

## COORDINATION, COOPERATION, AND THE EXTENDED COASEAN APPROACH TO ECONOMIC POLICY

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### ABSTRACT

The Coasean way to deal with the cooperation failure that is implicit in Pareto inefficiency is to remove or lessen the obstacles to cooperation through the attribution of property rights and the elimination or reduction of transaction costs. The relevance of this approach is however undermined by some intrinsic difficulties to its application in a real world context, such as those arising from the number and indeterminacy of the interested parties, as well as from the free rider problem. A way to extend the Coasean approach taking into account those real life limitations is to consider the local authorities as representatives of the interest of their local constituencies and, through the provision of an adequate institutional framework, to enhance the opportunities for cooperation through voluntary agreements involving private and public parties. Thus the extent of cooperation could be widened, as opposite to traditional remedial actions relying on non-contractual, or direct entrepreneurial action by the state. With the reduction in the appeal of direct and coercive action by the state a number of institutions emphasising the contractual cooperation between public and private parties have effectively grown of importance, as wide apart as the township and village enterprises in China, or the “programmazione negoziata” in Italy. In the final part of the paper the latter experience is briefly reviewed and appraised.

Keywords: cooperation, coordination, Coase theorem, economic policy, territorial pacts, transition.

“social sciences progress by means of concepts”  
(Von Hayek, quoted in Moulin, 1986, p. 6)

## 1. COORDINATION, COOPERATION, AND THE COASEAN APPROACH TO ECONOMIC POLICY

### *1.1 Coordination and Cooperation*

The concept of coordination refers to the carrying out of a set of activities by different individuals in a way compatible with the attainment of a given social (favourable, at any rate better than without coordination) result. Coordinating decisions, and the resulting activities, is the basic task of an economic system, indeed, of any social system. Coordination can be conscious and aimed for, according to a voluntary agreement, and may then be called cooperation, or can result from separate individual decisions, such as in Nash equilibrium, or in the paradigm of the invisible hand. In the general equilibrium formalization of the latter there is (implicitly at least) bilateral cooperation between buyers and sellers;<sup>1</sup> the overall outcome however involves the attainment of a Pareto efficient state for society as a whole; thus bilateral cooperation results in overall (Pareto) efficient coordination. In the general case of Nash equilibrium (where individuals act independently of explicit agreements) the outcome may turn out to be Pareto inferior to some other state that could be attained through cooperation, leading to

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<sup>1</sup> Even if markets are described as impersonal and in thick markets, in particular, cooperation may be reduced to the bare element of purchasing and selling a standard commodity at a given market price, transactions in the end take place between individual sellers and individual buyers. In general the market system relies on the fact that satisfactory overall coordination can be achieved through institutions leading to limited cooperation, amounting in most cases to bilateral exchange. On the other hand in the case of the traditional planned socialist economy, coordination is basically achieved through commands, even if there may be substantial elements of cooperation, bilateral or otherwise.

what may be called a cooperation failure. On the other hand, to be stuck in a Nash equilibrium when there is an alternative Pareto superior one is referred to as a coordination failure, as in this case the superior outcome does not necessarily require explicit cooperation: if only the separate self-interested agents were to behave differently (for instance because of different expectations as to the other agents' rational behaviour or on government policy), a better social state could be achieved in an alternative equilibrium situation, even without explicitly striking a deal. For instance, in the macroeconomic theoretical case of multiple equilibria arising from strategic complementarity,<sup>2</sup> the different possible Nash equilibria could depend on different levels of self-fulfilling expectations as to the level of demand.<sup>3</sup> In case a Nash equilibrium is Pareto dominated by another state that is not a Nash equilibrium, as in the case of the usual one-shot Prisoner Dilemma, or in the fixed time span Prisoner Dilemma supergame,<sup>4</sup> the Pareto superior state could in principle be achieved through cooperation, if cooperation is possible, which usually means if deals are enforceable. On the other hand it is well known that, in case of an infinitely repeated game, every Pareto efficient outcome dominating a Nash equilibrium can be sustained, even without explicit agreements, if everybody expects Nash reversion<sup>5</sup> as a punishing strategy, provided the discount factors are high enough (intertemporal preferences are not too myopic). If the expected

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<sup>2</sup> This occurs whenever “increased effort by other agents leads the remaining agent to follow suit” (Cooper, 1999, p.19).

<sup>3</sup> Cf. e. g. Cooper (1999).

<sup>4</sup> This means a game composed of a sequence of one-shot (stage) games. If the time-horizon is fixed, because of backward induction the solution becomes the repetition of the inefficient Nash equilibrium of one-shot games, since the dominating cooperative solution cannot be sustained by the self-interest of the players.

