

Achieving Social Harmony
through
Win-Win Strategies
通过双赢策略, 达到社会和谐

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An Outline

- ◆ Introduction
- ◆ The Concepts of Pareto-Optimality and Pareto-Improvement
- ◆ An Example of a Lose-Lose Strategy: The Prisoner's Dilemma Game
- ◆ Examples of Win-Win Strategies
- ◆ Are There General Principles? The Roles of Coordination and Enforcement
- ◆ Concluding Remarks

Introduction

- ◆ Win-win strategies are strategies that benefit everyone. Everyone should welcome win-win strategies because there is a gain for everyone—every one should support and no one can oppose such strategies unreasonably (sometimes the distribution of gains between the players may be an issue).
- ◆ However, in order to realize win-win strategies, cooperation and coordination among the players are frequently required—that is, all their actions must be coordinated in order to achieve a win-win outcome.

Introduction

- ◆ Coordination can take many forms: Signalling by players, government planning, implicit and explicit agreements amongst players.
- ◆ And often some enforcement mechanism, explicit or implicit, is also required; self-enforcement is sometimes possible in some situations.
- ◆ Win-win strategies are the dream of every political leader, because it means that everyone can be made better off without anyone being made worse off, that is, without any net cost to any one individual. And if everyone can be made better off without such net social cost, social harmony is naturally improved.

The Concept of Pareto-Optimality

- ◆ An economic outcome is said to be Pareto-optimal (or efficient) if no one can be made better off without someone else being made worse off.
- ◆ Pareto-optimality is equivalent to efficiency 有效率—the output of no one good can be increased without either decreasing the output of another good or increasing the input of at least one factor.
- ◆ Many economic outcomes are Pareto-optimal, or equivalently, efficient.
- ◆ Under certain conditions, the general equilibrium outcome of a competitive market system is Pareto-optimal or efficient.

The Concept of Pareto-Improvement

- ◆ An economic outcome is said to be Pareto-improving if everyone is better off relative to a base period. A Pareto-improving outcome is not necessarily Pareto-optimal, that is, it is not necessarily efficient.
- ◆ Win-win strategies result in Pareto-improving outcomes.
- ◆ Win-win strategies also imply that every player is and must be better off (at least no worse off) than before 要利己就必须利人(最少不损人)!

An Example of a Lose-Lose Strategy: The Prisoner's Dilemma Game 囚徒困境

- ◆ There are two prisoners, A and B.
- ◆ Each of them has two possible actions: (1) warn the warden 监狱长, or (2) not warn the warden.
- ◆ If A tries to escape, and B warns the warden, A will be heavily punished by the warden, and B will receive a reward.
- ◆ Similarly If B tries to escape, and A warns the warden, B will be heavily punished by the warden, and A will receive a reward.

An Example of a Lose-Lose Strategy: The Prisoner's Dilemma Game 囚徒困境

- ◆ However, if they both decide not to warn the warden, then they will both be able to escape—a win-win outcome.
- ◆ But because there is lack of coordination (and lack of trust), each player cannot be sure that the other player will not turn him or her in, so each will always warn the warden, and neither is able to escape—a lose-lose outcome.
- ◆ Thus a lose-lose strategy is always chosen over a win-win strategy for this particular game.

Examples of Win-Win Strategies

- ◆ International Trade
- ◆ The Responsibility System
- ◆ The Special Economic Zones
- ◆ The Market for Pork
- ◆ The Market for Cotton
- ◆ The Market for Owner-Occupied Residential Housing
- ◆ Long-Term Capital Management
- ◆ Should the People's Bank Hold on to its U.S. Bonds?
- ◆ Advertising of Cigarettes
- ◆ Mutually Assured Destruction (MAD)
- ◆ Financing Foreign Direct Investment
- ◆ Tertiary Educational Institutions and Potential Employers

An Example:

International Trade

- ◆ The theory of comparative advantage basically says that when two countries trade voluntarily, both must gain.
- ◆ Then why is there so much opposition to free trade in many countries?
- ◆ International trade is a two-way street: increased exports will imply an expansion in the exporting industries but increased imports will imply a contraction in the import-competing industries.
- ◆ Thus, international trade typically benefits the workers in the industries producing the increased exports but hurts the workers in the industries facing competition from the increased imports.

