

# States and Markets

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A Primer in Political Economy

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PUBLISHED BY THE PRESS SYNDICATE OF THE UNIVERSITY OF CAMBRIDGE  
The Pitt Building, Trumpington Street, Cambridge, United Kingdom

CAMBRIDGE UNIVERSITY PRESS

The Edinburgh Building, Cambridge CB2 2RU, UK  
40 West 20th Street, New York, NY 10011-4211, USA  
477 Williamstown Road, Port Melbourne, VIC 3207, Australia  
Ruiz de Alarcón 13, 28014 Madrid, Spain  
Dock House, The Waterfront, Cape Town 8001, South Africa

<http://www.cambridge.org>

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First published 2003

Printed in the United States of America

Typeface Times 10/13pt. System L<sup>A</sup>T<sub>E</sub>X 2<sub>ε</sub> [TB]

*A catalog record for this book is available from the British Library.*

*Library of Congress Cataloging in Publication Data*

Przeworski, Adam.

States and markets : a primer in political economy / Adam Przeworski.

p. cm.

Includes bibliographical references.

ISBN 0-521-82804-X – ISBN 0-521-53524-7 (pb.)

1. Economic policy. 2. Capitalism. 3. Decision making.  
4. Economics. I. Title.

HD87.P79 2003

330.12 – dc21

2003043587

ISBN 0 521 82804 X hardback

ISBN 0 521 53524 7 paperback

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## Introduction

### 1.1 Decentralized allocation mechanisms

Suppose each of you in the class has an *endowment* of some apples and some pears. Some of you like apples more than pears; some like pears more than apples. Each of you can rank all baskets of apples and pears by a *preference relation* such that for all baskets you can tell whether you prefer a particular basket to another or you are *indifferent* between them. For example, you may prefer to have 7 apples and 6 pears to having 6 apples and 7 pears, so that  $\{7a, 6p\} \succ \{6a, 7p\}$ , where  $\succ$  stands for “prefers.” In turn, you may be indifferent between having a basket of 7 apples and 6 pears and a basket of 4 apples and 11 pears, so that  $\{7a, 6p\} \sim \{4a, 11p\}$ . Your preferences can be also represented by a *utility function*  $U_i(a, p)$ , increasing in both arguments. If  $\{7a, 6p\} \succ \{6a, 7p\}$ , then  $U(7a, 6p) > U(6a, 7p)$ . If  $\{7a, 6p\} \sim \{4a, 11p\}$ , then  $U(7a, 6p) = U(4a, 11p)$ . Utility is just some number **you**,  $i$ , attach to the value of a particular basket.

Suppose now that each of you wants to *maximize* the utility you derive from consuming apples and pears by exchanging them with others. Once the exchange is completed, but not before, you eat the apples and the pears you have.

How can this exchange process be organized? Suppose we do it like this:

(1) Each of you puts your apples and your pears on the table. When this is done, a bell rings and each of you takes all the apples and pears you want and leaves the room with them.

What will happen? Obviously, a fight. What will be the final *allocation*? Bullies will take more and some black-and-blue marks will be inflicted.

Is this *allocation mechanism* a “market”? It does not quite look like one, since people grab, using force, rather than exchange voluntarily. There is nothing to safeguard your endowments and nothing to protect your allocation: only your big muscles and swift feet. But notice that this is a *decentralized mechanism*: Everyone acts independently. Moreover, the allocation process is completely free: You do what you want.

The outcome is bad. Some people will get injured. If it is possible to generate the same allocation of apples and pears without fighting, some people would be better off (without bruises) without anyone being worse off. Hence, if people care about bruises, this outcome is *inefficient*: Someone can be better off without anyone being worse off. Moreover, strong people may get a lot; weak people nothing, which somehow does not seem right. Even our most vague moral intuitions tell us that the allocation should be related to something like *effort* or *need*, not just the good *luck* of being physically strong. It should be *equitable*. Hence, this is not a good way to allocate.