<sup>5</sup> This means the return to the strategy bringing about the dominated Nash equilibrium for the indeterminate future.

punishing strategy is more severe, the above applies to every outcome that is associated with greater payoffs than those compatible with the maximum punishment the other parties can inflict (this means payoffs that are individually rational).<sup>6</sup> In this we have a kind of implicit cooperation, based upon no explicit agreement, but on the expectation of other players' sanctions bringing about an expected loss in case of non conforming behaviour.

### *1.2 Pareto Inefficiency as Cooperation Failure*

Generally speaking, however, Pareto sub-optimality is tantamount with cooperation failure, as by its very nature a Pareto inferior state could always be improved through cooperation, if cooperation finds no obstacle or constraint. In a nutshell this could be seen as the essence of the so-called Coase theorem.<sup>7</sup> However, for (explicit) cooperation to be possible a set of conditions are required. The first is that the agreements involved in cooperation should be implemented. This is not too complicated when they are struck among a limited number of agents and are enacted simultaneously, such as in barter or spot market exchanges. Even in this basic case however some general requirements concerning law and order must be fulfilled. For instance, the possibility for an agent, instead of entering into a mutually advantageous exchange, to grab somebody else's assets with dexterity or force, and get away with that, or to cheat, misrepresenting the nature of the exchange, should be prevented; in other terms property rights into the possible objects of exchange and rules determining the requirements of proper behaviour should be established, if only, minimally, by the power of custom and social conventions (such as in tribal trades, or trades along the old prehistorical trade

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<sup>6</sup> This is the content of the famed Folk theorem; see Mas Colell et al., 1995, pp. 418-423.

<sup>7</sup> See Coase, 1960. The nature of the "Coase theorem" has been amply debated in the literature. See for instance Usher (1998), Dixit and Olson (2000), where further bibliographical references could be found.

routes that operated in distant past,<sup>8</sup> even without the disciplining power of a state). But the requirement of implementation becomes more demanding whenever exchanges acquire, as is often the case, an inter-temporal dimension. In this case the problem arises of what would prevent agents who have to perform subsequently to behave opportunistically, not performing their side of the deal.

This issue is most clearly stated by Hobbes in well-known passage:<sup>9</sup>

*“If a covenant be made wherein neither of the parties perform presently, but trust one another ... upon any reasonable suspicion, it is void: but if there be a common power set over them both, with right and force sufficient to compel performance, it is not void. For he that performeth first has no assurance the other will perform after, because the bonds of words are too weak to bridle men's ambition, avarice, anger, and other passions, without the fear of some coercive power”*

To keep one's pledge and avoid behaving opportunistically can be induced by ethics or reputation, and by the incentives provided by the perspective of repeated exchanges, but usually requires some kind of outside sanction, if only to support the maintenance of the ethical values or habits that may be furthered and strengthened by compliance, and jeopardized by the experience of successful violation. Sanctions could be administered spontaneously by altruistic punishment,<sup>10</sup> but usually require

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<sup>8</sup> See Hermann, 1965, ch. 1.

<sup>9</sup> Hobbes, 1651, chapter xiv (“Of the First and Second Natural Laws, and of Contracts”), p. 84.

<sup>10</sup> Indeed, according to Fehr and Gächter (2002), “cooperation flourishes if altruistic punishment is possible, and breaks down if it is ruled out”. This may contribute to explain part of the economic success of Far-eastern societies where “shame”

the existence of some specific institutions, such as courts, police, state administration. The way in which these institutions are generated and maintained lies outside the scope of this paper and is the object matter of political theory.<sup>11</sup> Whenever lack of ex post enforcement of ex-ante agreements blocks potential efficiency improving transactions, a crucial task of the state is to perform as the enforcer. The importance of the state as the enforcer of contracts is borne out in particular by the recent experience of transition economies. While direct management of the economy by the state has proved relatively wasteful, according to the overall experience of the last century, the experience of transition countries has on the contrary proved how essential the role of the state is as a guarantor of public order and of law enforcement, the enforcement of contracts in particular.<sup>12,13</sup> Even independently of the issue of enforcement there are a number of difficulties in practice that could prevent theoretically possible cooperative deals to be struck:

1. Information. There are two sets of issues: a) Who may benefit from cooperative agreements? How to find them? b) What are the real characteristics of the object of contracting? Through deceit they could be quite different as it appears, whenever, as usually is the case, information is asymmetric, and this possibility

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allegedly plays a much more important social role than in the West (on this point see Lall, 1998).

<sup>11</sup> In this game theory is the source of some interesting lines of thought; for the game-theoretical approach to the issue of the origin of the state, see Taylor, 1987 and the literature quoted there.

<sup>12</sup> There are many areas where economic recovery has been hampered by lack of contract enforcement. For an interesting example in the area of agriculture, see O'Brien et alii (1999), p. 29.

