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THE LAW AND ECONOMICS OF POWER: MAKING SENSE OF INALIENABILITY RULES

Abstract

Economics has historically struggled with the concept of power. By emphasizing voluntary exchange, traditional economic analysis often overlooks the possibility that some exchanges take place within asymmetric relations. Despite the existence of imbalances, economic theory suggests that voluntary exchanges are beneficial to both parties, as even the weaker party would not engage in the exchange if it weren't advantageous to them.

In this paper, we challenge this view by arguing that recognizing an asymmetric relation characterized by power and understanding its characteristics is crucial to identify situations where the common assumption that exchange is mutually beneficial may not hold true.

In this regard, an important aspect to emphasize is that a situation of asymmetric power can be voluntary accepted by the parties; namely, an individual can accept to be subject to the "power" of another individual, that is to say, he can accept that another individual can impose some cost, possibly conditional on some actions or events. For example, I can accept to be subject to the "power" of an employer, a professor, or a judge.

These power relationships are characterized by the "principal" having discretion over decisions that impose costs on, or grant benefits to, the "agent" (firing, promoting, sentencing...). When the power relation is voluntarily accepted, an individual agrees—explicitly or implicitly—that the other party has some discretion over outcomes that may affect them negatively or positively.

Two conditions are necessary for such a relation to be accepted.

First, discretion is justified by contract incompleteness or non-verifiable information, which the principal possesses but cannot be verified by a third party. In effect, granting the principal this discretion amounts to shielding them from the consequences of their decisions on the agent.

Second, discretion and asymmetry of power can be accepted only under some conditions which limit the possibility for the principal to abuse their discretion. In fact, in asymmetric power relations, restrictions must be placed on the exchanges permitted between the parties, including limitations on theirs right so sell or buy. An individual would not accept to enter voluntarily into a power relation where the "principal" can bargain with no limitation with the "agent". This would amount to giving the principal the ability to use their power to extract resources from the agent.

A central claim of our paper is that limitations on the parties' rights to exchange are fundamental to power relations. However, these limitations are often difficult, if not impossible, to enforce only in cases of power abuse and typically result in broader restrictions. Consequently, these constraints lead to "second-best" outcomes. In this context, "second-best" refers to outcomes that may be inefficient from an ex post perspective, but are efficient ex ante, serving as guarantees that one party requires before entering the relationship.

This conclusion helps interpret a number of otherwise puzzling limitations on individuals' freedom to trade and contract, resulting in "inalienability rules". For example, in many cases rules not only prohibit monetary payments from principal and agents, but also forbid romantic relationship, whether or not they are consensual.

Such restrictions make power a costly institution. The optimal use of power relations must balance the benefit of delegating authority to a principal, aimed at solving or easing problems of market incompleteness, against the costs, namely, the consequences of restrictions that, in many cases, prevent mutually beneficial exchanges.