An Example: International Trade

- ◆ However, the net gain in each country is always positive—there is therefore enough gain to make everyone better off—so that it comes down to a question of redistribution: How to tax the winners and compensate the losers in each country so that everyone in the respective countries is better off?

An Example:

International Trade

- ◆ There are many ways to achieve this objective—the government in a country can compensate its displaced workers by providing subsistence and re-training grants; it can tax the increased exports and use the proceeds to compensate the workers displaced by the increased imports; it can award the import licenses to the industry facing contraction because of the increased imports, on condition that the industry will take care of the displaced workers (this is an example of internalization of a potential externality), etc.

An Example: The Responsibility System and Free Market under the Central Plan

- ◆ In late 1978, the “Responsibility System” and the free market was introduced in China in the rural areas, and then in the early 1980s, extended to in the urban areas.
- ◆ Under the responsibility system, the households and enterprises were given the autonomy to produce and sell on the free market, once their obligations to the state, in the form of delivery and sale of fixed quantities of output at fixed prices according to a mandatory central plan, had been fulfilled.
- ◆ If any household or enterprise did not want to participate in the free market, it is no worse off than before—it could continue to purchase planned quantities of inputs and consumption goods and sell planned quantities of outputs at planned fixed prices.

An Example: The Responsibility System and Free Market under the Central Plan

- ◆ However, if a household or enterprise chose to participate in the free market, it must be better off than before, otherwise it would not have chosen to participate.
- ◆ Thus, the introduction of the “responsibility system” and the free market on the margin, coupled with the retention of the mandatory central plan, proved to be a win-win strategy—everyone is made better off without anyone being made worse off.
- ◆ The free market and the autonomy of households and enterprises unleashed latent productive forces and made possible new economic activities that had not existed before.

An Example: The Responsibility System and Free Market under the Central Plan

- ◆ Profits and losses (taxes and subsidies) of enterprises under the central mandatory plan remain the same before and after the initiation of economic reform. However, profits from the free market outside the plan increase the total income of the enterprises. Since participation in the free market is voluntary, the profits of the enterprises cannot be lower than under the central mandatory plan.
- ◆ Continued planned consumer goods (e.g., grains) deliveries to the government enable the maintenance of the pre-reform standard of living as a floor.

An Example: Special Economic Zones and Foreign Direct Investment

- ◆ When the special economic zones were first established in the 1980s, they were specifically kept separate from the rest of China in an economic sense.
- ◆ Even though foreign direct investment is welcomed in the special economic zones, goods cannot flow freely between the special economic zones and the rest of China—tariff and non-tariff barriers apply. Almost all foreign direct investment at the time was engaged in processing and assembly exports.

An Example: Special Economic Zones and Foreign Direct Investment

- ◆ All the inputs, with the exception of labor, used in the special economic zones are all imported from outside of China; they cannot be purchased from the rest of China. The outputs produced in the special economic zones are all exported. They cannot be sold back into the rest of China. This is to assure that whatever the special economic zone does, it will not upset or disrupt the mandatory central plan that is in force in the rest of China.

An Example: Special Economic Zones and Foreign Direct Investment

- ◆ But labor is in surplus supply in China, so that the employment in the special economic zones has no impact on either the availability of labor in the urban areas in China or on its wage rate.
- ◆ Thus, the special economic zones led to a win-win outcome. No one in the rest of China is worse off, but the labor employed in the special economic zones are better off than before.

An Example:

The Market for Pork

- ◆ The market for pork can be characterized by a high degree of price fluctuation from year to year because of the response to the realized market price and to its production cycle of approximately a year.
- ◆ The hog cycle used to be quite common in the U.S. A high price one year caused by too little supply is followed by a low price in the next year caused by excessive supply in response to the high price, which is in turn followed by a high price in the year following next, etc. Without intervention the hog cycle will not be able to reach equilibrium on its own.