(2) Suppose then we do it in a different way. All the apple owners can exchange their apples for pieces of paper on which pear owners write the number of pears they will give in return for each apple tomorrow. Hence,  $i$  gives  $j$  an apple and  $j$  gives  $i$  a piece of paper that says “ $p$ ”: the pear *price*  $j$  is willing to pay tomorrow.

Let us ask again what will happen. What will be the final allocation? The obvious answer is that nothing will be exchanged. The fi



under this allocation mechanism, the final allocation is inefficient. Hence, the mechanism “exchange apples for promises of pears” is free and decentralized but it is bad in the sense of leading to an inefficient allocation.

(3) Yet another way. Suppose that there is someone who can and will, can **and** will, force the owners of pears to deliver them to the sellers of apples in quantities written on the pieces of paper, so that the pieces of paper are as good as real pears. Moreover, to make exchanges easier, one can also write pieces of papers promising apples in exchange for pears.

What will the outcome be? First, we need to answer the following question: Will the exchange process ever stop? There are many students in this class, each with some initial endowment. Now  $i$  sells  $2a$  to  $j$  for  $1p$ . But  $k$  comes along and offers to buy each of  $i$ 's pears for a price of  $3a$ . Suppose that, given the number of apples  $i$  has, he is willing to give up a pear for 3 apples. Then  $i$  will sell her pears to  $k$ . But, and so on. As you see, the stopping question is not a trivial one. But you know from your microeconomics course – and we will cover this material remedially in the next chapter – that this exchange will come to a stop. It will reach some allocation such that no one will want to trade anymore, an *equilibrium*.

What will be true of this equilibrium? First, all the potential gains from trade will be exhausted: No one will be able to benefit from continuing the exchange. Second, no one can be better off without someone else being worse off: The only way  $i$  could increase her utility is by someone else losing his. Finally, if we were to take a vote whether to alter the equilibrium allocation, then at least one person would vote against changing it: This allocation would not be defeated under unanimity rule. *These three conditions are equivalent, and they fully describe efficiency in the sense of Pareto or Pareto optimality.*

Note that we have smuggled in a number of assumptions. One is that no one eats during the exchange process. If you were to consume before the equilibrium allocation is reached, *out of equilibrium*, then some of you would be consuming apples or pears for which you would have paid too little or too much. You may have consumed an apple for which you paid  $2p$  while there may have been someone who would have sold you an apple for  $1p$ , so that you could have consumed more apples and pears. We assumed that trading is costless, that is, that it has no *transaction costs*.

Second, we assumed that everyone knows everything and everyone knows the same. Suppose that the pears are not all the same – some are rotten – and that only the sellers know their quality. Then you may suspect that if someone is willing to sell you a pear for a low apple price, this may be

because she knows that the pear is of poor quality. You may be unwilling to buy pears at all, so that there may be no market for pears (Akerlof 1970).

Suppose for the moment that these assumptions hold. We know that the equilibrium allocation will be Pareto efficient. Does it mean that this mechanism that generated this allocation is a good one? In the example we discussed thus far the initial endowments and the equilibrium allocation were

$$i : 3a, 2p \Rightarrow 1a, 3p$$

$$j : 1a, 2p \Rightarrow 3a, 1p$$

But suppose that the initial endowments were different and the exchange led to a different allocation:

$$i : 2a, 2p \Rightarrow 0a, 3p$$

$$j : 2a, 2p \Rightarrow 4a, 1p$$

Can these equilibrium allocations be compared by the Pareto criterion? Because the utility functions increase in both arguments,  $i$  is better off in the original than in the modified world: She has the same number of pears but one apple more. But  $j$  is better off in the new world: He has the same number of pears as in the original one but one more apple. Hence,  $j$  is better off but  $i$  is worse off. The Pareto criterion cannot be used to compare these two allocations: We cannot judge which is more efficient by this criterion. Each equilibrium allocation is *Pareto superior* to the corresponding endowment allocation: Otherwise there would have been no exchange. But each initial endowment leads to a different equilibrium allocation, and neither of them is Pareto superior to the other.

