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BLOCKCHAIN DISRUPTION AND SMART CONTRACTS

Lin William Cong  
Zhiguo He

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Cambridge, MA 02138  
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**ABSTRACT**

Blockchain technology provides decentralized consensus and potentially enlarges the contracting space using smart contracts with tamper-proofness and algorithmic executions. Meanwhile, generating decentralized consensus entails distributing information which necessarily alters the informational environment. We analyze how decentralization affects consensus effectiveness, and how the quintessential features of blockchain reshape industrial organization and the landscape of competition. Smart contracts can mitigate informational asymmetry and improve welfare and consumer surplus through enhanced entry and competition, yet the irreducible distribution of information during consensus generation may encourage greater collusion. In general, blockchains can sustain market equilibria with a wider range of economic outcomes. We further discuss anti-trust policy implications targeted to blockchain applications, such as separating consensus record-keepers from users.

Lin William Cong  
Booth School of Business  
University of Chicago  
5807 S Woodlawn Ave,  
Chicago, IL 60637  
will.cong@chicagobooth.edu

Zhiguo He  
University of Chicago  
Booth School of Business  
5807 S. Woodlawn Avenue  
Chicago, IL 60637  
and NBER  
zhiguo.he@chicagobooth.edu

# 1 Introduction

Blockchain, a distributed ledger technology managed in a decentralized manner (often autonomously), was first popularized as the technology behind the cryptocurrency Bitcoin. It has since emerged in various other forms, often with the ability to store and execute computer programs. This has given rise to applications such as smart contracts featuring payments triggered by tamper-proof consensus on contingent outcomes, and financing through initial coin offerings. Many industry practitioners argue that blockchain technology has the potential to disrupt business and financial services in the way the Internet disrupted off-line commerce. Others remain skeptical of its genuine innovativeness and real-world applicability, not to mention its association with money laundering or drug dealing.<sup>1</sup> Figure 1 displays Google searches showing the rising popularity of blockchain technology in recent years, as well as the growing number of open-source projects that are related to blockchain and smart contract.

In this paper, we argue that despite a plethora of definitions, descriptions, and applications of blockchain and decentralized ledger, the technology and its various incarnations share a core functionality in providing a “decentralized consensus.” Decentralized consensus is a description of the state of the world—e.g., whether the goods have been delivered or whether a payment has been made—that is universally accepted and acted upon by all agents in the system. Economists have long recognized that consensus enables agents with divergent perspectives and incentives to interact as if it provided the “truth,” which has profound implications on the functioning of society, including ethics, contracting, and legal enforcement, among others. What is key for blockchain technology is that such a consensus is generated and maintained in a decentralized manner, which blockchain advocates believe can improve the resilience of the system and reduce the rent extracted by centralized third parties.<sup>2</sup> For example, on the Bitcoin blockchain, given the transaction history, agents can check and verify transaction records digitally to prevent “double-spending” the digital currency and freeing everyone from the need of a centralized trustworthy arbitrator or third

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<sup>1</sup>The Oct 31, 2015 issue of the Economist ran a cover story, “the Trust Machine,” which argued that “the technology behind bitcoin could change how the economy works.” Marc Andreessen, the cocreator of Netscape, even exclaimed “This is the thing! This is the distributed trust network that the Internet always needed and never had.” On the negative side, see Narayanan and Clark (2017), *Blockchain is meaningless*, and *Ten years in, nobody has come up with a use for blockchain*.

<sup>2</sup>As is evident when Satoshi Nakamoto, founder of Bitcoin, remarked, “A lot of people automatically dismiss e-currency as a lost cause because of all the companies that failed since the 1990s. I hope its obvious it was only the centrally controlled nature of those systems that doomed them. I think this is the first time were trying a decentralized, non-trust-based system.”

party.<sup>3</sup>

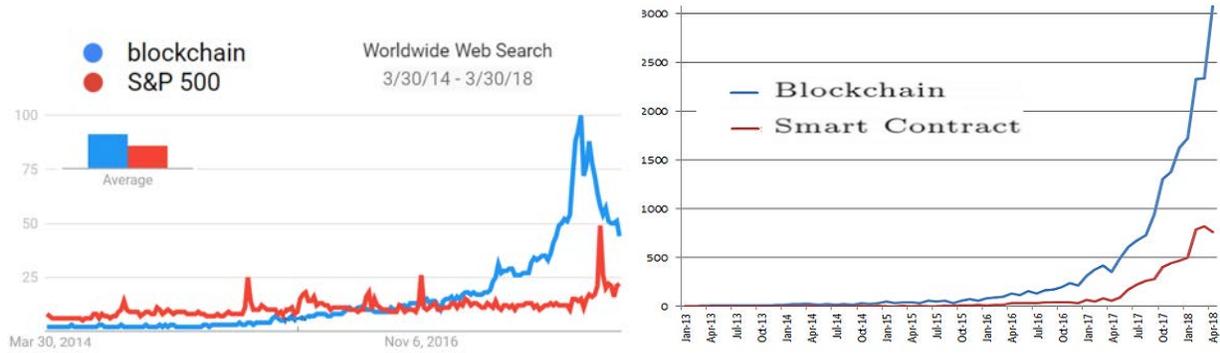


Figure 1: **Trends about Blockchain and Smart Contracts.** The left panel displays relative search interest and plots each search term relative to its peak (normalized to 100) for the given region and time. The right panel shows the number of blockchain and smart contract projects hosted on Github from Jan 2013-April 2018, a major open-source development platform for coding programs around the world.

Blockchains interact with dispersed record keepers to reach decentralized consensus using the latest technologies. Two economic forces then naturally arise: programmable decentralized consensus, if achieved, tends to make contracting on contingencies easier thanks to its temper-proof and automated nature; however, achieving such consensus requires sufficiently distributing information for verification. Consequently, blockchain applications typically feature a fundamental tension between *decentralized consensus* and *information distribution*. The former enhances contractibility and is welfare-improving, while the latter could be detrimental to the society. This fundamental tension we highlight has since been recognized by governments, media, and industry research. For example, the **Jasper Project** at the Bank of Canada in 2017 reveals that,

*“More robust data verification requires wider sharing of information. The balance required between transparency and privacy poses a fundamental question to the viability of the system for such uses once its core and defining feature is limited.”*<sup>4</sup>

Our paper offers the first analysis on this core issue of blockchain. As we discuss in more detail in the literature review, there are two economically relevant areas of research

<sup>3</sup>Double-spending is a potential flaw in a digital cash system in which the same digital currency can be spent more than once when there lacks a consensus record of transaction histories because the digital file it consists of can be duplicated or falsified.

<sup>4</sup>See, “‘Not There Yet’: Bank of Canada Experiments with Blockchain Wholesale Payment System,” by Maureen Gillis and Alexandru Trusca, CyberLex, June 19th, 2017, and Chapman, Garratt, Hendry, McCormack, and McMahan (2017). de Vilaca Burgos, de Oliveira Filho, Soares, and de Almeida (2017) emphasize the same point.

on blockchain: (1) blockchain mechanisms for generating and maintaining decentralized consensus; (2) real-world implications given the functionality blockchain provides. Our paper contributes to both fronts by highlighting a universal tradeoff in this technology (as opposed to analyzing the strategic mining games specific to the Bitcoin protocol), as well as studying the impact of this technology on industrial organization.

We first provide a simple framework to think about the process of reaching decentralized consensus on a blockchain in trade-finance application. Most blockchains have overlapping communities of record keepers and users. Similar to third-party arbitrators in the real world, they receive signals on the true state of the world and may have incentives to misreport (tamper or manipulate). With the help of fast-developing real-time communication technologies among decentralized record keepers, a carefully designed protocol on blockchains can reduce individual's incentive to manipulate and misreport, allowing more efficient information aggregation. Compared to traditional contracting, blockchains have the potential to produce a consensus that better reflects the "truth" of contingencies that are highly relevant for business operations, thereby enhancing contracting on these contingencies. Nevertheless, generating a more effective consensus (i.e., a consensus closer to truth) is predicated on decentralized record-keepers' observing and receiving greater amount of information.<sup>5</sup> The key insight is that information distribution process changes the informational environment, and hence the economic behaviors of blockchain participants.

Armed with this insight, we then analyze the impact of blockchain technology on competition and industrial organization. Specifically, our model features two incumbent sellers known to be authentic, and an entrant who only has some probability of being authentic. Authentic sellers always deliver the goods while the fraudulent ones cannot. In each period, buyers as a group show up with a constant probability (reflecting the aggregate business condition), shop the sellers based on price quotes, and then exit the economy. Each seller observes her own customers but does not observe the other sellers' prices or customers. We call this economic environment the "traditional world," in which it is infeasible to communicate information across agents, in the spirit of Green and Porter (1984).

In this traditional world, due to contract incompleteness, sellers cannot offer prices contingent on the success of delivering the goods. The lemons problem thus precludes entry. On the other hand, two incumbents might engage in collusion in equilibrium. However, because incumbent sellers cannot differentiate the event of no buyers showing up from the event of

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<sup>5</sup>Some of the information can be encrypted. In the case of public blockchains (e.g., Bitcoins), the consensus is typically generated by all users.

the other seller stealing her market share, aggressive price wars occur too often, making it relatively hard to sustain collusion among incumbent sellers.

In contrast, blockchains, via decentralized consensus, enable agents to contract on delivery outcomes and automate contingent transfers. Hence, the authentic entrant is now able to signal her authenticity fully. This eliminates information asymmetry as a barrier for entry and greater competition, enhancing welfare and consumer surplus in this “blockchain world”.

However, as mentioned before, generating decentralized consensus also inevitably leads to greater knowledge of aggregate business condition on the blockchain, which we show can foster tacit collusion among sellers. In contrast to the traditional world where sellers do not observe one another’s business activities, in the blockchain world they at least can infer the aggregate business condition on the blockchain—by serving as record keepers—and hence are able to detect deviations in any collusive equilibrium. Consistent with this intuition, we show that with blockchains in which only incumbents can participate, there are always weakly more collusion equilibria than those sustainable in the traditional world.

Our model thus features the trade-off between potentially enhanced competition and aggravated collusion, both arising from the blockchain technology. More generally, with blockchain (accessible to both incumbents and entrants) and smart contracts, the set of possible dynamic equilibria expands, leading to social welfare and consumer surplus that could be higher or lower than in a traditional world.