<sup>13</sup> The issue of how to enforce cooperative agreements is important but obviously it is not the only relevant one. Another related aspect is the fundamental impact of the quality of institutions and government policies on productivity and growth: cf. Hall and Jones, 1998; Knack, 1999.

may block possible Pareto improving transactions, hindering the opening of potential markets.<sup>14</sup>

2. Cost of contracting: how much would it cost to get the parties together and to organize the agreement?
3. Bargaining: how to divide the gains that could be obtained by the agreement? For instance, under realistic circumstances of fundamental uncertainty and private information, somebody could block the agreement with the strategic aim of forcing the surrender of almost all the gains to himself. In the process no agreement may be reached.
4. Free riding, whenever the benefits of an agreement could be reaped, because of externalities, by those who choose not to be part to it and to avoid paying the costs that its implementation may require.

The advantage of coordination through thick markets as a way to reach, if not optimal, at least comparatively satisfactory societal outcomes lies in the fact that these are attained by-passing the above difficulties that bedevil cooperation.

### *1.3 The Coasean Approach to Economic Policy*

If market failures are tantamount with the fact that potentially mutual beneficial agreements are not struck, it seems somewhat natural that the first task of policy should be to remove, or at least to lessen, the obstacles to Pareto improving voluntary agreements (this could be considered as the classical Coasean approach to economic policy):

1. Through the assignment of property rights, while taking into consideration the different consequences that alternative assignments of property rights can have in practice on the overall social outcome, the number of the concerned parties could be limited and the free rider problem reduced. For instance, the assignment of a property right to the exploitation of a resource, blocking the free access of indeterminate third parties, limits the number of agents that could be part of an agreement about its exploitation. The possible interested third parties

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<sup>14</sup> As in the classical case of Akerlof's "market for lemons".

could bid the right from those to whom the property right to its exploitation is conferred. This can avoid the tragedy of the commons, whereby those who may have an interest in an efficient exploitation of the resource are too numerous and indeterminate (and possibly prone to free rider behaviour) for allowing the practical possibility of striking an agreement as to its efficient management.<sup>15</sup> This could be the common sense translation of the Coasean requirement of the suitable assignment of property rights for facilitating Pareto improving agreements. Another translation could be that by assigning well-defined property rights Pareto improving deals can be favoured because the uncertainty and legal indeterminacy of the absence of clear legal provisions are removed. In the assignment of property rights issue one may well include that of setting up and maintaining a system of property rights protection and contract enforcement.

2. For similar reasons the explicit assignment of property rights could also reduce the cost of contracting to manageable proportions. On the other hand it is obvious that the assignment of property rights not necessarily can bring about the exploitation of all possible mutually advantageous exchanges. For instance, in the textbook case of pollution, if the subjects involved are many, and possibly necessarily indeterminate, the assignment of property rights may be not enough

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<sup>15</sup> Things are different in case of close-knit small communities where it is much more immediate to single out those interested in the efficient use of the common resource and where social control (the repeated game framework implied by the daily contacts of the members) may more easily prevent free riding and disruptive strategic behaviour. This applies for instance to the rules established and maintained by usage concerning the exploitation of the commons in the traditional medieval village (cf. Dahlman, 1980).



to lead to the exploitation, through cooperative agreements, of all the theoretical possibilities for Pareto improvements.<sup>16</sup>

3. By fixing the conditions of contracting the state could avoid the costs and indeterminacies of bargaining, and at the same time pursue some distributional or equity objectives.<sup>17</sup> But to fix the terms so as to be compatible with the interest of all the concerned parties to implement, through cooperation, potential Pareto improvements could be an informationally impossible task. Moreover, these kinds of intervention may succumb to wishful thinking (as is often the case, for instance, with rent control).
4. By certifying the nature of the object of possible transactions and supplying information the state could reduce those uncertainties as to the object of contracts that could block transactions.
5. State intervention should not be such as to make socially improving cooperation more difficult than otherwise could be. This apparently straightforward requirement is not so simple as it appears, however, since not all the possible agreements lead to social improvements, even if the assumed social welfare function has the Paretian property. A basic public task is to impede agreements that are social detracting (whatever the implied social welfare function may be). This requires distinguishing between social detracting and social improving contracts, and thus to have a set of institutions for controlling agreements, allowing or prohibiting them according to their nature.

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<sup>16</sup> Let us for instance suppose to have a polluting factory and a great number of residents in the area of pollution. Whether the factory is given or denied the right to pollute it is practically impossible for the residents (all of them) and the factory to strike a deal. A deal could be more easily struck between the factory and the local representative authorities, but this involves issues of a different nature, which are considered in the next section.

<sup>17</sup> A straightforward example may be the fixing of minimum wages in a context of monopsonistic power in the labour market.