Hence, if we want to evaluate these states of the world, we need some other criteria. We could, for example, ask which of these worlds is better in terms of total societal consumption or total utility. In the first case, we would use as the criterion a function  $W(C_i, C_j)$ , where  $C$  stands for consumption, such that

$$W(C_i, C_j) = C_i + C_j.$$

According to this criterion, an allocation that makes this sum larger is better than one that makes it smaller. Because we are not producing anything and because nothing is lost in exchange, total consumption is the same in the two worlds, so this criterion does not work. But even if total consumption associated with different allocations was different, this criterion would

be vulnerable to the criticism that the value of consumption to different individuals may be different.

So we are left with total utility, the classical utilitarian way to think of *social welfare*. This criterion is a function  $W(U_i, U_j)$  such that

$$W(U_i, U_j) = U_i(C_i) + U_j(C_j).$$

In terms of our example, the original world is better than the modified one if

$$U_i(1a, 3p) + U_j(3a, 1p) > U_i(0a, 3p) + U_j(4a, 1p),$$

or

$$U_i(1a, 3p) - U_i(0a, 3p) > U_j(4a, 1p) - U_j(3a, 1p).$$

As you see, to make this evaluation, we have to compare the utilities of  $i$  and  $j$ , which is hard, if not impossible, to do. The  $U$ s are numbers individuals attach and  $i$  may attach 3 to his difference but may as well attach 102, so how are we to tell if  $i$ 's difference is greater than  $j$ 's? Moreover, because  $i$  prefers  $\{1a, 3p\}$  to  $\{0a, 3p\}$ , if we asked  $i$  what her value of the difference is, she would say "1000": She would reveal her preferences strategically. Hence, this is not a promising route either.

How about comparing these allocations by the criterion of *equality*? Is this a good criterion? Note that in our example the world in which the equilibrium allocation would be perfectly equal would not be a good world: We already know that people would want to trade away from equal endowments. *Outcome-egalitarianism* does have its supporters. But even if we are egalitarians, we must ask: Equality of what? (Sen 1992).

"Utility" is an appealing answer: People should be able to be equally happy with their consumption baskets. If they do not envy other people's allocations, that is, if given their utility functions both  $i$  and  $j$  prefer their own allocation to the allocation of the other person, then these allocations are at least *fair*. But we have seen that as an operational criterion utility is hard to implement.

Perhaps what we should equalize is *opportunity*. Suppose now that what you consume is produced. Specifically, the output (you can think of it as total value of apples and pears measured in equilibrium prices) is produced by two factors of production: luck ( $L$ ) and effort ( $E$ ). We can write the production function generally as

$$Y = F(L, E)$$

increasing in both arguments. Suppose that the specific production function is simply

$$Y = L + E$$

Now, say that  $i$  has 8 lucks and exerts 2 efforts, while  $j$  exerts the same amount of effort but has no luck. Their output will be:

$$i : 8 + 2 = 10$$

$$j : 0 + 2 = 2$$

Note that their opportunities are very different:  $i$  can get 8 units of consumption doing nothing, while  $j$  must rely completely on her effort. We could equalize the opportunity for consumption by taking 4 lucks away from  $i$  and giving them to  $j$ . They will both have an opportunity of 4. Obviously, they may exert different amounts of effort and end up with different consumption. But their rewards will be, in Dworkin's (1981a and b) language, "ambition-" rather than "endowment-" sensitive.

But what is "luck" and what is "effort"? If I watch TV the whole day rather than work, is it because I am lazy or because I have a deficiency of laboramine in my brain? And how do luck and effort combine in production? Suppose that you observe  $Y$  but not  $L$  and  $E$  separately. How to equalize opportunity now? (The problem is not hopeless, see Roemer 1996.)