Our findings relate to the widespread concern that blockchains may jeopardize market competitiveness in a serious way. This becomes especially relevant for permissioned blockchains with powerful financial institutions as exclusive members.<sup>6</sup> Our paper highlights one salient economic mechanism through which blockchain facilitates collusion, and we explore policy implications of our model. For instance, an oft-neglected regulatory solution is to separate usage and consensus generation on blockchains, so that sellers cannot use the consensus-generating information for the purpose of sustaining collusion. By providing a conceptual description of blockchain and smart contracts from an economic perspective, our analysis aims to demonstrate that blockchains are not merely database technologies that reduce the cost of storing or sharing data. Rather, the design of the blockchain can have profound economic implications on consensus generation, industrial organization, smart contract design, and anti-trust policy. Overall, we provide a cautionary tale that blockchain tech-

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<sup>6</sup>See, for example, “Exposing the ‘If we call it a blockchain, perhaps it won’t be deemed a cartel?’ tactic,” by Izabella Kaminska, Financial Times, May 11th, 2015.

nology, while holding great potential in mitigating information asymmetry and encouraging entry, can also lead to greater collusive behavior.

**Related Literature** Our paper adds to the emerging literature on blockchains, which thus far has mainly come from computer scientists. There are two economically relevant areas of research on blockchain: (1) blockchain mechanisms for generating and maintaining decentralized consensus, and (2) real-world implications given the functionality blockchain provides. The first category can be further divided into the studies analyzing the general process of consensus generation for most blockchains, emphasizing the tradeoffs in decentralization, and the studies exploring the game theoretical topics including incentive provisions and market microstructure, taking as given a particular blockchain protocol such as the mining protocols in Bitcoin. While most of existing literatures focus on the latter subcategory, our paper adds to the former, and links the analysis directly to the technology’s impact on the real economy.

Among studies on the application and economic impact of the technology, Harvey (2016) briefly surveys the mechanics and applications of crypto-finance, especially Bitcoin.<sup>7</sup> Yermack (2017) evaluates the potential impacts of the blockchain technology on corporate governance. Complementary to our discussion on smart contracts, Bartoletti and Pompianu (2017) empirically document how smart contracts are interpreted and programmed on various blockchain platforms. We add by examining arguably the most defining features of blockchain, and how they interact with information asymmetry and affect market competition, both of which are important, general issues in economics.

Related to our analysis on the underlying mechanism for generating decentralized consensus are studies on Bitcoin mining games. Kroll, Davey, and Felten (2013) note that miners’ following the “Longest Chain Rule” should be a Nash equilibrium. Biais, Bisiere, Bouvard, and Casamatta (2018) formalize the mining game and discuss multiple equilibria.<sup>8</sup> Instead of taking as given specific blockchain protocols such as that of Bitcoin and analyzing strategic behaviors of miners or market microstructure, we take a holistic approach to examine universal features of blockchains, with a direct focus on how the information distribution

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<sup>7</sup>Other papers on various applications such as trading and digital currency include Catalini and Gans (2016), Malinova and Park (2016), Khapko and Zoican (2017), Raskin and Yermack (2016), and Cong, Li, and Wang (2018).

<sup>8</sup>Eyal and Sirer (2014) and Nayak, Kumar, Miller, and Shi (2016) study “selfish mining” and the related “stubborn mining” in which miners launch block-withholding attacks. Easley, O’Hara, and Basu (2017) and Huberman, Leshno, and Moallemi (2017) analyze Bitcoin transaction fees, and discuss the inefficiencies and congestion in mining and transactions. Cong, He, and Li (2018) study the organization of and compensation in mining pools.

that comes with decentralization interacts with the quality of consensus generation. Importantly, the technology’s core concept of decentralization has both pros and cons. Concerns for information distribution constitute a natural force to stay centralized under a supposedly decentralized system. We focus on the information channel in this paper while Cong, He, and Li (2018) explore a risk-sharing channel.

Our analysis on collusion adds to the large literature on industrial organization and repeated games with monitoring (see, e.g., Tirole (1988)). Our model ingredients partially derive from Porter (1983) and Green and Porter (1984), which study collusion in Cournot setting with imperfect public monitoring. A recent empirical study by Bourveau, She, and Zaldokas (2017) shows how collusion relates to firms’ financial disclosure strategies (information distribution in our language). We instead examine Bertrand competition, and link the additional observable or contractible information to the type of monitoring in repeated games under the technological innovation.<sup>9</sup>

The rest of the paper is organized as follows: Section 2 provides institutional details on blockchains, smart contracts, and their applications, with a simple framework for understanding the key economic trade-offs surrounding decentralized consensus and information distribution; Section 3 takes the core functionality of blockchain as given and analyzes dynamic industrial equilibria in both traditional and blockchain worlds, demonstrating that blockchain technology facilitates entry and cartelism; Section 4 discusses policy implications and model extensions; Section 5 concludes.

## 2 Blockchain as Decentralized Consensus

It is commonly recognized that blockchains provide many functions, such as distributed data storage, anonymity, data obfuscation, shared ledgers, and so on. Because solutions to these problems are well known outside of the blockchain space, the impact of blockchain along these dimensions, though material, is somewhat incidental. We therefore focus on their core functionality of providing decentralized consensus. In other words, rather than analyzing the technical details of various protocols or additional benefits the technology brings about, this paper underscores the economic implications of decentralized consensus, and the natural

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<sup>9</sup>Our analysis of sustainable equilibria is related to Fudenberg and Maskin (1986); our discussion on the application of blockchain and smart contract in financial services and transactions is broadly linked to optimal contracting, especially concerning information asymmetry and contract incompleteness (e.g., Baron and Myerson (1982), Hart and Moore (1988), and Tirole (1999)).

process that accompanies it — information distribution due to decentralization.

In this section, we first provide an overview of the blockchain technology, highlighting decentralized consensus as its core feature and the tradeoffs therein. We then model the generation of decentralized consensus and information distribution, before discussing various real-world business applications in the financial industry.

## 2.1 Blockchains and Smart Contracts

The work on blockchain dates back to 1991 by Stuart Haber and W. Scott Stornetta, but it was only until 2008 that the first blockchain was conceptualized by Satoshi Nakamoto. Nakamoto implemented and popularized the blockchain through the cryptocurrency **Bitcoin** (Nakamoto (2008)).<sup>10</sup> Its simplest form entails a distributed database that autonomously maintains a continuously growing list of public transaction records in units of “blocks,” secured from tampering and revision. Each block contains a time-stamp and a link to a previous block. Other forms of blockchains have emerged subsequently with different designs on exclusivity, transparency, and maintenance of the records. Yermack (2017) summarizes how blockchains work.

All blockchains—to varying degrees—aim to create a database system that parties can jointly maintain and edit in a decentralized manner, with no individual party exercising central control. One defining feature of blockchain architectures is thus their ability to maintain, in a relatively more effective way, a uniform view on the state of things and the order of events – a consensus.

As consensus is essential to many economic and social functions, the benefits and empowerment for everyone sharing and trusting the same ledger are clear. Settlements in some cases no longer take days, lemons problems and frauds can be mitigated, and the list continues. These outcomes will likely affect the agents’ ex-ante incentives in the economy. Traditionally, courts, governments, notary agencies, etc., provide such consensus, but in a way that was sometimes thought to be labor-intensive, time-consuming, and prone to tampering and monopoly power. In this regard, many advocates of the technology believe that blockchains hold the promise of disrupting many industries by providing consensus in a more decentralized manner, albeit still potentially costly in ways of energy consumption as well

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<sup>10</sup>Böhme, Christin, Edelman, and Moore (2015) surveys Bitcoin’s design principles and properties, risks, and regulation. Narayanan, Bonneau, Felten, Miller, and Goldfeder (2016) is an in-depth introduction for the technical details of Bitcoin blockchain. True to the Stigler’s law of eponymy, the ingredients and principles for Bitcoin were introduced much earlier, and Nakamoto’s innovation truly lies in putting it altogether. See Narayanan and Clark (2017) for further details.

as informational concerns that we focus on in this paper.

## Decentralized Consensus

To produce and maintain a *decentralized* consensus without a centralized authority, blockchain protocols are designed to incentivize responsible and accurate record-keeping by a community of dispersed “record keepers”, typically in a competitive manner, while reducing manipulation and tampering. In a sense, all decentralized consensus must come to some form of “majority” vote, though the algorithms may vary significantly across projects and applications.

Two widely discussed designs for maintaining decentralized consensus are proof-of-work (PoW) and proof-of-stake (PoS). PoW rewards record keepers who solve complicated cryptographic puzzles in order to validate transactions and create new blocks (i.e., mining). It prevents attacks such as denial-of-service (DoS attack) and ensures that once one observes a valid state of the ledger, transactions that have certain age cannot be negated, as doing so requires the malicious entity to have computing power that can compete with the entire network. Consequently, the blockchain achieves tamper-proof consensus on the validity of these transactions. Unlike PoW, in PoS the creator of the next block is chosen in a deterministic manner, and the chance that an agent is chosen depends on his/her wealth (i.e., the stake). Other prominent designs include practical byzantine fault tolerance algorithm (PBFT) and the delegated proof-of-stake algorithm (DPoS).<sup>11</sup> Instead of comparing specific designs, we will model decentralized consensus algorithm in abstraction in order to shed lights on most extant designs.

It is worth noting that many algorithm designs in their current forms are imperfect; but they have improved quickly and substantially. For instance, while there have been several hacking incidents on blockchains and criticisms of Bitcoin mining for wasting electricity, there have been multiple proposals to address these issues by improving the protocol design and furthering decentralization.<sup>12</sup> Another problem practitioners are actively researching on is the lack of consensus on how to modify blockchain protocols, which generally leads to

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<sup>11</sup>DPoS works along the same lines as the PoS system, except that individuals vote an overarching entity to represent their portion of stake in the system (hence the word delegation). PBFT deals with robust synchronous agreement in the presence of some malicious fault nodes.

