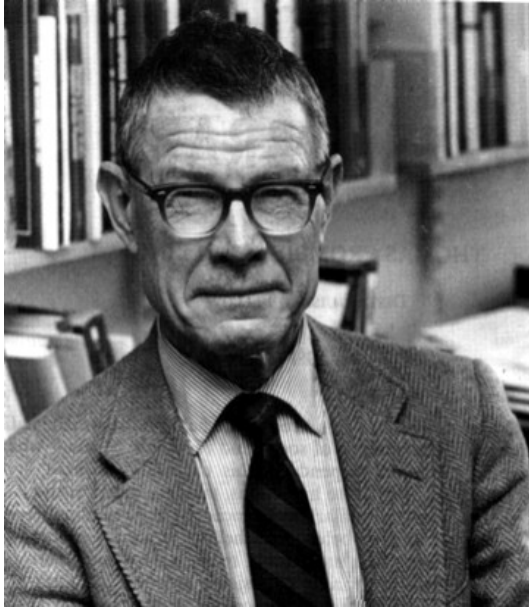
- Foreseeing such contractual hazards parties will be reluctant to cooperate
- Or will choose a less specialized and less efficient technology

What is Needed: Credible Commitment



Odysseus and the Sirens by John William Waterhouse, Scene from Homer's *The Odyssey*

What Doesn't Kill You Makes You Stronger



Thomas Schelling

1921–2016

Economics Nobel 2005

“Bargaining power”..s that the advantage goes to the powerful, the strong, or the skillful. It does, of course, if those qualities are defined to mean only that negotiations are won by those who win...The sophisticated negotiator may find it difficult to seem as obstinate as a truly obstinate man,” (p.22).

“**Bargaining power [is] the power to bind oneself,**” (p.22).

Schelling, Thomas, 1960, *The Strategy of Conflict*

Vertical Integration in Firms



- One solution in markets is **vertical integration**: the firm internalizes a stage of production in the supply chain
 - Often by **buying its supplier**
- Avoids hold up problems and post-contractual opportunism

Vertical Integration in Firms

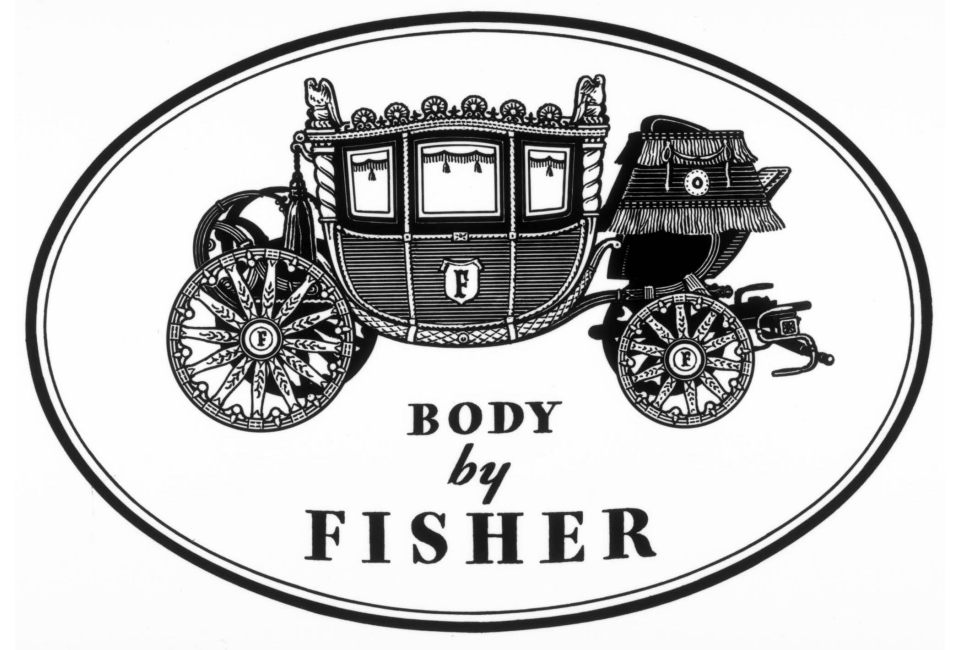


Benjamin Klein

1943-

"Long-term contracts used as alternatives to vertical integration can be assumed to take two forms: (1) an explicitly stated contractual guarantee legally enforced by the government or some other outside institution, or (2) an implicit contractual guarantee enforced by the market mechanism of withdrawing future business if opportunistic behavior occurs...[However, they are] often very costly solutions. They entail costs of specifying possible contingencies and the policing and litigation costs of detecting violations and enforcing the contract in the courts..every contingency cannot be cheaply specified in a contract or even known and because legal redress is expensive..."
(p.303)