Is opportunity a good *equalisandum*? Suppose we equalized opportunity, so that everyone has 4 lucks and  $i$  turns out to be a bum, exerting no effort, and starves having only 4 to consume. Should we accept this allocation or should we ensure that everyone has some basic consumption basket? You may say with Giddens (1998), "no rights without responsibilities":  $i$  had the same chance to produce the basic basket as everyone else and if she decided to squander her opportunities it is just tough. But suppose that the reason she did not exert any effort was that she fell ill. Again, you may say that she should have insured herself against this possibility; to anticipate what follows, you may even say that she should have been *forced* to insure herself. But suppose she was not forced and did not buy insurance: A hiker climbs a mountain, breaks a leg, and is lying on a ledge, dying from the cold. A helicopter televises his agony. He could have bought rescue insurance but he did not. Should he be allowed to just die or should he be saved?

Finally, you may want to evaluate allocations by a *maximin* criterion (Rawls 1971). Suppose that we rank all the baskets of some basic goods from the largest to the smallest. Then an allocation is better if it makes larger the smallest basket.

## 1.2 Centralized allocation mechanisms

There are obviously other ways we can allocate and other ways we can evaluate the allocations and the mechanisms that generate them. Let us consider a few more.

(4) Here is the most obvious:  $i$  is a *dictator* and she decides who gets what for everyone. What individuals get does not depend on their actions, just on the decision of the dictator, who can enforce it using physical coercion if need be. Will the resulting allocation be a good one? Is this a good allocation mechanism? Do not jump to conclusions. Whatever the dictator decides, the allocation will be Pareto efficient: Any other allocation would make someone worse off, namely, the dictator. But this may just show that the Pareto criterion is too weak. More interestingly, the dictator may be benevolent: She may just want to implement one of the criteria we discussed above.

One question arises immediately: Will a decentralized mechanism generate the same allocation as a benevolent and omniscient dictator? This question is often posed by economists as a **counterfactual** method to evaluate allocations: It makes sense to think that an allocation chosen by a benevolent, omniscient dictator is the best possible, so that any mechanism that deviates from the *command optimum* must be in some way deficient. This is, however, an excessively demanding standard: How would the dictator know everything? We can weaken it by assuming that the dictator knows no more and not less than individuals and ask about the *constrained command optimum*. For example, we can ask whether the allocation that results from the last decentralized mechanism we considered is *constrained Pareto efficient*, that is, whether this allocation could be Pareto improved on by a benevolent dictator who knows only what the trading individuals know.

Yet even this weaker criterion is still counterfactual. Individuals know things the dictator does not know: Most obviously what makes them happy but perhaps also how much they need to survive or how much luck they enjoy and how much effort they exert. If a benevolent dictator is to act in their interest, he must somehow elicit this information. But individuals will *reveal* their private information only if they have *incentives* to do so. This may mean that even constrained Pareto efficiency may be unattainable to the dictator.

Note that what is at stake in these distinctions is what we can realistically expect as the best possible. Many debates about the virtues and vices of different allocation mechanisms hinge on this question. We will return to such issues several times.

(5) Let us consider another centralized mechanism. Say the Central Authority confiscates the initial endowments of apples and pears, puts them in baskets as before, and runs a lottery to determine who gets which basket. Once the results of the lottery are known, the Central Authority distributes to individuals the baskets they won.

Before we consider how to evaluate this mechanism, let us pause on the notion of a *centralized mechanism*. In what sense is this mechanism centralized? Is it because we have a Central Authority? But in the example of decentralized exchange of commodities for commodities through pieces of paper, that we also had some kind of an authority that used or threatened coercion if people did not deliver on their pieces of paper. We have already seen that there can be no exchange, at least no generalized anonymous exchange, without some kind of an enforcement mechanism.

It is useful to ask first why we did not pose this question with regard to the dictator. The answer is that in the case of the dictator, it is obvious that one decision generates the entire allocation to all the individuals. The dictator decides how much to give to each. But so does the lottery. Lots are thrown into an urn, a handsome television actor, smiling broadly, reaches into the urn to allocate consumption baskets to everyone. Contrast this with exchange, where  $i$  decides whether to sell to  $j$  but their exchange does not affect the allocation to  $k$ . Exchange is a decentralized mechanism because the final allocation results from independent decisions of each agent; dictatorship and lottery are centralized mechanisms because one decision allocates to everyone.