<sup>12</sup>**Lightning**, which builds on the Bitcoin blockchain, reduces the amount of information that has to be recorded on the blockchain to increase processing power; **LITEX** similarly facilitates using various cryptocurrencies as means of payment among retailers; **Phi** from **String Lab** builds on Ethereum to ensure higher security and execution speed; startup firms such as **BOINC** channel mining computation to solving scientific problems.

forking and temporary confusion about which blockchain users should follow.

## Smart Contracts

The recent development of blockchain technology has revived the notion and facilitated the creation of smart contracts, originally envisioned by Szabo in 1994 (e.g., Tapscott and Tapscott (2016)). While a universally-accepted definition (no pun intended) for smart contracts has yet to be reached, their core functionality is clear: contracting on contingencies reached based on a decentralized consensus, with low-cost and more automated execution. This leads to a natural functional definition of smart contracts:

*Smart contracts are digital contracts allowing terms contingent on decentralized consensus that are tamper-proof and typically self-enforcing through automated execution.*

Our definition is consistent with and nests the definitions commonly seen among legal scholars (Lauslahti, Mattila, Seppälä, et al. (2016)), and in Szabo (1997, 1998). It is important to note that smart contracts are not merely digital contracts (many of which rely on trusted authority for reaching consensus and execution), nor are they entailing artificial intelligence (on the contrary they are rather robotic).

Without decentralized consensus, the party providing centralized consensus often enjoys huge market power (for example, a third party with data monopoly). And traditional resolutions by third parties such as courts or arbitrators involve high degrees of human intervention that are less algorithmic, potentially leading to greater uncertainty and cost. Smart contracts can increase contractibility and facilitate exchanging money, property, shares, service, or anything of value in an algorithmically automated and conflict-free way.<sup>13</sup>

Concerning contracting theory, the decentralized consensus reached by blockchain technology has the potential to greatly reduce the scope of noncontractible contingencies, the underpinning of the incomplete contract literature (e.g., Hart (1995)). In particular, smart contracts can augment contractibility and enforceability on certain contingencies, be it the lock-in requirement for fund withdrawal or the automated payment upon an importer's successfully receiving the goods. That said, the enhanced contractibility comes at the expense of greater information distribution, and the overall impact on the economy is far from obvious.

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<sup>13</sup>Even with a weaker definition of smart contracting requiring execution be conducted by centralized parties, having a consensus record reduces contracting and execution frictions significantly, as seen in recent applications in the land registry in Georgia (Weiss and Corsi (2017)).

## Information Distribution

Achieving decentralized consensus requires information distribution among participants in the system. The economic tradeoffs involved in information distribution necessary for generating a decentralized consensus are highly relevant from the practical or regulatory perspective. With Bitcoin, the consensus is reached and maintained through distributing all transaction information (with public-key-encrypted owner addresses) to the entire population on the blockchain, so all transaction details (except for identities) recorded on the consensus are public information. One obvious issue that arises when pushing for real-world blockchain applications is business privacy. For instance, financial institutions are typically sensitive to reveal the details of the transaction to unrelated parties. For example, traders may want to hide their identities to prevent front-running (Malinova and Park (2016)), and greater information distribution may also affect industrial organization and competition, as this paper shows.

Facing this fundamental trade-off, there are many proposals for better encryption which effectively masks sensitive information in the process of consensus generation. Another straightforward compromise is to reach a decentralized consensus only on a subset of important states of world, or requesting verification from fewer nodes (record keepers) in the blockchain network.<sup>14</sup> In what ways does information distribution matter beyond privacy concerns? Will it affect the effectiveness of blockchain consensus? Extant theory tells us very little.

## 2.2 A Model of Decentralized Consensus and Information

We build a simple economic model of the mechanism of consensus generation, highlighting the role of record keepers and the inevitable nature of information distribution. Our model setup is motivated by the application of trade-finance, which has been proposed and widely explored by industry practitioners.

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<sup>14</sup>For example, Aune, O’Hara, and Slama (2017) discuss the use of first-stage hashing to secure time-priority without revealing detailed information and revealing information later, in order to prevent front-running a transaction before it is recorded on a block on distributed ledgers. Directly related is the so-called “Zero Knowledge Proof” in computer science; in layman’s language, participants can agree on certain facts without revealing useful information.

## Trade-finance Example

Consider the following scenario many industry pioneers discuss: there are multiple potentially international exporters (sellers) of certain goods which require shipping with proper care (say, wine, so the temperature is critical for good condition). The success of selling these goods to importers (customers) require various other parties such as logistics providers, international ports and customs (for the flow of goods), notaries, and financing intermediaries (for the flow of payments).

Say a seller is shipping the goods to a customer. Let us examine the information flow in generating the consensus on delivering the goods, a contingency represented by  $\tilde{\omega}$  in Figure 2.

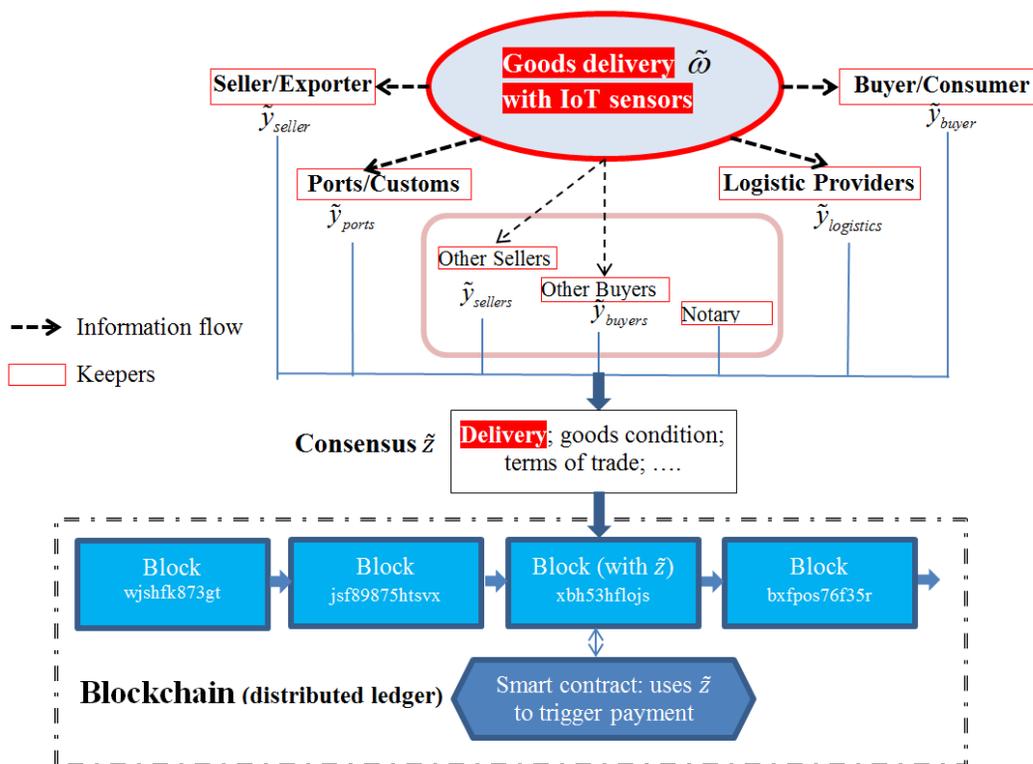


Figure 2: **A diagram of Trade-Finance example on blockchain.** A seller delivers goods to a buyer, with  $\tilde{\omega}$  denoting the contingency of successful delivery. record keepers, potentially with real-time IoT sensors, monitor the delivery and submit their reports  $\tilde{y}_k$ 's. The protocol of blockchain aggregates these reports to form a decentralized consensus  $\tilde{z}$ . This consensus, together the smart contract, is stored in the block and then added to the blockchain.

The participants, necessarily including the seller and buyer, can monitor the physical

conditions (e.g., location and temperature) of the goods via the end-to-end information collection, enabled by sensors, smart input mechanisms, and real-time data processing, or more broadly, Internet-of-Things (IoT). For better monitoring and more transparency, these IoT sensors could be installed on other relevant parties that handle logistics. The seller-buyer pair receives this information (including notification of final delivery) along the way.

Other parties on the blockchain may receive relevant information that can help monitor the process. For instance, the other sellers may also have installed IoT sensors able to detect the goods' delivery. Even without the help of IoT, other customers who happen to collect other goods at the same port may observe relevant information on this particular delivery. At this stage, these signals are not yet recorded on blockchain.

The crucial step on blockchain is to generate a decentralized consensus on whether the goods has been successfully delivered, so that information from many relevant parties can be aggregated to something that is accepted by the community—and recorded to the blockchain. This is done by contacting verifiers on the blockchain. In our trade-finance example, the seller-buyer pair, logistic providers, and ports must be contacted. Likely, other sellers with IoTs are contacted as well, because they have the expertise to verify the success of the delivery in case of disputes. In blockchain applications, they are what we call “record keepers.” Contacted agents might not truthfully report their signals—a possibility that is allowed by our model. Finally, other customers are contacted as well, perhaps serving the purpose of consistency check.

Contacted parties then submit their reports  $\tilde{y}_k$  to the blockchain. Then the blockchain protocol generates the decentralized consensus  $\tilde{z}$  regarding the contingency in question based the reports  $\{\tilde{y}_k\}$ . A newly created block is added to the entire chain, as shown in the bottom of Figure 2. This newly created block must pass certain consistency checks with respect to the history of the existing blockchain (which can be thought of incorporating past reports as an input for generating current consensus) before more blocks are added to it.<sup>15</sup>

In this example, sellers beyond the seller-buyer pair may receive information via two sources on blockchain: one via the terminals connected to the IoT sensors, and the second via being contacted to verify the transaction. In our perspective, they are playing different roles, but the second—as the essential step in generating the consensus—is more crucial for the blockchain technology. Putting the concern of collusion aside, the more information these industry experts have, the better the chance of forming a higher quality consensus in this

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<sup>15</sup>This thematic treatment covers the case where the added block still requires further verification as in the case of Bitcoin, so “added” corresponds more to “finalized” or “confirmed.”

process. There is also a lower bound on information distribution: Even if the transaction to be verified is encrypted, the mere fact of being contacted actually reveals information (this point will be highlighted in our model).

## Model Set-up

To illustrate how decentralization makes the consensus more effective at the expense of greater information distribution, we now formalize the above trade-finance example. Our analysis applies to both public and permissioned blockchains.

