Power and Inefficient Institutions

by

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"The ... stumbling blocks to beneficial institutional change in many poor countries may have more to do with distributive conflicts and asymmetries in bargaining power." Pranab Bardhan, *Distributive Conflicts, Collective Action, and Institutional Economics, 2001.*

Introduction and Motivation

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- Inapplicability of the Coase "Theorem" — Transaction Costs (North, 1990).

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(a) [Transaction Costs]. Winners Unable to Make Binding Commitments (i.e., Write Enforceable, Long-Term Contracts); and Wealth-Contrained [and Unable to Borrow; Imperfect Capital Markets].

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(iv) Empirical Observation: Efficiency of Small Farms (many reasons such as agency arguments).

Bardhan (2001):

"A Productivity Enhancing institutional change may create winners and losers, and the former may be unable to compensate the latter; and thus the losers would resist the change that is potentially Pareto improving, in the sense that the gainers could compensate the losers."

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The per-period payoffs on issue $k = X,Y$ to players 1 and 2: z_1^k and z_2^k, where $z_1^k + z_2^k < m^k$.

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it is $f_i(x)$ ($x \in [0, m^X]$), where $f_1(x) + f_2(x) < m^Y$.

- Nash bargaining solution

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- Two-stage game with complete information.

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$$P_1(x) = x + \left[f_1(x) + \frac{1}{2}[m^Y - f_1(x) - f_2(x)] \right]$$

$$P_2(x) = [m^X - x] + \left[f_2(x) + \frac{1}{2}[m^Y - f_1(x) - f_2(x)] \right]$$

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ERGO: *Some* shift in relative bargaining power is *necessary* for persistence of inefficient institutions.

Equal Bargaining Powers

The *benchmark* case of perfect equality in both *ex-ante* and *ex-post* bargaining powers. That is, the case in which (i) for $k = X, Y$, $z_1^k = z_2^k$, and (ii) for any $x \in [0, m^X]$, $f_1(x) = f_2(x)$.

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Corollary 1. *If players have equal ex-ante bargaining powers and equal ex-post bargaining powers, then agreement is reached over both issues, and the inefficient status quo is replaced by an efficient outcome.*

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Corollary 1. *If players have equal ex-ante bargaining powers and equal ex-post bargaining powers, then agreement is reached over both issues, and the inefficient status quo is replaced by an efficient outcome.*

An important implication of Corollary 1 is that, *inequality* in the players' bargaining powers is *necessary* for the persistence of inefficient institutions.

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Inequality in the players' aggregate *ex-ante* bargaining powers can be plausibly measured by, or interpreted as, the "distance" between d_1 and d_2.

If either holds, then persistence of inefficient institutions (from two 'characterisation' inequalities).

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Since the sum of the left-hand sides of these two inequalities exceeds (by assumption) the sum of their right-hand sides, both of them cannot hold. This implies that in equilibrium *at most* one player would refuse to bargain.

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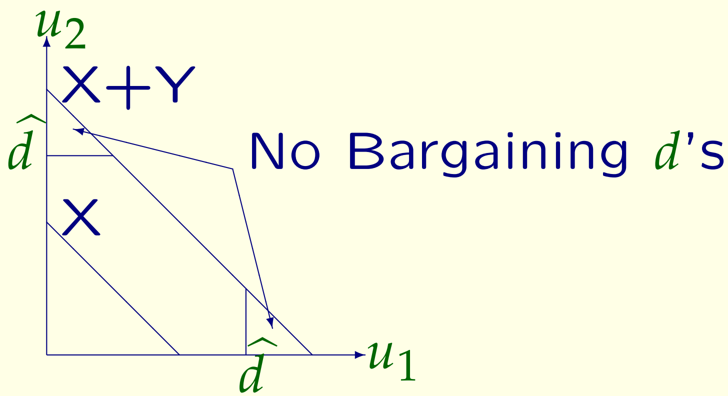
More, $d_j < m^Y/2$ ($j \neq i$) — since (by assumption) $d_1 + d_2 < m^X + m^Y$.


u_2
X+Y
$\widehat{d}$
No Bargaining d's
X
$\widehat{d}$
u_1

Proposition 1. *Assume that the players have equal ex-post bargaining powers, but have unequal ex-ante bargaining powers. Then, in equilibrium, negotiations don't commence and the inefficient status quo remains in place if and only if the degree of inequality in the players' aggregate ex-ante bargaining powers is sufficiently large.*

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- A key message:

A small degree of inequality in the players' aggregate ex-ante bargaining powers is conducive for efficient institutional change, but not a large degree of such inequality; in that case, inefficient institutions are likely to persist.

- Importance of *Aggregate*, Ex-ante Bargaining Power; rather than ex-ante bargaining power over *individual* issues.

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Proposition 2. *(General Case) Fix the players' ex-ante bargaining powers. If the degree of inequality in the players' ex-post bargaining powers is sufficiently large, then negotiations don't commence and the inefficient status quo remains in place.*

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- *Applications*: Land Ownership; Research Joint Ventures in Oligopolistic Markets; Israel-Palestinian Conflict; *etcetra*.