#### *1.4 Social Improving and Social Detracting Transactions*

Indeed, a basic difference between economic systems lies in the kind of transactions that are seen as social detracting, and are therefore forbidden, or as social improving, and are therefore permitted. Under socialism, in its extreme or “classical” Soviet-type form, all kinds of contracts between private individuals leading to the hiring of labour are in principle forbidden. Under “capitalist” institutions, contracts of this sort are in principle allowed, and even encouraged. Under most regimes a set of voluntary transactions are considered to be social detracting and therefore forbidden, such as those aiming at carrying out all sort of criminal activities. In market economies some transactions can be forbidden that are specific of these economies, such as falsifying balance sheets, or agreeing about price-setting in a cartel.

The reasons to forbid transactions can be intrinsic (for instance the transaction to sell an organ for transplant in exchange for money or other utilities is seen as unethical and therefore forbidden). But in most cases the basic reason to forbid certain types of transactions lies in the perceived external effects, in the short or in the long run. From a “classical” socialist viewpoint transactions that imply the private hiring of labour are supposed to lead to exploitation and alienation. Whatever the meanings of these words may be, these are seen as fundamental social evils, and therefore, as a matter of principle, the transactions alleged to bring them about are forbidden. Moreover other externalities of private market behaviour that are supposed to justify its suppression, according to what we may call the extreme socialist viewpoint, are considered to be the propensity to insufficient utilization of productive capacity, and macroeconomic instability generating the business cycle, as well as the tendency to produce excessive economic inequalities. Other less sophisticated views, especially in more backward countries, intrinsically see transactions as a zero sum game: if somebody gains, it means somebody else loses, hence the lack of legitimation of private property rights in the eyes of vast sectors of society. This is even more so, as often may be the case in third world countries, under conditions of widespread violations of law and order leading to private enrichment through socially detracting activities. All this can in turn limit the

propensity to risk-taking and entrepreneurship in legitimate social improving activities, and contribute to perpetuate conditions of backwardness.

### *1.5 The Externalities Issue*

If we abstract from transactions that are considered intrinsically wrong and are forbidden because of ethical reasons, all other voluntary and informed transactions that do not generate negative external effects of some sort could be considered to be socially advantageous, from a Paretian perspective.<sup>18</sup> But in reality transactions, indeed all sorts of human activities, usually bring about non-negligible external effects. Thus cooperation by some agents may lead to a Pareto non-comparable change, possibly even to a social worsening in the Kaldorian sense. (Obviously the latter outcome can take place only if some abstractly possible exchanges are concretely blocked.) As there are hardly any human activities that are in practice deprived of effects on somebody else's welfare, one must decide which external effects should be considered to be relevant and regulated by the state, and which instead should be considered as irrelevant and ignored. The external effects of a strictly economic nature, be they real or pecuniary, are a traditional economic policy concern.<sup>19</sup> Of course, from a Coasean viewpoint the need to have a specific consideration for economic externalities does not exist, once the state has performed its role in attributing property rights and favouring the reduction of transaction costs. Either the external interests do take care of themselves through Pareto improving cooperative agreements or, if those agreements are blocked by unavoidable transaction costs, the real (transaction) cost of internalizing the

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<sup>18</sup> We are not going here into some delicate issues, that are beyond the simple Paretian framework, such as the issue of time consistency of decisions or that of the formation of preferences, which would complicate the matter.

<sup>19</sup> Pecuniary externalities are not an issue in the general equilibrium perfectly competitive paradigm (and accordingly they have been neglected for a long time), but are very much relevant in an imperfectly competitive framework. See on this point Makowski and Ostroy (2001), pp. 529-531.

externalities (such as those needed to set up and organize markets) makes the internalization of externalities constrained Pareto inefficient.<sup>20</sup> Whenever this happens, however, the coercive intervention of the state could, but needs not, remedy the situation. Moreover coercion is needed whenever changes that are not Pareto improvements (somebody loses) are seen as leading to socially preferable outcomes (obviously on the basis of evaluations that respond to criteria different from the Paretian principle).

### *1.6 Hierarchical vs. Voluntary Coordination*

In real economies command by some in authority is another method of coordination. Authority implies a hierarchy: hierarchies and command are methods of coordination alternative to markets and voluntary cooperation. Hierarchies can either be based on voluntary agreements (labour contracts in particular, which are founding hierarchies inside the firm) or result from coercion and sheer (non-contractually based) authority exertion (as in an army based on military draft, for instance, or in the traditional patriarchal family, or forced labour camps, or in slave societies). Moreover everywhere, even in the most liberal market economies, widespread elements of coercion are present in state activities such as taxation, maintenance of law and order, conscription. These activities are part of the most essential functions of every state, and to be effective they require some form of

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<sup>20</sup> According to Demsetz (1969), if there are theoretically unexploited possibilities of exchange, and the private parties concerned have freedom to contract, we do not have a situation of inefficiency because the cost of reaching the agreements is higher than the benefit to be reaped. On the other hand transaction costs themselves depend on the institutional arrangements, and can be dramatically reduced by public intervention (providing for instance relevant public goods such as the introduction of standards or legal enforcement of contracts), whose costs can be lower than the added value of the resulting transactions. Only coercive state intervention can, in particular, overcome the familiar free rider problem, which, not being addressed by Coase, undermines the relevance of the “Coase theorem” (cf. Dixit and Olson, 2000).