Suppose a smart contract references a contingent outcome  $\tilde{\omega}$  which we refer to as the “delivery” of service or goods, in the context of our main model in Section 3. The random variable  $\tilde{\omega}$  takes the value of one if the delivery is successful and zero otherwise, and denote the decentralized consensus on  $\tilde{\omega}$  on a blockchain by  $\tilde{z}$  which takes value in  $\{0, 1\}$  as well.

As illustrated by the trade-finance example, participants on the blockchain receive various signals with the aid of real-time IoT technologies.<sup>16</sup> For simplicity we assume all agents observe  $\tilde{\omega}$  perfectly. Although we could model the information environment as agents receiving signals that might be different from the true contingency  $\tilde{\omega}$ , this complication is unnecessary given the misreporting incentives introduced later. In fact, In Appendix A, we consider this possibility under a more general formulation, and repeat the analysis for a large class of linear models to demonstrate the robustness of the tradeoff that we highlight.

In practice, to reach decentralized consensus, blockchains contact a set of record keepers, who are typically dispersed blockchain participants and hence the name “decentralized”, for verification. Cryptocurrency mining as a way to maintain consensus record is a prominent feature for the likes of **Bitcoin** and **Ethereum**. **Ripple** and **R3 CEV** use their own consensus process but also rely on a community of record keepers. The process typically entails both competition and assignment for recordkeeping as well as post-block validations, and is an interesting industry on its own. Table C in the Appendix contains a list of further examples of record keepers, including finer descriptions of their roles.

To model this, suppose that the blockchain protocol contacts a set of  $K$  potential record keepers. Record keepers in the set  $\mathbb{K} \equiv \{1, 2, \dots, K\}$  are homogeneous, and for simplicity we model the **effectiveness** of the consensus for contracting (and potentially other purposes) by  $-Var(\tilde{\omega} - \tilde{z})$ .<sup>17</sup> An effective consensus is the cornerstone for the trust that many Fintech

<sup>16</sup>Clearly, the technology is not applicable for verifying subjective experience.

<sup>17</sup>In reality, the effectiveness depends on the purpose and use of consensus on each specific blockchain. Our specification qualitatively captures the universal feature that a consensus is not effective even when it is unbiased if it is uncertain to always reflect truth accurately. Our results are robust to introducing penalty

firms purport.

Upon contact, each record keeper  $k \in \mathbb{K}$  submits  $\tilde{y}_k$  taking values in  $\{0, 1\}$ , yielding a collection of reports  $\mathbf{y} \equiv \{\tilde{y}_k\}_{k \in \mathbb{K}}$ . As we will elaborate later, record keepers might misreport, i.e.,  $\tilde{y}_k \neq \tilde{\omega}$ . For illustration, we examine the case where the consensus is given by

$$\tilde{z}(\mathbf{y}) = \begin{cases} 1 & \text{with probability } \sum_k w_k \tilde{y}_k \\ 0 & \text{otherwise.} \end{cases}$$

where the weights of the validating notes,  $w_k$ , are non-negative and sum to unity. We also assume that  $w_k \rightarrow 0$  as  $K \rightarrow \infty$ , which captures the key concept of decentralization. The consensus function implies that if record keepers report more successful delivery, then the consensus is more likely to be successful delivery. We focus on how the metric of decentralization  $K$  affects the quality of decentralized consensus and the system-wide information distribution.<sup>18</sup>

## Record Keepers' Information and Misreporting

Suppose each record keeper on the blockchain observes the realization of  $\tilde{\omega}$ , the delivery status. While payment verifications on **Bitcoin** mostly concerns double-spending issues and require limited information distribution (e.g., the real identities of transaction parties are masked), the validations of general economic activities are typically more complicated, potentially requiring more nuanced information. For example, many trade-finance blockchains use information from local ships, ports, banks, and border customs to track delivery status, potential aided by sensors and IoT devices with details not fully publicly available (e.g., **Corda** or some **Hyperlydger** blockchains).<sup>19</sup> In addition, record keepers may also receive extra information about the transaction upon contact. For example, **IBM** currently works on trade-finance blockchains that provide record keepers additional information about shipment status, since to generate consensus on delivery requires off-chain collaborations and cross-validations with shipping companies and import-export controls.

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terms for bias as well as high moments of  $-Var(\tilde{\omega} - \tilde{z})$ .

<sup>18</sup>Our results hold for a general  $\tilde{z}(\mathbf{y}) = \tilde{Z}(\sum_k w_k \tilde{y}_k)$ , Where  $\tilde{Z}$  is a function that takes values in  $\{0, 1\}$ , and satisfies that  $\mathbb{E}[\tilde{Z}]$  is differentiable and increasing in the argument, and takes the value of 0 or 1 when the argument is 0 or 1. This implies that if the reports are all accurate, the consensus reflects the true state of the world. These requirements are broadly consistent with extant blockchain protocols.

<sup>19</sup>For such more complicated business situations, the record keepers likely only observe a noisy signal of the true state, and public information disclosure policy on any blockchain likely affects the record keeper's signal quality, thereby affecting the quality of decentralized consensus. We discuss these issues in Appendix A when we introduce the general linear model.

Record keepers may have incentives to misreport. For example, in trade-finance applications record keepers are also parties involved in the transaction; Bitcoin miners may hide report through “selfish-mining”, or double-spend certain coins.<sup>20</sup> Such incentives also exist in traditional economies: business arbitrators may favor a client, and double-spending was the issue in traditional online payments that originally inspired the creation of Bitcoin. In fact, media reports and practitioners’ discussions have largely centered on how blockchain helps reduce tampering, manipulation, and hacking.

In our reduced-form model, we assume that each risk-neutral record keeper  $k$  submits a report of  $y_k$  to maximize his normalized utility  $U(y_k; \mathbf{y})$ . In particular, he solves

$$\max_{y_k \in \{0,1\}} U(y_k; \mathbf{y}) = b_k \cdot |\tilde{z}(\mathbf{y}) - \tilde{\omega}| - h_k |y_k - \tilde{\omega}|, \quad (1)$$

where  $b_k$  and  $h_k$  are positive, uniformly bounded above and below from zero for all  $k$ . The first coefficient  $b_k$  is record keeper  $k$ ’s benefit when the wrong consensus is reached (forming  $1 - \tilde{\omega}$  when the true state is  $\tilde{\omega}$ ). In the second term,  $h_k$  captures the cost of misreporting. Depending on the protocol design in specific trade-finance applications,  $h_k$  could correspond to reputation cost in a blockchain alliance, or it could be the cost of counterfeiting signals in IoT sensors. In the case of Bitcoin, inaccurate records take longer to be confirmed and have a higher probability to be reversed, not to mention the extremely large computation power required in PoW systems.

### Information Distribution and Quality of Consensus

Each contacted record keeper chooses  $y_k$  to optimize  $U$  in (1), which gives

$$\tilde{y}_k^* = \begin{cases} \tilde{\omega} & \text{if } b_k w_k \leq h_k \\ 1 - \tilde{\omega} & \text{otherwise.} \end{cases} \quad (2)$$

The benefit of misreporting is  $b_k w_k$  because it shifts the consensus by  $w_k$  given other people’s equilibrium strategies, whereas the cost is  $h_k$ . The equilibrium consensus then is

$$\tilde{z} = \begin{cases} \tilde{\omega} & \text{w.p. } \sum_{k \in \mathbb{K}^*} w_k \\ 1 - \tilde{\omega} & \text{otherwise.} \end{cases} \quad (3)$$

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<sup>20</sup>To the extent that in our model misreporting represents some noise, it can also come from the possibility that record keepers are hacked.

where  $\mathbb{K}^* \equiv \{k \in \mathbb{K} : b_k w_k < h_k\}$  is the set of truth-telling record keepers. The resulting quality of the decentralized consensus can be shown to be

$$-Var(\tilde{\omega} - \tilde{z}) = -Var(2\tilde{\omega} - 1) \left(1 - \sum_{k \in \mathbb{K}^*} \omega_k\right)^2, \quad \text{where } \mathbb{K}^* \equiv \{k \in \mathbb{K} : b_k w_k < h_k\}. \quad (4)$$

Notice that  $Var(2\tilde{\omega} - 1)$  is independent of  $K$ . Therefore, the greater the set  $\mathbb{K}^*$ , the higher the quality of the decentralized consensus. The benefit of decentralization manifests in how the size of contact  $K$  improves the quality of consensus, by diminishing each record keeper’s manipulation incentives and edging the set with truthful report  $\mathbb{K}^*$  closer to the full set  $\mathbb{K}$ . For illustration, consider the case with homogeneous symmetric record keepers with  $b_k = b > 0$ ,  $h_k = k > 0$ , and  $w_k = 1/K$ , where the consensus quality is proportional to  $-\mathbb{I}_{\{K \leq \frac{b}{h}\}}$  which is increasing in  $K$ .

For more general  $b_k$  and  $h_k$  satisfying conditions given below Equation (1), the consensus becomes perfect, i.e.,  $\tilde{z} = \tilde{\omega}$  as  $K \rightarrow \infty$ ; we focus on this case in Section 3, and show how decentralized consensus improves the contractibility and enhances entry (hence competition). We discuss imperfect consensus in Section 4.

## Relating to the Literature on Information Economics

It is important to highlight the difference between our analysis and the extant literature applying information economics to finance and trading. The key difference hinges on the unique functionality provided by blockchain, i.e., the generation of decentralized consensus through information distribution among the set of record keepers. This is the first stage involving “decentralization:” in our trade-finance example illustrated by Figure 2, the system contacts record keepers like trading partners, ports, and other sellers/customers and they contribute to form the consensus that is accepted by the community. Then, the consensus can be, and often is, further distributed to all agents on the blockchain—this is the second stage of information distribution.

Earlier literature in financial economics often studies distribution of available information, which can be thought of the second stage described above. The leading example is studies on information disclosure that typically concern transparency, for example the TRACE reporting system on the corporate bond market.<sup>21</sup> Although transparency affects traders’ incentives

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<sup>21</sup>See, e.g., Goldstein, Hotchkiss, and Sirri (2006) and Bessembinder and Maxwell (2008). In particular, Bloomfield and O’Hara (1999) also find that market makers can use trade information to maintain collusive behavior.

and the effectiveness of market function, it is arguably true that trading and aggregation can still take place, even without pre- and post- transparency requirements on TRACE. In other words, in traditional settings, when greater public information is detrimental, regulators or agents can opt to distribute less information.