Is lottery a good mechanism? It does have its virtues. One would want to say intuitively that it is fair, but we have seen that economists reserved this term for an allocation that does not produce envy, and lottery certainly does. It equalizes chances, but they are not quite the opportunities we discussed above, because all you can do with your basket is to consume it. It is obviously inefficient and outcome-inegalitarian. We tend to employ lotteries, I suspect, when we think that exchange is not an ethically defensible mechanism and have no obvious criteria by which to allocate (on these issues, see Elster 1992). For example, some countries use lotteries to allocate scarce medical resources, including body parts. We do not think they should be exchangeable for money and we cannot see other clear criteria. Hence, we leave things to luck.

(6) One more, I promise the last, allocation mechanism. Suppose we use majority vote. Say there are three individuals so that we can easily use the

Table 1.1

	Apples	Pears
$i$	1	3
$j$	3	1
$k$	2	2
Total	6	6

majority criterion. The mechanism works as follows. Any individual can propose any allocation  $\{\mathbf{a}, \mathbf{p}\}$  where, note, the members of this allocation are column vectors of size 3, because there are three individuals. The only condition we will impose is that of a *balanced budget*, so that the sums allocated must equal the total endowments available. For example, say that individual  $i$  proposes the following allocation to all three.

The proposal of  $i$  is then paired against the status quo (say the initial endowments of each individual) and people cast their votes either for the status quo or for  $i$ 's proposal. Whichever of the two alternatives wins is the new status quo and everyone,  $i$  included, can propose a different allocation, which will be paired against the status quo, and so on. Note that this mechanism is a centralized one: Everyone together decides how to allocate to each.

The first thing we need to do is to return to the stopping problem. Will this process ever end? Or will it continue ad infinitum? Because this is an issue shrouded in confusion, let us be careful about the question we are asking. We are not asking how much time it will take to reach the final decision about allocation. This was not the question about exchange either: We asked in fact whether there exists some allocation such that, **whenever** it is reached, exchange will stop. So let us ask the same question now: Is there some allocation such that, whenever it is reached, voting will stop? Suppose that there is some allocation that beats every other possible allocation by majority vote. Say the proposal of  $i$ , which we will call  $X$ , does it. If  $j$  proposes some other allocation, say  $Y$ ,  $X \succ_M Y$  (read  $\succ_M$  as "beats by" or "is preferred to" under majority rule). If  $k$  proposes  $Z$ ,  $X \succ_M Z$ , and the same is true for every other proposal. Then  $X$  is the *majority (or Condorcet) winner*. And if  $X$  is the majority winner, then the voting process will "stop" at  $X$ : Nothing will defeat it. The electorate will have chosen to allocate consumption according to  $X$ , given in the Table 1.1.

Before we raise a problem, let us consider the qualities of this allocation. Is it efficient? This is the same as to ask whether individuals would want to trade their allocations after the voting process had stopped. You will see that  $i$ 's proposal gives  $i$  and  $j$  the same they were being allocated in our example of free exchange. Hence, if this were the allocation, trading would stop (assuming that  $k$  does not want to trade). Moreover, someone would vote against any other allocation. So it is efficient.

The problem is that voting would not stop at  $X$ . Even worse, there is no proposal that beats every other alternative by a simple majority rule. Just think: Say that in response to  $X$ ,  $j$  proposes an allocation  $Y$  that gives less to  $i$  and more to  $j$  and  $k$ . Then the latter two will vote for  $Y$  over  $X$ , so that  $Y \succ_M X$ . But then  $k$  will propose an allocation  $Z$  that gives more to  $k$  and  $i$  than  $Y$ , so that these two will not vote for it and  $Z \succ_M Y$ . But  $i$  can offer her initial proposal again. This proposal will give  $i$  and  $j$  more than  $Z$ ,  $X \succ_M Z$ . Hence, we have  $X \succ_M Z \succ_M Y \succ_M X$ . There is no proposal that beats every other proposal under pairwise majority rule. Majority winner does not exist, which means that this mechanism is not *decisive*: It fails to pick one from among all alternatives.<sup>1</sup>

As you see, this is a different kind of a deficiency than those we discussed above. The problem here is not that the equilibrium allocation is somehow undesirable but that there is no allocation that constitutes an equilibrium. We just do not know what to expect in this situation. Perhaps this only means that we did not describe the voting mechanism adequately, but this is for later.