basic coordination (if only through implicit collusion) in setting up and maintaining the institutions (this means repetitive ways of behaviour) on which their very nature depends. The same applies to the institutions concerned with the organization of exchanges. The creation and maintenance of them require the setting up of rules of behaviour, in particular, but not necessarily so, by coordinated (and coercive) action by state authorities.<sup>21</sup>

Whatever the source of the hierarchy, the basic principle of hierarchical coordination is command. This would present no problem in case of perfect information. But, because information is imperfect, agents in a hierarchy must be given a span, more or less large, of autonomous decision-making and part of their activities must be coordinated through voluntary cooperation with other agents. Agents must also be persuaded to use their autonomous span of decision in the best interest of their organization. A way to proceed is through the structure of pay and the shaping of careers, as well as by internal discipline. Another is to build up an ethos and ideology so as to stimulate behaviour in hierarchies. One may only recall all the nationalistic paraphernalia of the states and the armies. But corporations too have their ethos and ideology. Ethos and ideology also affect the nature and productivity of market interactions, as is shown by the classical studies on the relationships between religion and market performance.

### *1.7 Failures of the Market, Failures of the State, the Nirvana Fallacy, and the Reverse Nirvana Fallacy.*

Building up hierarchies as an alternative to voluntary (contractual) coordination can be justified whenever coordination through hierarchies brings about better overall results. In the Coasean view of the firm, the firm as a (contractually founded) hierarchy is seen as being more efficient than market relations as a tool of

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<sup>21</sup> The policing and organization of markets require the expenditure of resources that typically is not considered in the basic theoretical framework, but which introduces a type of transaction cost that (together with the other features considered in the text) constitutes an essential departure from it.

coordination, because of the economy in transaction costs that the firm brings about in comparison to relying on market contractual relations.<sup>22</sup> Under the notion of the economy in transaction costs one can also include the avoidance of opportunistic behaviour and hold-ups by occasional contractors, potentially disrupting production and distribution processes.<sup>23</sup> Another, intermediate, way between the firm as a net of long-run contracts, allowing hierarchical coordination, and the alternative approach of relying on anonymous market transactions is the creation of formal or informal networks, binding personal and enterprise collaboration through formal or informal contractual relationships.<sup>24</sup>

Obligatory membership, hierarchy and command are organizational principles intrinsic to the very nature of the state, with no need of a contractual foundation as in the firm, even if sometimes given a fictitious social contractual foundation in political theory. The idea that whenever the market system and contractually based voluntary cooperation fail, there is automatically a case for the state to intervene with remedial actions, out of his superior knowledge and organization, is seen these days as a fallacy, the well known Nirvana fallacy,<sup>25</sup> but was conventional wisdom in a not too distant past, dispelled both by experience and theoretical advances. It is

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<sup>22</sup> For some further perspectives on the nature of the firm a comprehensive but concise summing up is provided by Hart (1989).

<sup>23</sup> Cf. Williamson (1975).

<sup>24</sup> Cf. Richardson (1972). For the nature of collaborative inter-firm relations one may refer in particular to Mariti and Smiley (1983). For the role of informal networks, sometimes based on ethnic, religious or family ties, see Coleman (1988), quoted in O'Brien (1999), where the preconditions to establish these kinds of informal network ties are seen as a component of social capital.

<sup>25</sup> Cf. Demsetz, 1969.

conventional wisdom at present that along with the failures of the market there are the failures of hierarchies, and the failures of the state, and there is no guarantee that the latter are any less damaging than the first.<sup>26</sup> On the other hand one should beware of what we may call the reverse Nirvana fallacy, rather widespread in some quarters, of assuming that, because the state is imperfect, the market (in the general meaning of voluntary contracts of any sort) must necessarily lead to better results.<sup>27</sup>

## 2. THE EXTENDED COASEAN APPROACH TO ECONOMIC POLICY

### *2.1 The Extended Coasean Approach and its Limitations*

Whenever potential socially improving agreements are frustrated by the obstacles that are resilient to the classical Coasean policy approach, such as those deriving from the indeterminacy of the interested parties, or their great number, leading to

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<sup>26</sup> As Stiglitz (1994, p. 243) puts it “We live in an imperfect world in which often we face nothing but the choice of the lesser of two evils!”