An Example:

The Market for Pork

- ◆ In the market for pork, and in many similar markets for agricultural commodities, the government has two social objectives:
- ◆ (1) How to assure that pig farmers can expect to have sufficient income to support their subsistence needs, so that they will continue to raise pigs, thus also assuring a steady supply? And
- ◆ (2) How to reduce the volatility in the price of pork so as to stabilize its price for urban consumers and to prevent it from causing a rise in the cost of living?

An Example:

The Market for Pork

- ◆ The government can intervene by:
- ◆ (1) granting to each pig farmer a put option, that is, an option to sell a fixed quantity of pork to the government at a fixed price, sufficient to allow the pig farmer to make a living no matter what the market price of pork turns out to be. Of course, the pig farmer does not need to sell if the market price turns out to be higher than the fixed government purchase price.

An Example:

The Market for Pork

- ◆ (2) The government puts into storage the pork purchased. When the next season comes around, if the price of pork turns out to be too high (say, more than 20% of the fixed government purchase price), the government can sell pork into the market from its inventory, driving down the price of pork. Such a strategy effectively keeps the price of pork from rising more than 20% above the fixed government purchase price.
- ◆ Thus, everyone is better off than before. The pig farmer has an assured minimum income. The urban consumers have a more stable price of pork with a price cap and reduced volatility. (And the government faces fewer complaints.)

An Example:

The Market for Cotton

- ◆ A futures market in cotton can enable a farmer to grow cotton when in the absence of the futures market he or she may not do so.
- ◆ A futures market in cotton can also enable a cotton spinner to enter the spinning business—building plants, buying equipment, hiring workers, accepting orders--with significantly reduced risks, when in the absence of the futures market he or she may not do so.
- ◆ Thus, a futures market in cotton is a win-win strategy. It helps to create both value-added (GDP) and employment that otherwise will not be there. Both the cotton farmer and the cotton spinner win in this case.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ The demand for owner-occupied residential housing is potentially huge and it should be a major government objective to make residential housing affordable for almost all urban households.
- ◆ Owner-occupancy also has other social advantages—it enhances the feeling of security on the part of households and encourages maintenance and improvements. It contributes immensely to social harmony and stability.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ The challenge is making owner-occupied residential housing affordable to all urban households, including low-income households. The goal should be that everyone with a regular job should be able to afford to own and live in his or her own home.
- ◆ A long-term mortgage loan for owner-occupied residential housing means low monthly payments because the amortization and repayment of the principal can be spread out over a very long period, which makes buying and owning a home affordable. A thirty-five year loan implies a monthly payment of less than a half of a ten-year loan.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ A fixed-interest-rate mortgage means the home-owner is protected from fluctuations in the short-term interest rate and has the security that he or she will always be able to meet the monthly payments as long as he or she has a job, even if the short-term interest rate goes sky high.
- ◆ Thus, the availability of long-term fixed-interest-rate mortgage loans greatly increases the demand for ownership of residential housing units. And with the demand, the market will create the appropriate supply.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ However, one problem is that commercial banks do not have long-term fixed-rate deposits with which to fund the long-term fixed-rate mortgage loans. They have mostly short-term deposits the interest rate on which can move up and down, depending on the market conditions. If they make long-term fixed-rate loans, they will face large losses if and when the short-term interest rate goes up, causing the interest rate spread to become negative. But they cannot call the long-term loans, so the losses will continue to mount, until they finally go broke. This is precisely what happened in the U.S. Savings and Loan Associations crisis in the 1980s. The resulting losses cost the U.S. Government approximately US\$600 billion in 1980 prices.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ Securitization of long-term, fixed-rate owner-occupied residential mortgages is the best way to secure long-term funds to finance long-term mortgage loans. It can greatly broaden the ownership of residential housing by their occupants.
- ◆ The securitization can be facilitated and regulated through the establishment of Chinese versions of Fannie Mae and Freddie Mac, which, however, must remain completely state-owned, since they are, in their nature, policy banks implementing government policy.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ Both Fannie Mae and Freddie Mac are policy banks established and sponsored by the U.S. Government to make possible long-term (up to 30 or even 35 years), fixed-interest-rate mortgage loans for owner-occupied residential housing units. Without such loans, most U.S. families will be unable to purchase and own their own homes. The objective of Fannie Mae and Freddie Mac is thus not so much to maximize profit or to make money, but to promote, facilitate and support the residential housing market in the U.S. They were successful for a long time and were responsible for the revival of the residential housing market after the Savings and Loan Association debacle in the 1980s.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ Fannie Mae and Freddie Mac were created to solve this problem of maturity mis-match between the assets and liabilities of the mortgage lenders, so that it is possible for mortgage lenders to extend long-term fixed-rate loans even though they only have short-term variable-rate deposits.
- ◆ Basically, the mortgage lenders can sell their mortgage loans to Freddie Mac, for example, provided that they meet certain specifications: the underlying residential housing unit is owner-occupied; the value of the housing unit is below a maximum ceiling; the loan amount is below a maximum ceiling; the loan to value ratio is below a maximum percent (so that there is significant equity in the form of a down payment); the value is established through proper third-party appraisals; the unit satisfies safety requirements and quality construction standards; the borrower has regular and continuing income/employment and has the ability to service the loan; the loan has a maximum maturity (can be up to 35 years), etc.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ Freddie Mac in turn packages these qualified mortgage loans together and use them to back up long-term bonds that it issues in the market. The long-term bonds can also be up to 35 years in duration. The purchasers of the bonds are typically pension funds and life insurance companies which have long-term funds and do not have to worry about short-term cash flows or liquidity. Thus, maturity of the mortgage loans is matched by the maturing of the bonds, removing the potential risk of maturity mis-match.
- ◆ This is still a viable model, perhaps the only viable model for the financing of affordable owner-occupied residential housing.
- ◆ This is one of the major reasons why the U.S. Government cannot afford to have Fannie Mae and Freddie Mac collapse. If that had happened, the entire residential housing market of the U.S., for both new units and existing units, would have come to a complete standstill.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ However, there is one problem with this model, and that has to do with moral hazard.
- ◆ Since the original mortgage lenders typically do not have to keep their mortgage loans in their portfolio, but instead sell them off (say to the equivalent of Freddie Mac) as soon as the loans are made, they do not have the incentive to do a thorough vetting of the borrowers or the collateral itself. Thus, non-qualified borrowers may be granted loans and non-qualified properties may be accepted as collateral because the risks will be transferred to the purchasers of the mortgage loans and ultimately to the purchasers of the securities backed by the mortgage loans.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ In order to discourage moral hazard, the original mortgage lenders should be required to buy back any mortgage loan that becomes non-performing within three years of its initial funding from the bond holders. Thus the original mortgage lenders will have the incentive to be careful in making the loans in the first place.
- ◆ Had this rule been in place, the entire sub-prime loan problem in the U.S. would have never arisen.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ This is the right time, with the advanced industrial economies all in various stages of economic slowdown and recession, for China to promote its domestic demand, and owner-occupied residential housing should be the primary focus.
- ◆ To provide proper residential housing for all Chinese citizens will take several decades. And this should keep the Chinese economy growing, not only from the development and construction of the housing itself, but also from the derived demands of appliances, furniture, wall, window and floor coverings, etc.

An Example: The Market for Owner-Occupied Residential Housing

- ◆ But to do this successfully, and to avoid the risks of maturity mis-match, China should push for securitization of qualified mortgage loans on owner-occupied residential housing units on a large scale.
- ◆ Such an effort should also promote social harmony and enhance social stability. In particular, note that everyone is better off—the owner-occupants of the homes (more affordable residential housing with stable monthly payment requirements), the commercial banks (more fee income without the maturity mis-match risk) and the life insurance companies and pension funds (a good long-term, low-risk asset).