In contrast, our paper emphasizes the first stage: the distribution of information during consensus generation serves the core function of blockchain in providing decentralized consensus and tamper-proofness. The greater the degree of information distribution, the higher the quality of decentralized consensus. This point shares the same spirit as Chapman, Garratt, Hendry, McCormack, and McMahon (2017), who find that attempts of restricting decentralization in order to reduce information distribution often reduce the operational resilience that is supposedly the technology’s advantage over centralized systems.

In general, the quality of consensus, and the amount of information distribution on blockchains depend on their specific protocols. There is a great diversity of algorithms for building consensus based on requirements such as performance, scalability, consistency, data capacity, governance, security, and failure tolerance. Detailing the various consensus mechanisms or deriving the “optimal” blockchain design is beyond the scope of this paper. Nevertheless, we provide a brief description of blockchain applications in the financial industry and the concerns practitioners share about the informational issue we highlight.

## 2.3 Blockchain Applications in the Financial Industry

With the core functioning of blockchain in mind, we now discuss various blockchain projects in real-world. The applications of blockchain technology and smart contracts are broad, sometimes even beyond the Fintech industry; and the applications discussed here are not merely proofs of concept.<sup>22</sup> Readers familiar with the institutional background may skip this subsection and directly go to Section 2.4.

### Trade and Trade Finance

Recall our motivating example in Section 2.2 that involves international trade and its associated financing activities. International trade accounts for more than USD 10 trillion annually according to a WTO report in 2015. Despite technological advances in many areas

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<sup>22</sup>Bartoletti and Pompianu (2017) analyze 834 smart contracts from Bitcoin and Ethereum with 1,673,271 transactions. They find five main categories of uses (financial, notary, games, wallet, and library), three of which are related to monetary transfers and transactions, with the remaining two related to recording consensus information. More than two-thirds of the uses are on managing, gathering, or distributing money.

of financial services, trade finance remains a largely paper-based, manual process, involving multiple participants in various jurisdictions around the world, and prone to human error and delays along the supply chain.<sup>23</sup> An importer may fail to strike a deal because the bank offering the letter of credit is not well-known in the exporter’s country. An exporter may fail to get advanced financing because the bank worries whether the goods can be successfully and timely delivered and whether payments from the importer can be secured.

Blockchain technology can help alleviate the aforementioned frictions in trade. As mentioned, there are two classes of solutions that the blockchain technology can offer. One concerns the flow of goods, as a decentralized ledger can better track goods during the process in which goods are shipped, stored, and delivered (e.g., physical locations and movements, whether goods are kept with the right temperature, etc.), with the help of modern communication technology such as Internet of Things (IoT) and “oracles” that are feeders of information from the offline world. The second solution concerns the flow of money associated with trade (e.g., letter of credit and trade finance; this is related to Trusted Payments discussed above). Though currently both solutions are being developed in isolation, the industry envisions a fully integrated system in the future, with the potential benefit of a network of shippers, freight forwarders, ocean carriers, ports and customs authorities, and banks, all of them interacting on a blockchain in real-time.

In 2016, **Barclays** and Fintech start-up **Wave** claim to have become the first organizations to complete a global trade transaction using the new Wave blockchain platform, handling the letter of credit (LC) transaction between Ornua (formerly the Irish Dairy Board) and Seychelles Trading Company. IBM has also been spearheading the application of blockchain and smart contracts to trade finance, launching solutions for Indian Mahindra Group in December 2016, and in partnership with Danish shipping behemoth Maersk. In March 2017, IBM and Maersk, cooperating with **Hyperledger Fabric**, announced the completion of an end-to-end digitalized supply chain pilot using blockchain technology, which involves trading parties and various ports and custom authorities.<sup>24</sup> In early 2017, IBM has

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<sup>23</sup>While a seller (or exporter) can require the purchaser (an importer) to prepay for goods shipped, the purchaser (importer) may wish to reduce risk by requiring the seller to document the goods that have been shipped. Typically, banks may assist by providing various forms of support. For example, the importer’s bank may provide a letter of credit to the exporter (or the exporter’s bank) providing for payment upon presentation of certain documents, such as a bill of lading. The exporter’s bank may make a loan (by advancing funds) to the exporter on the basis of the export contract. Small suppliers have to wait as long as 60 to 90 days to be paid for delivered goods, which hinders their access to working capital.

<sup>24</sup>This pilot was a consignment of goods from Schneider Electric from Lyon to Newark, which involved the Port of Rotterdam, the Port of Newark, the Customs Administration of the Netherlands, and the U.S. Department of Homeland Security Science and Technology Directorate, and U.S. Customs and Border

ventured further by rolling out the **Yijian Blockchain Technology Application System** for the Chinese pharmaceutical sector. It has also collaborated with a group companies to develop a blockchain-based crude oil trade finance platform.<sup>25</sup>

There has also been progress in applying blockchain technology to the freight and logistics industry. In September 2017 Maersk partnered with EY, Microsoft, Willis Towers Watson, and several insurance companies to securely share shipping data on **KSI**, a blockchain developed by Guardtime. In November 2017, it was reported that the association **Blockchain in Transport Alliance** (<https://bita.studio/>) whose members include start-up blockchain companies like **ShipChain**, had attracted global giants like SAP and UPS in the traditional sector.<sup>26</sup>

## Trusted Payments

Payments across long distance or among unknown parties are difficult due to the lack of trust. The Society for Worldwide Interbank Financial Telecommunications (SWIFT) mitigates the problem, but often entails ineffective coordination across multiple institutions and hefty fees. This concern becomes further exacerbated with digital payments, which are plagued by “double-spending” issues.

**Bitcoins** was first offered as a solution and it enables anonymous peer-to-peer transactions recorded on the Bitcoin blockchain that is secure and time-stamped to make it tamper-proof;(Nakamoto (2008)).<sup>27</sup> More importantly, by broadcasting all candidate transactions publicly and having “miners” constantly competing for the recording right of new blocks to earn Bitcoins, its distributed ledger provides a decentralized consensus on whether a transaction has taken place.

By design, maintaining the decentralized consensus record on Bitcoin blockchain requires the miners to solve NP-complete computational problems (i.e., mining, a form of PoW) whose difficulty level increases with computation power by design, making it unsuitable for large volumes of financial transactions. Subsequent platforms such as **Lightning** (built on the

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Protection. For details, see <http://www.ibtimes.co.uk/maersk-ibm-aim-get-10-million-shipping-containers-onto-global-supply-blockchain-by-year-end-1609778>.

<sup>25</sup><http://www.coindesk.com/ibm-blockchain-platform-oil-trade-finance/>. Other blockchain-based platforms that support lending, issuing letters of credit, export credit and insurance include **HK Blockchain** for trade finance, **TradeSafe**, and **Digital Trade Chain (DTC)**. Recently, Blockchain startup **R3**, trade finance tech provider **TradeIX**, and a group of major banks have moved their **Marco Polo** trade finance platform to the pilot stage; see <https://www.coindesk.com/r3-pilots-blockchain-trade-finance-platform-with-global-banks/>.

<sup>26</sup><https://www.cryptocoinsnews.com/bitcoin-looking-disrupt-freight-logistics-industry/>.

<sup>27</sup>Many retailers in Japan already accept Bitcoins (e.g., *The Economist* Nov 4 (2017)).

Bitcoin blockchain) and **Stellar** (a separate blockchain) help improve the processing capacity through local channels and multisignature accounts so that unnecessary information does not have to be part of the decentralized consensus.<sup>28</sup>

That said, these blockchains' scripting language is limited. **Ethereum**, the second largest blockchain platform by market capitalization after the Bitcoin blockchain, allows the use of Turing-complete language and permits more complex contingent operations (Turing (1937)), providing the archetypal implementation of smart contracts (Buterin (2014)). All valid updates to the contract states are recorded and automatically executed. A group of voluntary participants (Ether miners) maintain a decentralized consensus recording of the states, and other interacting parties utilize the consensus information to automate executions of contract terms. Additional applications such as **Monax** and **Phi (String Lab)** build on Ethereum to enrich and optimize its smart contract functionalities and processing power, similar to how websites build on the Internet protocol.

Traditional players in the financial industry have started the process of accommodating the blockchain technology to address the payment problem. Originally known as Ripple Labs, **Ripple** was founded in 2012 to provide global financial transactions and real-time cross-border payments, and has since been increasingly adopted by major banks and payment networks. A (typically large) set of validating nodes achieve decentralized consensus using the **Ripple** transaction protocol RTXP—an iterative consensus process as an alternative to PoW, in which transactions are broadcasted repeatedly across the network of validating nodes until an agreement is reached. Digital transfers are then automated by connecting electronically to bank accounts or using the native crypto-token Ripples (**XRP**).

## Other Applications

In addition to applications in payments and trade finance, blockchain and smart contracts can also be used in exchanges and trading, voting, and even syndicated loans. To that end, in 2015 Nasdaq Inc launched the **Linq** Platform for managing and exchanging pre-IPO shares, and in early 2017 successfully completed a test using blockchain technology to run proxy voting on Estonian Tallinn Stock Exchange.<sup>29</sup> Smart contracts can enforce a standard

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<sup>28</sup>**Counterparty** also builds on the Bitcoin blockchain, but allows for more flexible smart contracts and maintains consensus through “proof-of-burn,” i.e., fees paid in cryptocurrency paid by clients are destroyed, and nodes are rewarded for validation from the appreciation of the currency.

<sup>29</sup>Korea Exchange (KRX) also launched a blockchain-based marketplace, **Korean Startup Market** (KSM), where equity in startup companies can be traded. Other efforts in applying blockchain and smart contracts to exchanges and trading include **Digital Asset Holdings (DAH)** backed by the Australian Securities Exchange (ASX) to upgrade post-trade services. The costs consumers save from brokerage arbitration

transactional rule set for derivatives (a security with an asset-dependent price) to streamline Over-The-Counter (OTC) financial agreements. **Symbiont** offers product with a simple interface for specifying the terms and conditions when issuing smart securities, as well as integration with market data feeds.<sup>30</sup>

Furthermore, on the application of loan syndication in which multiple banks agree to extend syndicated loans to a single borrower so that a decentralized consensus among participating banks is perhaps crucial, a blockchain project led by Credit Suisse and twelve other banks together with **Symbiont** will be ready to go into production in early 2018.<sup>31</sup> Finally, Walmart recently partnered with IBM and JD.com for a blockchain tracking food production, safety, and distribution.