<sup>27</sup> There are some economists of the radical right who purport that because of general considerations (such as the special severity of agency problems in state organization as well as the assumed logic of politicians’ and bureaucrats’ behaviour) state intervention, if only to furnish pure public goods, must be avoided. But this radical stance is proved to be incoherent by the usually unopposed acceptance of the fact that some basic public goods such as external security and law and order, including the assignment of property rights, must be provided by the state anyway. Thus one does not see why the suitability of publicly furnishing other public goods (instead of leaving the measure of their provision to the market, possibly through the creation of specific and costly barrier to access, with consequent undersupply) should not be considered case by case on its own merits instead of being dismissed by the sleight of a hand.<sup>28</sup> The latter point is an important qualification to the advantages provided by any kind of policies based on consensual agreements, such, as for instance income policies based on covenants between the government and the representatives of organized social interests.

excessive transaction costs, or the free rider and social action problem, public bodies, instead of resorting to direct and coercive measures, could become part of some cooperative agreement as the elected representatives of the constituencies affected by the deal. We could conceive here an effective extension of the Coasean approach to economic policy, according to a kind of generalized subsidiarity viewpoint. The philosophy, based on the consideration that “the interested parties know better”, could run as follows: First of all the conditions favouring the autonomous cooperation of the interested parties for achieving social improving agreements should be created, if possible, by reducing transaction costs and suitable assignment of property rights. (The latter is a coercive measure against those who are excluded from property. So, in the assignment of property rights the coercive power of the state enters anyway.) If this cannot be done or cooperation is not forthcoming, public authorities can become part of a deal on behalf of their constituencies. This requires the legal system to validate agreements of this kind. The above presents no problem whenever standard market transactions are involved. Things are different if the transactions under consideration require some undertaking concerning the behaviour of authorities in their public decision making capacity (for instance a deal between a local public authority and an investing outside company including the pledge to shape the town plan so as to allow the company to use a given parcel of land for building its plant, or for the local authority to construct some kind of infrastructure, such as a road). Thus, in order for these kinds of agreements to be possible one needs to have the corresponding legal institutions in place. Otherwise their validation could be de facto granted by a suitable social and political context (one may refer here to the guarantee provided by the permanence of the local ruling structures of the Communist Party, in the case of the township and village enterprises in China, or, in a quite different context, in the industrial districts of Emilia Romagna). The advantage of reaching voluntary deals lies in the fact that they are revealed improving the state of all the parties of the deal (but obviously not the state of third parties that could also be affected).<sup>28</sup> This aspect is missing in case public bodies implement a measure in their coercive



capacity (such as through expropriation, taxation, or regulation) or through direct economic initiative.<sup>29</sup>

On the other hand, if we do not want to be confined to policy measures supposed to lead to effective Pareto improvements only, coercive action is an obvious necessity (in particular in case of measures of a redistributive nature). Moreover, whatever way public bodies intervene, the possibility that their action be captive of private rent-seeking interests must always be taken into account. But this is a general problem of agency: whenever there is a delegation of responsibility there is always the possibility that the agents behave against the interest of the principals to their own advantage. Outside the area of the state this is obvious in the case of corporations, where officers can act in different well-known ways against the interest of the shareholders.<sup>30</sup> In both cases supervision and control may be necessary, even if there are some well known reasons why the agency problem in case of public bodies may be much more severe.<sup>31</sup>

## *2.2 The Present Relevance of the Extended Coasean Approach*

Coercive and substitute direct types of intervention have lost their appeal, through the collapse of the planned economies, the manifestation of the negative consequences of dirigistic policies all over the world, and the increasing awareness

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<sup>29</sup> However, some pledges concerning the use of these administrative powers by the public authorities concerned could be part of a deal.

<sup>30</sup> Such as through asset stripping or, as has come of prominence in recent times, cashing in stock options after artificially increasing through deceit the value of shares. One may recall in this connection Adam Smith's pessimistic appraisal of the agency problem in joint stock companies (cf. Smith, 1976, 740-758).

<sup>31</sup> For instance the usually much greater number of ultimate principals (the voters) increasing the severity of the social action problem, and the fact that the option of "exit" is certainly more practicable for partners or shareholders than for members of political constituencies.

that, if the market fails, so does the state. Thus, the failure of coercive and substitute direct types of intervention enhances the interest for models of policy creating opportunities for the coordination of decisions through mutual agreements by the agents concerned (public or private they be). Different varieties of this kind of approach can be found in successful applications in various institutional and geographical contexts. One may refer to the township and village enterprises in China, based on private-public (or local-state) partnerships, to specific aspects of Japanese and, more in general, far-Eastern industrial policies,<sup>32</sup> implying large scale private-public concerted action, and, turning closer home, to certain aspects of the functioning of industrial districts or of successful regional economic systems (such as the Baden-Württemberg model) in Europe, making up sorts of “associational economies”, as they have been dubbed.<sup>33</sup> Lately the institutions leading to large scale policy interventions based on decentralized compacts between public and private entities have been introduced in Europe, and in Italy, in particular, with the aim to pursue objectives (such as regional development) that previously would have been thought to demand direct intervention from above through planning or direct public economic initiatives. In this framework, as instances of a cooperative, voluntary approach to economic policy, we may refer to the Italian set of institutions that go under the name of “programmazione negoziata” and the European analogue, the “Employment Territorial Pacts”. On the macroeconomic level one may refer to policies based on contractual agreements between the representatives of public and organized interests (income policies).