An Example:

Long-Term Capital Management

- ◆ Long-Term Capital Management (LTCM) was a hedge fund that collapsed in 1998, in part as a result of the collapse of the Russian Ruble.
- ◆ At the time, it owed US\$100 billion worth of debt to a group of international banks and had a net worth of not more than US\$4 billion.
- ◆ It was in the interests of these creditor-banks to continue to provide the liquidity to LTCM so as to enable an orderly liquidation. Thus, they needed to stay together for their own collective good.

An Example:

Long-Term Capital Management

- ◆ However, each creditor bank had the incentive to demand repayment immediately and not to stay in the creditor group if it could get away with it. But if everyone pulled out of the creditor group, LTCM would have to be liquidated immediately, as in a fire sale, and the results would be horrendous not only for LTCM, but also for all the creditor banks—a lose-lose outcome, not to mention the huge disruption to the financial markets of the world.

An Example:

Long-Term Capital Management

- ◆ Thus, an “enforcer” is needed to make sure that any agreement among the creditor banks is strictly followed by everyone.
- ◆ The Federal Reserve Bank of New York was invited to be a witness to the discussions (and to make sure that no one opts out).
- ◆ As it turned out, the losses to the international banks were minimized because the creditor group managed to stay together, enabling an orderly liquidation.

An Example: Should the People's Bank Continue to Hold Its U.S. Bonds?

- ◆ In the current financial crisis, a big question is whether the People's Bank of China, which holds an estimated US\$1.2 trillion worth of bonds and notes issued by U.S. Government and Agencies (e.g., Fannie Mae and Freddie Mac) out of a total of US\$1.9 trillion worth of foreign exchange reserves.
- ◆ Other East Asian central banks, such as the Monetary Authority of Hong Kong, the Bank of Japan, the Monetary Authority of Singapore, and the Central Bank of the Republic of China (Taiwan), are also major holders of U.S. Government-issued securities.

An Example: Should the People's Bank Continue to Hold Its U.S. Bonds?

- ◆ If they all sell at the same time, the market for U.S. Government securities will collapse and the U.S. Dollar is likely to devalue significantly against the East Asian currencies. The result will be heavy losses for all the East Asian central banks.
- ◆ It is therefore in the interests of all the central banks to hold and not to sell their U.S. Government-issued securities at this time. So far, there appears to be a tacit understanding that none of them will sell, and none has done so, a win-win outcome.

An Example: Should the People's Bank Continue to Hold Its U.S. Bonds?

- ◆ However, if ever one of the central banks feels that someone else is planning to sell, then it may decide that it is better off selling first, and selling fast, preferably before others start selling. But if every one thinks this way, the result will be total collapse of the U.S. Government-issued securities market in no time, a lose-lose outcome.
- ◆ This is not unlike the Long Term Capital Management situation, except that there is no external “enforcer” in this case, only the individual self-interests of the central banks.

An Example: Advertising of Cigarettes on U.S. Television

- ◆ It is in the interests of all U.S. tobacco companies not to advertise on U.S. television because the U.S. aggregate demand for cigarettes is not growing and advertising becomes purely defensive against poaching of customers by other tobacco companies.
- ◆ Every tobacco company is better off if all of them can agree not to advertise on U.S. television. There will be no decline in revenues, but a decline in costs due to the savings from not advertising, and hence a rise in profits.

An Example: Advertising of Cigarettes on U.S. Television

- ◆ However, every tobacco company has the incentive to cheat, that is, to advertise on U.S. television while the others do not. If that occurs, everyone will have to advertise, a lose-lose situation.
- ◆ It is therefore in everyone's interest to have someone enforce the agreement of no advertising.
- ◆ The U.S. Congress obliged by passing a law that prohibits the advertising of cigarettes on U.S. television. One may argue that the U.S. Congress is motivated by public welfare considerations, but given the lobbying power of the U.S. tobacco companies, the law prohibiting advertising could not have been passed with their consent.