## 2.4 Verification and Informational Concerns in Practice

Our theory highlights the potential downside of information distribution during the process of decentralized consensus. The concern about information distribution and privacy is voiced by practitioners, among which **R3 CEV**, an active blockchain consortium, has been outspoken. R3's **Corda** system sets out to tackle the challenge that the only parties who should have access to the details of a financial transaction are those parties themselves and others with a legitimate need to know. Even with that, the request, itself a form of information, for proving transaction uniqueness is distributed to some independent observers, changing the information environment of this economy at least partially.

While these measures potentially ensure confidentiality, two important economic insights are missing from current discussions. First, contacting fewer record keepers may reduce the effectiveness of the consensus; second, encrypting data means some contingencies cannot be validated and thus cannot be used in smart contracts. Moreover, even encrypted data are still data, as the mere act of verification request is still informative to record keepers, an insight to be highlighted in our model. As de Vilaca Burgos, de Oliveira Filho, Soares, and de Almeida (2017) point out in a report for the central bank of Brazil, simply encrypting sensitive data is not a viable solution because smart contracts then cannot decide whether a transaction is valid.

These observations imply that restricting information distribution often comes at the ex-

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could also be substantial.

<sup>30</sup>**Symbiont** is a member of the **Hyperledger** project, a cross-industry, open-source, collaborative project led by the non-profit Linux Foundation to advance blockchain technology by coming up with common standards.

<sup>31</sup><http://www.businessinsider.com/credit-suisse-led-blockchain-solution-makes-progress-2017-8>.

pense of compromising the consensus effectiveness. For instance, **R3’s Corda**’s validating model restricts information distribution only to the notaries.<sup>32</sup> As pointed out in the Bank of Canada report mentioned earlier, Chapman, Garratt, Hendry, McCormack, and McMahon (2017), **Corda**’s model requires data replication from the notaries to ensure business continuity rather than each node providing resilience to the system, as in the case with many public blockchains. This makes the so-called Single Point of Failure (SPOF) more likely because the system is once again centralized. In fact, in Phase 2 of **Project Jasper**, the role of notary in **Corda** is performed by the Bank of Canada, so an outage at the Bank would prevent the processing of any payments.

Our model underscores this tension: contacting fewer record keepers reduces the information distribution, but at the expense of compromising the quality of consensus. We now go one step further to analyze the consequence of distributing information on industrial organization and competition in Section 3.

### 3 Blockchain Disruption and Industrial Organization

To understand blockchain’s impact on the real economy, we now cast our model of decentralized-consensus generation in a standard dynamic industrial organization setting similar to Green and Porter (1984). We show that smart contracts on decentralized consensus help entry which promotes competition, but greater information distribution may foster collusion which hurts competition.

#### 3.1 Model Setup

Consider a risk-neutral world in which time is infinite and discrete and is indexed by  $t$ ,  $t = 0, 1, 2, \dots$ . Every agent has a discount factor  $\delta \in (0, 1)$ . In every period  $t \geq 0$ , with probability  $\lambda$  a unit measure of buyers show up, each demanding a unit of goods. They shop sellers and choose the most attractive offer. We use  $\mathbb{I}_t$  to denote this aggregate business condition whether buyers show up in period  $t$ . Throughout, we use “buyers”, “consumers”, and “customers” interchangeably.

The goods delivery between the seller and the buyer is modeled as in Section 2.2. It

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<sup>32</sup>In the white paper, this restriction is to prevent Denial-of-Service (DoS) attacks, i.e., a node knowingly builds an invalid transaction consuming some set of existing states and sends it to the notary, causing the states to be marked as consumed. For more details, please see <https://docs.corda.net/key-concepts-notaries.html> and <https://docs.corda.net/key-concepts-consensus.html>.

should be clear that although we are building our model in the context of trade-finance, the goods can be interpreted as a service such as a fund transfer, a loan origination, or the financing of a trade. Buyers (if present) only live for one period and then exit the economy.

There are three long-lived sellers who are either authentic or fraudulent. A fraudulent seller is unable to deliver the good, while an authentic seller always delivers the good to the consumer. The consumer obtains an expected utility  $q_i$  from seller  $i$ . In particular, with probability  $q_i$ , the consumer obtains a utility of one and with probability  $1 - q_i$ , they obtain zero.

At the start of the game  $t = 0$ , two of the sellers,  $A$  and  $B$ , are incumbents known to be authentic (who have already established a good reputation). There is also a new entrant  $C$  who privately knows her authenticity, but others only have the common prior belief that  $C$  is authentic with probability  $\pi$ , later referred to as  $C$ 's reputation.

In every period  $t \geq 0$ , each seller gets an i.i.d. draw of  $q_i$ ,  $i \in \{A, B, C\}$ . The quality profile  $\mathbf{q} = (q_A, q_B, q_C)$  is publicly observable, capturing temporal differences among sellers. We discuss the case when quality is the seller's privately information in Section 4.3. Denote the elements in  $\mathbf{q}$  in decreasing order by  $q^{(1)}$ ,  $q^{(2)}$ , and  $q^{(3)}$  respectively; this implies that even buyers' choice of incumbent sellers has welfare consequences. We denote the cumulative distribution function and probability density function of quality distribution by  $\phi(q)$  and  $\Phi(q)$ , and its support by  $[\underline{q}, \bar{q}]$ . It costs a seller  $\mu$  to produce the goods, where  $\mu < \underline{q}$  to reflect that the transaction with an authentic seller is welfare-improving.

Seller  $C$  can potentially enter by paying an arbitrarily small cost of  $\epsilon > 0$ ; hence  $C$  enters only if she can ever make strictly positive profit in this market after entry.<sup>33</sup> This allows us to focus on information asymmetry of seller authenticity as the relevant entry barrier. We further assume that before getting customers, the entrant has no loss-absorbing capacity.<sup>34</sup>

## 3.2 Traditional World

We analyze the model in the traditional world, starting with the key assumption on contracting space and information environment there.

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<sup>33</sup>Whether the entry decision is made before the quality  $q_C$  realization or not is immaterial, given the arbitrary small entry cost.

<sup>34</sup>This can be microfounded by some borrowing capacity, so that potential entrants cannot implement aggressive penetration pricing schemes. It is a sufficient condition to rule out aggressive penetration pricing (in which entrants suffer huge losses in order to enter). This is realistic because without accumulation of service profit over time, the entrant typically does not have large initial capital (deep pocket) to undercut price aggressively. In fact, all we need is that  $C$ 's tolerance for loss,  $L$ , is no more than  $[\underline{q} - \pi\bar{q}]^+$ .

## Contracting Space and Information

**Assumption 1.** *In traditional world, no payment can be contingent on whether service delivery occurs or not. Each seller can only observe her own buyers and associated transaction information.*

The first part of Assumption 1 reflects certain real-life contract incompleteness that either limits the effectiveness of consensus or makes contracting on it too costly; for a good reference on the costs of writing and enforcing complete contracts, see Hart (1995) and Tirole (1999). In our context, this implies that the sellers can only quote a non-contingent price  $p_i(\mathbf{q})$  privately to buyers.<sup>35</sup> The second part of Assumption 1 implies that in the traditional world sellers do not observe others' price quotes, and can be interpreted as seller's quoting customized or "bespoke" prices based on their proprietary data and private interaction with buyers. In other words, it is infeasible to communicate information across agents beyond transactions. This assumption plays a role when we solve for the sellers' collusion equilibrium, and is similar to the assumption in Green and Porter (1984) and Porter (1983).

## Bertrand Competition and Entry

We first consider a competitive equilibrium, in which sellers keep lowering their offered prices until their competitors quit. Suppose that an authentic  $C$  enters. If  $\pi q_C < \max\{q_A, q_B\}$ , any incumbent will compete to lower the price to  $\mu$  to get the customer this period and prevent the enhanced future competition they face had  $C$  entered in this period. Without a reputation of being authentic, an authentic  $C$  only stands a chance of getting a customer if  $\pi q_C \geq \max\{q_A, q_B\}$ .<sup>36</sup> Basically, an entrant can get customers only when her perceived quality is higher than the incumbents. The next proposition follows.

**Proposition 3.1.** *In a competitive equilibrium, the first time an authentic  $C$  can serve customers is in period  $\tau \equiv \min\{t \geq 0 | \pi q_{C,t} \mathbb{I}_t \geq \max\{q_{A,t}, q_{B,t}\}\}$  or later. Consequently,  $C$  never enters if  $\pi \bar{q} < \underline{q}$ .*

In the remainder of the paper, we focus on the case  $\underline{q} > \pi \bar{q}$ ; in other words, the entrant  $C$ 's reputation is sufficiently low that no entry ever occurs in the traditional world. The

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<sup>35</sup>That sellers make offers is realistic in many applications where the customers or buyers are short-lived and dispersed. For example, banks typically quote the fee for making an international transfer, and customers can decide which bank to go to. Our main results are robust to this particular trading protocol.

<sup>36</sup>Even so,  $C$  may not get a customer if the incumbents use predatory pricing. Note that when  $\pi \bar{q} < \underline{q}$ , no matter what  $\mathbf{q}$  is,  $C$  cannot enter even with penetration pricing because the maximum loss  $C$  can afford is less than  $\underline{q} - \pi \bar{q}$ .

expected future consumer (buyer) surplus and social welfare at any time  $s$  are, respectively,

$$\Pi_{buyer} = \mathbb{E}_s \left[ \sum_{t=s+1}^{\infty} \delta^{t-s} \mathbb{I}_t (\min\{q_{A_t}, q_{B_t}\} - \mu) \right] = \frac{\delta\lambda}{1-\delta} \mathbb{E} [\min\{q_A, q_B\} - \mu] \quad (5)$$

and

$$\Pi_{total} = \mathbb{E}_s \left[ \sum_{t=s+1}^{\infty} \delta^{t-s} \mathbb{I}_t (\max\{q_{A_t}, q_{B_t}\} - \mu) \right] = \frac{\delta\lambda}{1-\delta} \mathbb{E} [\max\{q_A, q_B\} - \mu]. \quad (6)$$

The presence of fraudulent sellers causes no-entrance of a high quality  $C$ , a standard lemons problem. We show later that this problem can be better or even fully resolved by smart contracts with blockchain technology offering decentralized consensus.