### 3. COORDINATION OF PUBLIC AND PRIVATE DECISIONS AND DEVELOPMENT POLICY IN ITALY

#### *3.1 At the Macroeconomic Level*

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<sup>32</sup> Cf. Aoki et alii (1997); Nakatani (1998).

<sup>33</sup> Cf. Cooke and Morgan, 1998.

Coordination of public and private decisions through voluntary agreements between the concerned parties has been an important aspect of Italian economic policies in the 90-ies, both at the macro and at the micro level.<sup>34</sup> At the macroeconomic level the income policy agreements of July 1992 and July 1993 played an essential part in the path towards financial stabilization that led first Italy away from the brink of financial disaster (in 1992) and then to rapid disinflation and the unexpected inclusion of Italy in the EMU from the start.<sup>35</sup> These agreements, which amounted to pledges of coordinated cooperative behaviour by the parties concerned (government, trade and employer unions), apparently produced for them, as well as for the national economy as a whole, a much better overall outcome than could be expected from separate non-cooperative alternative courses of action.

### *3.2 At the Local and Regional Level: the Territorial Pacts*

At the regional policy level, both aspects, of coordination of investment decisions and of coordination of private and public initiatives, have found in Italy an institutional counterpart in the territorial development pacts. The latter were pushed to the centre-stage of Italian regional development policy in the nineties, following the collapse of the previous dirigistic type of intervention, the so-called *Intervento straordinario*. As often is the case, Italian legislation is rather cumbersome. There are a number of different, complementary or overlapping, measures of so called negotiated planning (*programmazione negoziata*)<sup>36</sup> whose declared aim is the coordination of economic policy measures and the creation of private-public partnerships at the regional, or at any rate, local level.<sup>37</sup> The legal foundation of

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<sup>34</sup>There is an important related issue, that of the coordination of economic policy authorities among themselves, which is however out of the scope of the present paper.

<sup>35</sup>See Rossi, 1998, pp. 97 f.

<sup>36</sup>Defined by art. 1 of the law no. 104, 7/4/1995.

<sup>37</sup>Up-to-date information can be found at: [www.dps.tesoro.it](http://www.dps.tesoro.it).

territorial pacts lies in the law 23.12.1996, n. 662, even if the first launching of the institution dates back to April 1995.<sup>38</sup> Some general principles of consensual agreements as an admissible instrument of administrative action and policy had been stated previously by the law 241/1990 (art. 11, 14 and 15).

In what follows we will not distinguish between the different types of intervention, referring in general to them as "territorial pacts". An alleged aim of these measures is to favour the coordination of activities at the local level, between public authorities themselves, and between public authorities and private parties, with the hope, among others, to stimulate bottom-up development and to replicate the more spontaneous, successful experience of Italian industrial districts.<sup>39</sup> The latter have been characterized by the beneficial interaction in time of the different private and public initiatives, which have resulted in static, but especially dynamic, economies of scale through external effects. .

Unfortunately the institutional provisions regulating territorial pacts have been marred by a set of negative features, which have affected their implementation. The first one is the persistence of cumbersome administrative procedures.<sup>40</sup> A set of administrative bodies, both at the local, and at the central administrative level have been compulsory involved in their elaboration and approval. This has led to the lengthening of procedures up to the point where the change in the factual situation makes the coordinated intervention uncoordinated or unsuitable any more. The legal

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<sup>38</sup> *Decreto legge* 103/95 of 24 April 1995.

<sup>39</sup> Another, more concrete, hope is apparently to induce the local authorities to organize projects which could draw the support of European Union structural funds. In this respect at least the *programmazione negoziata* has been rather successful.<sup>40</sup> Some simplifications in the procedures of the *patti territoriali* have been introduced in 1997.

framework includes some power to surrogate the local authorities in case of delay or procrastination, but it seems that the responsibility for delays lies often with the central authorities themselves.<sup>41</sup>

Moreover, and this is the crux of the matter, territorial pacts imply substantial funding (for investment and for employment) from the state or EU (especially in the *Mezzogiorno*), up to 80% of investment expenditure,<sup>42</sup> and this, rather than genuine coordination of decisions seems to be the objective that is really pursued in practice, leading to an improper use of the institutional instrument. If the objective is the pursuit of the coordination of decisions between different, public and private, economic agents, whose decisions interrelate one with another, what is required is the setting up of legal instruments to validate compacts between the agents concerned, and, perhaps, some advisory agency, helping with ideation of coordinated projects and interventions, and reducing transaction costs through its mediation and initiative. Subsidies falsify the coordination exercise, artificially inducing the creation of coordinating structures where none are needed, and encouraging the elaboration of fake coordination projects. Ideally, the scope for agreements should be left to the judgement of the agents concerned, provided the commitment of each of them remains inside their powers and responsibilities. In practice subsidies may be justified to induce compliance: if you abide by the terms of the agreement you receive the subsidy, otherwise you do not. Other, legal, instruments for ensuring compliance would in theory be available but one can have some doubts on their real efficacy.<sup>43</sup>

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<sup>41</sup> Cf. ISFOL, 1998, p. 242.