An Example:

Mutually Assured Destruction

- ◆ The nuclear stand-off between the great powers can also be considered a cooperative game with a win-win outcome.
- ◆ Each country has a fully equipped nuclear arsenal that is ready to be used. However, the catastrophic nature of the response discourages any adventurous moves.
- ◆ Survival of a first-strike is essential—it is the potential retaliation afterwards that discourages a first strike.

An Example:

Mutually Assured Destruction

- ◆ Thus, neither country will decide to use nuclear weapons against the other—a win-win situation.
- ◆ A nuclear deterrent capacity therefore contributes to peace and stability in this context.
- ◆ If there is no certain and devastating retaliation, countries may be tempted to use nuclear weapons first.

An Example:

Financing Foreign Direct Investment

- ◆ Foreign direct investors with good credit should be allowed to borrow Renminbi in China for its direct investment in China, either from banks or through the issuance of bonds. In this way, the foreign direct investor has a natural currency hedge. Both its assets and liabilities will be in Renminbi and because they are nearly balanced there is little or no net foreign exchange risk. The foreign direct investor will need to secure the loan or the bonds issued with a guarantee from the parent in the home country, with a standby letter of credit, or with deposits in terms of its home currency.

An Example:

Financing Foreign Direct Investment

- ◆ Such an arrangement is win-win because the foreign direct investor can minimize its foreign exchange exposure and its financial statements are less subject to the vagaries of exchange rate fluctuations (current accounting rules require marking to market every reporting period).
- ◆ For China, with its excess savings and liquidity, this will help to absorb both savings and liquidity without crowding out other domestic investment. The Chinese commercial banks will acquire a valuable customer with minimal risk. And no foreign exchange needs to flow into China, putting upward pressure on the Renminbi to appreciate.

An Example: Tertiary Educational Institutions and Potential Employers

- ◆ Some tertiary educational institutions can specialize in providing education and training to students of the specific knowledge and skills that are needed for employment in certain specific industries, through the collaboration between universities and industries in the design of curricula, the provision of internship opportunities, and in early recruitment of graduates, especially for the professional schools.

An Example: Tertiary Educational Institutions and Potential Employers

- ◆ The educational institution may have prior agreements with potential employers such that if a graduate meets certain academic performance requirements he or she will be offered a job. The educational institution can then in turn guarantee to its graduates that they will each have a job upon graduation provided that they satisfy certain academic standards, to the point of refunding their tuition if no job is forthcoming.

An Example: Tertiary Educational Institutions and Potential Employers

- ◆ This approach matches the content of education and training to actual market demand of the employers and is win-win-win all the way around. The universities can place their graduates much more easily; the graduates can more easily and readily find suitable employment; and enterprises will be more ready and willing to employ new graduates with no prior employment experience and can save on their internal training programs.

Are There General Principles?

- ◆ In many of these situations, credibility, reputation and history can be important, especially when the situations repeat themselves.
- ◆ Any win-win strategy is completely consistent with the self-interest of each and all of the players. No altruism is required.
- ◆ Coordination is frequently required to for the win-win strategy to work.
- ◆ Some enforcement mechanism, whether explicit or implicit, is also frequently required in order for the win-win outcome to be sustainable.

Can Codes of Behavior Help?

- ◆ Common codes of behavior, grounded in culture and tradition, can sometimes be helpful.
- ◆ For example, Code of behavior I—”Don’t Do unto Others What You Do not Want Done to Yourself”—may lead the players in the Prisoner’s Dilemma Game to select the actions that allow both of them to escape.
- ◆ Code of behavior II—”Do unto Others What You Want Done to Yourself”
- ◆ Exchange of position: 换位 in formulating a strategy, think of what one would do if one were in the shoes of the other player, which can help make the strategy win-win.
- ◆ Codes of behavior can therefore sometimes substitute for signaling and sometimes even serve as an implicit self-enforcement mechanism.

Concluding Remarks

- ◆ Win-win strategies maximizes support, minimizes opposition and promotes social stability. However, they frequently require non-market coordination and sometimes an enforcement mechanism to have the desired effect.