### Collusive Equilibria

Besides the competitive equilibrium derived, there may exist collusive equilibria in this economy. Given no-entrance of seller  $C$ , we only need to examine potential tacit collusion among the incumbents.

We restrict each seller's strategy to the standard supergame strategies discussed in, for example, Green and Porter (1984). Specifically, consider the following strategy, indexed by  $\{T, f\}$ , for  $A$  and  $B$  to collude. There are two phases:

1) *Collusion phase*: Every period, after the realization of types,  $A$  charges price  $q_A$  and  $B$  charges price  $q_B$ .  $A$  and  $B$  get  $\mathbb{I}_t f(q_A, q_B)$  and  $f(q_B, q_A) = \mathbb{I}_t (1 - f(q_A, q_B))$  fractions of buyers, respectively.<sup>37</sup> Here  $f(x, y) \in (0, 1)$  is the proposed anonymous allocation function, potentially as a function of realized types (e.g., via setting quotas). This allocation function  $f$  includes the case where sellers always equally split buyers, and the case where buyers all go to the better seller.

2) *Punishment phase*: The punishment phase is triggered once one of the sellers does not have any buyers. More specifically, the punishment phase can be triggered either by i) buyers not showing up this period or ii) one of the sellers deviating by quoting a cheaper price to get all the buyers. Once triggered,  $A$  and  $B$  are engaged in Bertrand competition for a fixed  $T$  period.

Recall that the sellers do not observe other sellers' price quotes, and only observes their own customers. However, this repeated game with private monitoring is essentially a game with imperfect public monitoring, because sellers can use the private observation to infer

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<sup>37</sup>Our analysis is robust to a collusion where sellers charge a lower colluding price (less than  $q_i$ ).

whether there is aggregate activity (customers arriving). It is imperfect in the sense that punishment could be triggered even when no one deviates. The equilibrium notion corresponding to the above strategies is thus akin to public perfect equilibrium.

A standard result in the literature of dynamic repeated games is that sustainable equilibria crucially depend on the discount factor  $\delta$ , with the Folk Theorem as the best-known example. We therefore proceed to derive the lower bound of discount factor, denoted by  $\delta_{(T,f)}$ , above which an equilibrium with a specified  $T$  and  $f(x,y)$  exists.

**Lemma 3.2.** *A collusion strategy with  $(T, f)$  as described above is an equilibrium, if*

$$\frac{\lambda\delta(1-\delta^T)}{1-\lambda\delta-(1-\lambda)\delta^{T+1}} \geq \frac{M_3}{M_1-M_2} \quad (7)$$

where  $M_1 \equiv \mathbb{E}[f(q)(q-\mu)]$ ,  $M_2 \equiv \mathbb{E}[(q_i - q_{-i})^+]$ ,  $M_3 \equiv \max_q\{(1-f(q))(q-\mu)\}$ ,  $f(q_i) \equiv \mathbb{E}_{q_{-i}}[f(q_i, q_{-i})]$ .

Here,  $M_1$  ( $M_2$ ) is a seller's expected payoff in the "stage game" in each period during the collusion (punishment) phase, and  $M_3$  is the maximum gain from deviating. When the discount factor  $\delta$  is sufficiently low (impatient), the payoff from deviation is relatively large compared with the punishment going forward, so no collusion equilibria can be sustained.

**Proposition 3.3.** *When the discount factor  $\delta < \delta_o^{Traditional} \equiv \inf_f \delta_{(T,f)}^{Traditional} = \inf_f \frac{1}{\lambda} \frac{M_3}{M_1+M_3-M_2}$ , no collusion equilibrium exists for any  $(T, f)$ .*

The welfare under  $(T, f)$  collusion is determined by  $f$ , and consumer surplus is determined by both  $(T, f)$  and the colluding price. The consumer surplus depends on the length of punishment period  $T$  because buyers earn positive surplus only when the punishment phase is triggered due to absence of buyers in the economy (which occurs with probability  $1-\lambda$  in each period).

### 3.3 Blockchain World

Blockchain technology enables the consensus recording of success or failure of goods delivery rendered by verifying and validating certain transactions. As detailed earlier in Section 2.2, this verification typically involves distributing information.

To highlight the economic force, we examine the case of perfect consensus, i.e., when  $K \rightarrow \infty$  so that  $\tilde{z} = \tilde{\omega}$ , and smart contracts on the blockchain can trigger payment based on this consensus. This case captures many extant blockchains such as **Bitcoin**, **Ripple**, and

**Symbiont**, where either the verification request or transaction information is distributed to sufficiently large numbers of parties including major institutional participants. Note, this does not imply record keepers are the entire population of the blockchain. Moreover, as we discuss in Section 4.2, the basic tradeoff under imperfect consensus is qualitatively the same.

**Assumption 2.** *The blockchain contacts infinite participants (including the sellers and a continuum of consumers) to generate an effective decentralized consensus. More specifically, the blockchain consensus  $\tilde{z} = \tilde{\omega}$ , and a seller knows the aggregate business condition either by observing the presence of her own customers, or by inferring the presence of customers upon being contacted.*

Recall  $\tilde{\omega}$  is the delivery outcome (whether successful or not). This assumption implies that i) self-executed smart contracts can be perfectly contingent on delivery outcome consensus, and ii) the sellers observe the aggregate business condition. These are in sharp contrast to Assumption 1. We also note that the blockchain system may have richer information and the results can be extended to the cases whereby this information is used. But our arguments require weaker conditions and it suffices that they observe the aggregate activity.

In the rest of this section, we first demonstrate how blockchain and smart contracts can enhance entry and competition, then show that the same technology can lead to greater collusive behavior before discussing regulatory implications.

### Smart Contracts and Enhanced Entry

With blockchain, the entrant now can offer a price contingent on the success of delivery so that  $\mathbb{P} = (p^s, p^f)$ , with  $p^s$  and  $p^f$  being prices charged upon success and failure. An authentic entrant  $C$  can separate from her fraudulent peer by offering  $(p^s, 0)$ . The fraudulent type gains nothing from mimicking: she knows that she will fail to deliver and hence never receive the payment. As a result, the authentic seller  $C$  enters for sure. We have the following proposition for the competitive equilibrium without potential collusion.

**Proposition 3.4.** *In the competitive equilibrium in the blockchain world, the authentic entrant  $C$  enters almost surely, and first gets customers in period  $\tau = \min\{t \geq 0 | q_{C,t} \mathbb{I}_t \geq \max\{q_{A,t}, q_{B,t}\}\}$  or earlier.*

In the world with blockchain, the expected future consumer surplus and total welfare at

$t = s$  under a competitive equilibrium are, respectively,

$$\Pi_{buyer} = \mathbb{E}_s \left[ \sum_{t=s+1}^{\infty} \delta^{t-s} \mathbb{I}_t (q^{(2)} - \mu) \right] = \frac{\delta \lambda}{1 - \delta} \mathbb{E} [q^{(2)} - \mu] \quad (8)$$

and

$$\Pi_{total} = \mathbb{E}_s \left[ \sum_{t=s+1}^{\infty} \delta^{t-s} \mathbb{I}_t (q^{(1)} - \mu) \right] = \frac{\delta \lambda}{1 - \delta} \mathbb{E} [q^{(1)} - \mu]. \quad (9)$$

Notice that the  $q_i$ s are observed,  $q^{(2)}$  not  $q^{(1)}$  enters Equation (8). Compared to (5) and (6), we see that with smart contracts that facilitate entry and hence competition, the economy becomes more efficient, as both consumer surplus (linear in the second order statistic) and welfare (linear in first order statistic) improve.

### Enhanced Collusion under Permissioned Blockchain

While blockchain and smart contracts can improve both consumer surplus and welfare by encouraging entry and competition, a dark side of blockchain may result in dynamic equilibria with lower welfare or consumer surplus than in the traditional world. To highlight the collusion-enhancing effect of blockchain, we first focus on permissioned blockchain for the incumbents which  $C$  cannot use (hence no entry), before discussing blockchains that  $C$  can utilize.

***Collusion using Smart Contract*** With blockchain and smart contracts, sellers can use the enlarged contingencies and hence side payment to facilitate collusion, as illustrated by the following example. All sellers collude to charge the highest amount they can charge upon delivery, i.e.,  $q_i$ , effectively extracting full rents from buyers. The sellers reach an agreement that only the best-quality seller in each period takes all consumers, and if a seller who does not have the best-quality takes any consumer, a smart contract can take all its profit automatically and transfer it to other sellers.<sup>38</sup> By imposing such automatic punishment upon deviation, the smart contract can potentially support any collusion, regardless of the discount factor.

Such explicit form of collusion using smart contracts is easy to detect and can be forbidden

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<sup>38</sup>For such smart contracts to work, decentralized consensus on delivery contingency of the seller identity is needed in the sense that the blockchain system has to recognize whether the best quality seller is serving all consumers. In general, depending on specific collusive equilibria, one may penalize deviating contingencies using smart contracts, even without information on seller's identity/characteristic.

by anti-trust law (Section 4.1). The more relevant and interesting phenomenon is that even without explicit side payment, the blockchain still can facilitate greater collusion, which we discuss next.

***Tacit Collusion with Permissioned Blockchain*** In the case of tacit collusion, consider exactly the same collusion and punishment phases as well as the allocation rule  $f$  as in the traditional world. The catch is that, instead of triggering punishment upon deviating or receiving no buyers, punishment in the blockchain world can be further conditioned on whether buyers show up. This is because participants upon being contacted for verification at least know that service requests are made; this does not even require installment of IoT sensors on participants. However, being contacted for verification reveals the aggregate state of the presence of buyers, which allows the sellers to perfectly monitor deviation behavior by a colluding fellow.<sup>39</sup>

In other words, the repeated game with traditionally imperfect public monitoring now achieves perfect public monitoring as deviations can be accurately detected on blockchain during the consensus generation process. Collusive equilibria hence become easier to sustain (without punishment along the equilibrium path).