### 1.3 Political-economic equilibria

Let us first summarize what we have done thus far. We discussed three decentralized mechanisms of allocation: “grab all you can,” “exchange commodities for pieces of paper,” and “exchange commodities for commodities via pieces of paper.” Then we discussed three centralized mechanisms: dictatorship, lottery, and majority rule. With regard to each of them, we asked first which allocation they will generate. We discovered that in some cases this question has a relatively easy answer but in one case the answer may be

<sup>1</sup> The word “cycling” is banned from this book. Nothing “cycles” here. This paragraph does not describe how proposals will be made but only a property of the function that transforms individual preferences into a collective one. All that we have learned is that this function fails to pick a unique allocation.



impossible. Then, with regard to each allocation, we asked how to evaluate it. We found that there is a number of possible criteria and that each of them is in some way problematic. Efficiency in the sense of Pareto is an appealing criterion because any allocation that is inefficient is obviously undesirable. But, first, it is a weak criterion: There are normally lots of efficient allocations and this criterion does not distinguish them any further. Second, we have to ask ourselves what is the best possible world: The fact that an allocation is not as good as it would have been under unrealistic conditions is just not very enlightening. We also considered other criteria, particularly different versions of equality, and discovered that while each has normative appeal, it is not obvious to pick one among the competing criteria.

Why did we go through this discussion using silly examples, rather than begin with big guns: “the market” and “the state”? This is what we have been discussing all along, so why use the subterfuge?

The first point I wanted to make is that there is no such thing as “the” market and “the” state. Grabbing is different from exchanging for a piece of paper, which is different from exchanging commodities via pieces of paper, and all three are different from other examples one could cook up. Dictatorship is different from lotteries, which are different from majority voting, and again they are all different from other centralized mechanisms. There are different ways of organizing production and exchange and different ways of organizing political institutions. Markets and states are always organized in some particular ways, and how they are organized matters. Hence, it is more useful to inquire about the properties of the particular decentralized and centralized mechanisms. This is what, in my view, political economy is all about.

The second conclusion is that no general anonymous exchange is possible without some centralized enforcement mechanism lurking in the background. The state is everywhere. This is a long story, which goes back to Marx before Polanyi. Capitalism is a system in which most productive resources are owned privately. Yet under capitalism property is institutionally distinct from political authority: This separation is necessary for markets to exist. The slaveowner or a feudal lord was at the same time the owner of the instruments of production and the political sovereign. The capitalist employer has no authority over the worker outside the labor contract. As Marx put it, “the mediaeval proverb *nulle terrae sans seignor* was replaced by that other proverb: *l’argent n’a pas de maître*.” As a result, there are two mechanisms by which resources can be allocated to uses and distributed

among households: markets and the state. Individuals are simultaneously market agents and political actors.

Markets are decentralized mechanisms: Households and firms decide how to allocate the resources they own. Depending on market structure, their decisions may or may not be independent, but they affect each other only via the consequences of actions of one agent for the welfare of another. The state is a centralized mechanism: It coerces economic agents to do what they would have not done voluntarily. Depending on the political structure, the decisions of the state can be made by one individual, the “dictator,” or can result from a process involving all citizens. Yet, however they are reached, once reached state policies are binding.

Given the coexistence of these two mechanisms, one concept of *political-economic equilibrium* is the following. Consider the following game. First, political actors reveal their preferences for policies by a variety of mechanisms ranging from voting to bribes to rioting. Second, the state maximizes its objectives by adopting a policy such as the tax rate. Finally, economic agents choose their actions to maximize their utility, subject to the constraint of the policy. The equilibrium of this game is a policy of the state and a set of actions by individuals *qua* political actors and *qua* economic agents, such that no one would want to act differently given their beliefs and given the actions of others. Associated with this equilibrium is an allocation of resources to uses and a distribution of incomes.