Vertical Integration in Firms: Example



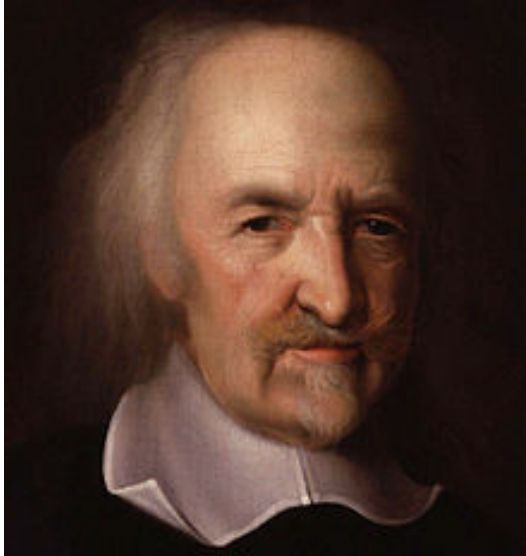


The Political Problem

17th Century England



Hobbes: Modern Pluralism



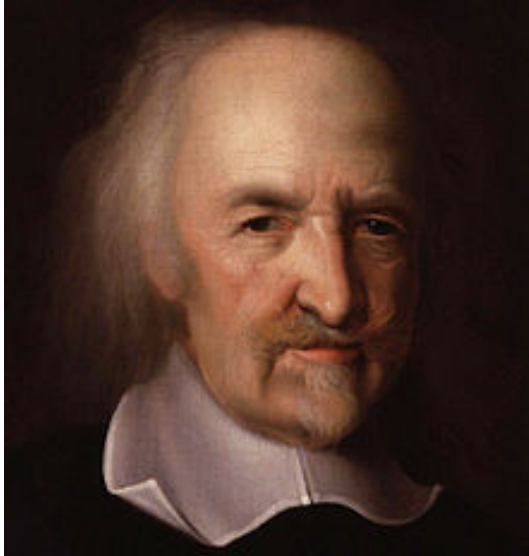
Thomas Hobbes

1588-1679

"[T]here is no such *finis ultimus* (utmost aim) nor *summum bonum* (greatest good) as is spoken of in the books of the old moral philosophers...And therefore voluntary actions and inclinations of all men tend not only to [attaining a contented life] differ only in the way [in] which produce the effect desired, (Ch. XVIII).

Hobbes, Thomas, 1651, *Leviathan: Or the Matter, Forme and Power of a Commonwealth, Ecclesiasticall and Civil*

Thomas Hobbes: State of Nature



Thomas Hobbes

1588-1679

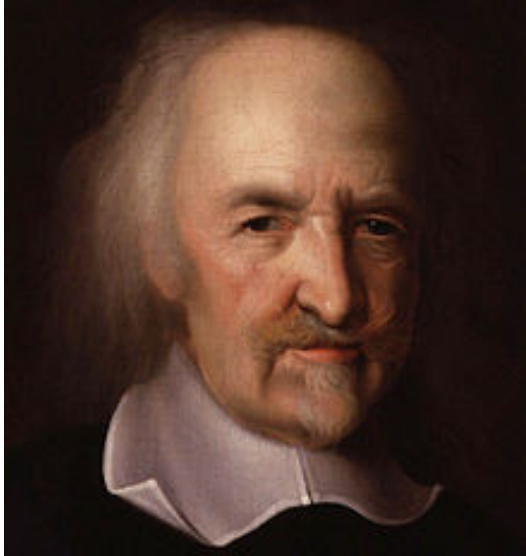
"In [the state of nature], there is no place for Industry; because the fruit thereof is uncertain; and consequently no Culture of the Earth...no Knowledge of the face of the Earth; no account of Time; no Arts; no Letters; no Society; and which is worst of all, continuall feare, and danger of violent death; And the life of man, solitary, poore, nasty, brutish, and short, (Ch. XVIII).

Hobbes, Thomas, 1651, [*Leviathan: Or the Matter, Forme and Power of a Commonwealth, Ecclesiasticall and Civil*](#)

Thomas Hobbes: War of All Against All



Hobbes



Thomas Hobbes

1588-1679

"Nature hath made men so equal in the faculties of body and mind...From this equality of ability ariseth equality of hope in the attaining of our ends...And from this diffidence of one another, there is no way for any man to secure himself so reasonable as anticipation..to master the persons of all men he can so long till he see no other power great enough to endanger him... [M]en have no pleasure...in keeping company where there is no power able to overawe them all. (Ch. XVIII).

Hobbes



Thomas Hobbes

1588-1679

"And because the condition of man...is a condition of **war of every one against every** one...it followeth that in such a condition **every man has a right to every thing, even to one another's body**. And therefore, as long as this natural right of every man to every thing endureth, **there can be no security to any man**...The **first fundamental law of nature** is: **to seek peace and follow it** (Ch. XIV).

Hobbes, Thomas, 1651, *Leviathan: Or the Matter, Forme and Power of a Commonwealth, Ecclesiasticall and Civil*

The Hobbesian Dilemma



Thomas Hobbes

1588-1679

"For the Lawes of Nature (as Justice, Equity, Modesty, Mercy, and (in summe) Doing To Others, As Wee Would Be Done To,) if themselves, without the terrour of some Power, to cause them to be observed, are contrary to our naturall Passions, that carry us to Partiality, Pride, Revenge, and the like. And **Covenants, without the Sword, are but Words, and of no strength to secure a man at all**, (Ch. XVIII).