<sup>42</sup> See CIPE, Deliberazione 21 marzo 1997, art. 2.9 d).

<sup>43</sup> The basic legal background of negotiated programming (or more in general, for having legal negotiated agreements between private and public parties, or among different public parties) is provided by the the law 7/8/1990, n. 241, in particular art. 11. The latter gives the power to the administration to recede unilaterally from the contract, with the private party being entitled only to some kind of indetermined

Some further misgivings apply to the ad hoc introduction of exemptions from administrative procedures and attenuation of labour relations constraints. It is not clear why the rules should be attenuated with respect to territorial pacts and not in general, if they are too rigid, or upheld in any case, if their respect is supposed to lead to better social outcomes.<sup>44</sup> If the issue lies in the existence of social and economic conditions that bring about a large divergence between social and private costs at the local level, the most straightforward way to intervene would be toward the reduction of this divergence. Finally, if the issue lies in lack of appropriability of external effects, and free riding, this is not entirely resolved through the voluntary stipulation of pacts (even if the latter can lead to the endogenization of some externalities), but may require some form of coercive or direct intervention (for instance the creation of obligatory consortia).

One should also consider that the organization and implementation of territorial pacts are not devoid of real costs, administrative and otherwise. The financial resources that are used for the initiatives envisaged in the pacts have an obvious opportunity cost, if only in terms of reduced financing of other alternative initiatives, and there is no *prima facie* reason why credit at concessionary rates

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indemnization. Even if in practice the legal enforceability may be seen to be doubtful, there are other ways in which the agreements can exert their effects. First of all there is the prime mover, the quest for subsidies and for the financing of infrastructure, which could be jeopardized by the non-fulfillment of the contractual obligations, second there is the political aspect which in theory could lead to possible reprisals against the non performing parties. On the other hand one must add that in practice verification of the execution of the pacts has been by and large limited and insufficient (Moro, 2001).

<sup>44</sup> In reality in the period in which the territorial pacts were introduced a consensus was emerging that the norms that regulate employment contracts in Italy were much too rigid and a cause of unemployment. Pending a wholesale rehauling of Italian labour relations, some weakening of existing rules were introduced in a piecemeal fashion, among others in the design of territorial pacts.

should be included, as is usually the case, not to speak of the huge investment subsidies that have been mentioned above.

On the other hand the subsidies and sundry advantages that are offered may stimulate local initiative and coordination which otherwise would stay latent, and lead to the creation of some social capital through the effort, however artificial, in coordinating decisions. Much depends on the extend of subsidies; some subsidies may be an incentive to local initiative and project-making. Too much may lead to waste of resources and the creation of economic initiatives which may not be self-supporting in the long run (not unlike the previous centralized development planning experience of the *Cassa del Mezzogiorno*).<sup>45</sup> Moreover, another crucial aspect is the nature of the subsidies. While direct subsidies to private initiatives (such as subsidization of interest or capital payments by private investors) are hardly justifiable in view of past experience, financing and organizing the creation of infrastructures and in general the provision of public or collective goods that are functional to an overall coherent set of coordinated decisions enter naturally in the scope of public intervention.

#### 4 CONCLUSION

Whenever the Coasean approach of favouring the agreements between the concerned parties cannot be used to remedy market failures, for instance because of the large number or indeterminacy of them, or the intractability of the free rider problem, instead of resorting to the more traditional forms of public policy through the direct or coercive action of the state one could turn to what we may call the extended Coasean approach to public policy, centring on the setting up of the conditions whereby public authorities, as representatives of the concerned constituencies, could strike voluntary deals between themselves, and with private

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<sup>45</sup>This applies in particular to investment subsidies in the South. For an appraisal of some more successful experiences of territorial pacts elsewhere, see Regalia (2002), pp. 7-9.

parties, so as to arrive to some desired overall social improvement. Thus in theory there is a strong case for setting up institutions for favouring the voluntary coordination of various private and public decisions. In practice the suitability of these institutions depends on the quality of public intervention and organization that would be brought about by them. The way to favour socially improving coordinating agreements is for the state to introduce into the legal system instruments for their determination, enforcement and validation, and, at the same time, to provide some suitable contribution to the provision of the required institutional infrastructure. In the practice of European territorial pacts these have been vehicles for the distribution of subsidies. But this is only one possible, and not particular commendable, use of this kind of institution of economic coordination.

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