One example that will be studied in the course is the following. Suppose all individuals seek to maximize their consumption, which is given by

$$c_i = (1 - \tau)w_i L_i + \tau \overline{w_i L_i}$$

where  $\tau$  is the tax rate,  $w_i$  is the individual-specific hourly wage rate,  $L_i$  are labor services measured in hours, and the bar stands for “average.” Individuals first vote on the tax rate and in this case the majority voting procedure considered above does yield a Condorcet winner,  $\tau^*$ . Given this tax rate, each individual decides independently how much labor services to sell and the outcome is  $\mathbf{L}^*(\tau^*)$ . Finally, associated with  $\{\tau^*, \mathbf{L}^*(\tau^*)\}$  is the allocation of consumption  $\mathbf{c}[\tau^*, \mathbf{L}^*(\tau^*)]$ . The equilibrium of this situation has two components:  $\{\tau^*, \mathbf{L}^*\}$ , where  $\mathbf{L}$  is an  $N$ -vector of the amounts of labor supplied by the  $i = 1, \dots, N$  individuals. Associated with this equilibrium is a vector  $\mathbf{c}^*$  of consumptions of all the  $N$  individuals. This is a political-economic equilibrium.

Exchange and production cannot occur without the presence of some centralized mechanism. To make this point clear, let us go back to the exchange of commodities example. We have seen that trades will occur only if there is some mechanism to assure the agents that promises will be fulfilled. But we did not consider what this mechanism might be; we did not even note that it must cost something. Remember that the initial endowments were traded according to

$$i : 3a, 2p \Rightarrow 1a, 3p$$

$$j : 1a, 2p \Rightarrow 3a, 1p.$$

But if the trades can occur only if there is a policeman to enforce the promises, then the policeman must earn an income. Suppose the policeman,  $s$ , who has no initial endowment, must get

$$s : 0a, 0p \Rightarrow 1a, 1p$$

to want to work as a policeman. Now the society has to decide whether it wants to bear this cost and be able to trade or to remain with the initial endowments. Suppose it decides to hire the policeman. But how is the tax decided on? Whatever is the mechanism that allocates taxes, it must be a centralized one. (Voluntary contributions will generally not work: We will discuss why in the next chapter.) Either someone is a dictator or a lottery is used or the decision is reached by voting. But some joint decision has to be made: Joint, because taxes are allocated to everyone. Hence, the only way to describe the exchange situation is in two steps: (1) A centralized decision is reached whether to employ a policeman and how to tax. (2) Given the presence of the policeman and the taxes, decentralized exchange occurs. The final allocation results from a combination of a centralized and a decentralized mechanism: It is a property of a *political-economic equilibrium*. One way, therefore, to represent the insight of Polanyi is to say that all equilibria of production and exchange situations are political-economic equilibria: They always combine a centralized with a decentralized mechanism.

Consider a slightly different example, due to Stiglitz (1994). Suppose you drive your car to some meeting place. You can park your car just in front of this place and avoid walking, but the probability that your car will be stolen in this place is not insignificant. Alternatively, you can park the car three blocks away, in a place that is safer, and walk. Suppose your car is insured and it is raining. You park in front. The situation is as follows: You paid  $a$  as your

insurance premium, you will get  $b$  if your car is stolen, and the probability of this event is  $\bar{p}$  in the dangerous place and  $\underline{p}$  in the safe place. The amount  $a$  you pay as premium takes into account the fact that if you are insured, you will park in a dangerous place: *moral hazard*. The insurance industry is competitive, so that  $a = \bar{p}b$ . Suppose now that the insurance company (or you; it does not matter in this case) is taxed some amount  $\tau$  and the tax revenue is spent to put a policeman in the dangerous place, which now becomes safe. Your premium is now such that  $a - \tau = \underline{p}b$  or  $a = \underline{p}b + \tau$ . The insurance