Hobbes, Thomas, 1651, *Leviathan: Or the Matter, Forme and Power of a Commonwealth, Ecclesiasticall and Civil*

The Hobbesian Dilemma



- Consider society a **prisoner's dilemma** for social cooperation or conflict:
 - *a*: everyone else obeys the law, but I don't
 - *b*: everyone obeys the law
 - *c*: no one obeys the law
 - *d*: I obey the law, but no one else does

		Player 2	
		Cooperate	Defect
Player 1	Cooperate	b b	d a
	Defect	a d	c c

$a > b > c > d$

The Hobbesian Dilemma



- **Nash equilibrium:** everyone *defects!*
- **Socially optimal equilibrium:** everyone *cooperates*
- Hobbes' insight: **no individual has an incentive to cooperate when everyone defects!**

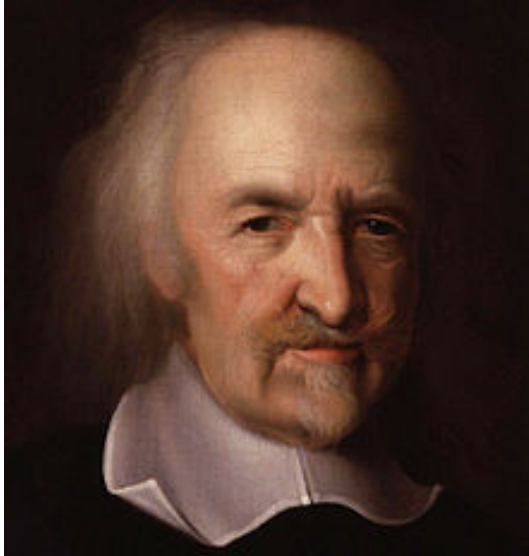
		Player 2	
		Cooperate	Defect
Player 1	Cooperate	b b	d a
	Defect	a d	c c

$a > b > c > d$

The Hobbesian Solution I



The Hobbesian Solution



Thomas Hobbes

1588-1679

"The only way to erect such a common power, as may be able to defend them from the invasion of foreigners, and the injuries of one another, and thereby to secure them in such sort as that by their own industry and by the fruits of the earth they may nourish themselves and live contentedly, is **to confer all their power and strength upon one man, or upon one assembly of men, that may reduce all their wills, by plurality of voices, unto one will:...**and therein to submit their wills, everyone one to his will, and their judgments to his judgment," (Ch. XVII).

The Hobbesian Solution



Thomas Hobbes

1588-1679

"It is a real unity of them all in one and the same person, made by covenant of every man with every man, in such manner as ife every man should say to every man: **I authorise and give up my right of governing myself to this man, or to this assembly of men, on this condition; that thou give up, thy right to him, and authorise all his actions in like manner.** This done, the multitude so united in one person is called a **COMMONWEALTH**," (Ch. XVII).

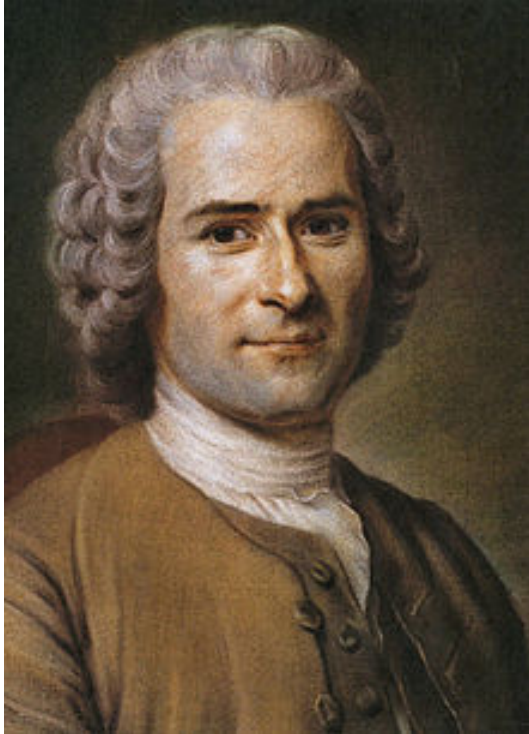
The Hobbesian Solution



- **The State is our commitment device**
- Citizens (in principle) sign a **social contract**, i.e. a "**constitution**" that deliberately restricts their liberties
- In each of our interests to give up some liberties that restrict the liberties of others (e.g. theft, violence)
- In exchange, we empower **the State as our agent** to punish those of us that fail to uphold the social contract



The Social Compact, Once Again



Jean-Jacques Rousseau

1712-1778

“There is but one law which, from its nature, needs unanimous consent. This is the social compact; for civil association is the most voluntary of all acts...Apart from this primitive contract, the vote of the majority always binds all the rest. This follows from the contract itself. But it is asked how can a man be both free and subject to wills not his own. How are the opponents at once free and subject to laws they have not agreed to?”

“I retort that the question is wrongly put. The citizen gives his consent to all laws, including those which are passed in spite of his opposition, and even those which punish him when he dares to break any of them,” (Book IV, Ch. 2, “Voting”),