**Proposition 3.5.** *For given  $(T, f)$ , denote the threshold discount factor above which collusion is sustained with permissioned blockchain by  $\delta_{(T,f)}^{Blockchain2}$ , and recall  $\delta_{(T,f)}^{Traditional}$  and  $\delta_o^{Traditional}$  are defined in Proposition 3.3.*

1. *For any  $(T, f)$ , we have  $\delta_{(T,f)}^{Blockchain2} < \delta_{(T,f)}^{Traditional}$ .*
2. *When  $\delta \in \left[ \inf_f \{ \delta_{(\infty,f)}^{Blockchain2} \}, \delta_o^{Traditional} \right)$ , there cannot be collusion without blockchain, but there could be with blockchain.*

In case 2), the consumer welfare under collusion with blockchain is lower than that under competitive equilibrium but without blockchain.

### 3.4 Blockchain Disruption

Suppose now that there is a (potentially public) blockchain that all three firms (incumbents  $A$ ,  $B$ , and new entrant  $C$ ) have access to. Would the benefit of entry to consumer

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<sup>39</sup>The deviating seller might potentially choose to conduct his/her transaction off-chain to avoid triggering the price war, and this is relevant given our simplified assumption of incumbents being established authentic ones. However, in general, the augmented contractibility of smart contracts benefits all participants, and off-chain stealing can be quite ineffective even for incumbents. Besides, the flexibility of sellers' switching between on-chain and off-chain businesses is also questionable, given the context of our trade-finance applications.

outweigh the cost of potential greater collusion?

### Consumer Surplus under Public Blockchain

Recall that Section 3.3 has solved the competitive equilibrium. To characterize other collusive equilibria in this economy, consider the following collusion strategy:

1) *Collusion phase*: Every period, after the realization of types, each seller  $i$  charges  $q_i$  contingent on success. Let  $\hat{f}(q_i, q_j, q_k)$  be the fraction of the buyers that go to the seller with quality  $q_i$  when the other two sellers have qualities  $q_j$  and  $q_k$ .

2) *Punishment phase*: The punishment phase is triggered if one of the sellers does not have any buyers AND there are buyers showing up in this period. In other words, the punishment phase is triggered only if there is some seller deviates. Once triggered, all sellers get involved in Bertrand competition for  $T$  periods.

**Lemma 3.6.** *With blockchain, the above strategy is an equilibrium if the parameters satisfy*

$$\frac{\delta\lambda(1-\delta^T)}{1-\delta} \geq \frac{\hat{M}_3}{\hat{M}_1 - \hat{M}_2} \quad (10)$$

where  $\hat{M}_1 \equiv E[\hat{f}(q)(q - \mu)]$ ,  $\hat{M}_2 \equiv E[(q_i - \max_{j \neq i} q_j)^+]$ , and  $\hat{M}_3 \equiv \max_q \{(1 - \hat{f}(q))(q - \mu)\}$ .

The  $\hat{M}$ s have similar interpretations as in Lemma 3.2, but for three sellers instead of two. The left-hand-side of equation (10) is also modified because with perfect public monitoring, the punishment is more accurately targeted.

### Dynamic Equilibria under Blockchain Disruption

More generally, in terms of welfare and consumer surplus, the set of equilibrium outcomes with blockchain disruption is a non-trivial superset of those in equilibria in the traditional world. Denote by *Blockchain3* the public blockchain with all three sellers.

**Theorem 3.7.** *The threshold of discount factor  $\delta_a^{Blockchain3} \equiv \sup_{\hat{f}} \{\delta_{(\infty, \hat{f})}^{Blockchain3}\}$  is well-defined and satisfies  $\delta_a^{Blockchain3} < 1$ . For all  $\delta > \delta_a^{Blockchain3}$ , any consumer surplus and welfare attainable in the traditional world can be attained with blockchain, and some additional equilibria with higher or lower consumer surplus or welfare can also be sustained.*

In this theorem, the subscript  $a$  in  $\delta_a^{Blockchain3}$  stands for ‘‘all’’, indicating that *all* collusion equilibria can be sustained if the discount factor is above  $\delta_a^{Blockchain3}$ . We can similarly define

threshold  $\delta_o^{Blockchain3} \equiv \inf_f \{\delta_{(\infty, f)}^{Blockchain3}\}$ . Then an even weaker condition for blockchain to potentially hurt consumers is  $\delta > \delta_o^{Blockchain3}$ .

It is also worth remarking that with blockchain the total welfare can be reduced, because it is now possible to sustain an equilibrium in which firms collude so that in any given period all sales go to the seller with the lowest  $q_i$ , which is lower than that with only incumbents.

Our findings are robust qualitatively to having more incumbents and entrants, and the next corollary illustrates how consumer surplus could be lower with blockchain in this more general case.

**Corollary 3.8.** *For  $m \geq n \geq 2$ , if  $\lambda < \frac{n-1}{n}$ , then  $\delta_o^{Traditional, n} > \delta_o^{Blockchain, m}$ , where  $m$  and  $n$  indicate the number of colluding sellers with and without blockchain respectively. Consequently for all  $\delta \in [\delta_o^{Blockchain, m}, 1)$ , there is no collusion in the traditional world with  $n$  incumbents, while blockchain can lower consumer surplus (with  $m$  sellers including new entrants).*

## 4 Discussions and Extensions

This section provides discussions from a regulatory angle, and considers several extensions of our model.

### 4.1 Measures to Reduce Collusion on Blockchain

Our concern that blockchains can jeopardize market competitiveness is also shared by other market observers. The concern becomes especially acute for permissioned blockchains like **R3** whose members are powerful financial institutions. As described in a Financial Times article, what “...the technology really facilitates is *cartel management* for groups that don’t trust each other but which still need to work together if they are the value and stability of the markets they serve.”<sup>40</sup> Our paper highlights one particular economic mechanism through which blockchains could hinder competition, and provides a rigorous analysis on why and how collusion could occur. In fact, empirical evidence suggests that greater information sharing indeed facilitates collusion (e.g., Bourveau, She, and Zaldokas (2017)). We now explore regulatory and market solutions to curb collusive behaviors in our framework.

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<sup>40</sup>“Exposing the ‘If we call it a blockchain, perhaps it won’t be deemed a cartel?’ tactic,” by Izabella Kaminska, Financial Times, May 11th, 2015.

## Blockchain Competition versus Firm Competition

Although we focus on the case of a single blockchain on which multiple sellers compete, in practice there are likely to be multiple blockchains which both sellers and buyers can choose. The competition among blockchains naturally goes against the collusive behaviors of sellers on one blockchain, as buyers can always pick the blockchain which offers the best price-adjusted service. Recent research by Budish, Lee, and Shim (2017) formally analyses this force. Although blockchain competition may mitigate collusive behaviors on specific blockchains, in the long run if a single blockchain becomes dominant due to a network effect, regulators still have to step in to prevent collusion by breaking up blockchain platforms. While this approach of “breaking up big players” works for traditional industrial firms as well, this point is especially relevant for blockchain. This is because coordination is integral to the ecosystem of blockchain, and likely interferes with its operation. For a new blockchain platform to be used and competition-enhancing, different institutional and retail users have to coordinate on adoption. Coordination issues have already manifested themselves in the dominance of early movers, such as **Bitcoin** and **Ethereum** in the cryptocurrency markets.<sup>41</sup>

Of course, the above discussion raises other questions: Why is it more difficult for blockchains to collude, at least relative to sellers on the same blockchain? What can governments do to facilitate coordinated adoption of better designed blockchain platforms? These are all interesting questions for future research.

## Regulatory Node and Design

In the traditional world, in general it helps for regulatory agency to observe and collect more information about the market in order to better detect collusive behaviors. Similarly, adding a regulatory node in the blockchain, especially for private permissioned chains that do not automatically include regulators as part of the business ecosystem, can help regulator monitor the economic behaviors of market participants and reduce tacit collusion. However, in this regard, blockchain is no different from traditional world: The government who has the authority to investigate and penalize firms can reach the same outcome in both scenarios. For instance, within our model, the regulator can detect and hence deter collusion by monitoring whether buyers (if present) are purchasing goods with the highest quality.

In this regard, blockchain may offer a significant advantage relative to the traditional world thanks to real-time and tamper-proof records. As a result, regulators do not have

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<sup>41</sup>We thank the editor, Itay Goldstein, for pointing this out to us.

to worry about misreporting and time-delays, enabling the detection and containment of collusion and market malfunctions at relatively high frequency. Moreover, retrospective auditing is no longer prone to manipulation. These effects can be seen in the **Hyperledger Fabric** example in Section 2.3.

Regulators can also potentially participate in the protocol design. For example, the government can reserve access to certain encrypted information that is broadcasted to blockchain participants or record keepers. Not only does this direct access enables elimination of collusions using smart contracts (see Section 3.3), but also allows detection of tacit collusion based on statistical analysis of transaction and pricing behaviors.<sup>42</sup>

### Separation of Usage and Consensus Generation

In the model, sellers can use the information on the blockchain to punish deviations from collusion in a more accurate way. They observe the information because the information is distributed and recorded on the blockchain during the process of consensus generation. From this perspective, one obvious potential solution is to separate the players who help generate the decentralized consensus, from the users of that consensus. For example, in our model if sellers can only use the blockchain for signing smart contracts with buyers but are excluded from recordkeeping activities, they no longer have access to the aggregate-activity information that fosters collusion.

As discussed in the trade-finance example in Section 2.2, it might be challenging to exclude sellers from recordkeeping activities. This is because naturally, the parties that we should exclude from being contacted for recordkeeping are also likely the ones who are the most qualified to validate a record (e.g., the experienced sellers with great expertise within the same industry). Most extant public blockchains do not separate the two groups. On some blockchains such as **Symbiont**, record keepers tend to be a rather separate group from the end users, though this resolution has not been sufficiently explored.

The separation of usage and consensus generation is new in the discussion among blockchain practitioners. It reflects yet another economic trade-off between decentralization (a resilient

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<sup>42</sup>Regulation also touches another important concern when the blockchain stores and processes data on a large scale. In trade-finance applications, it is most likely that a significant portion of the data are personal data and hence is subject to regulations such as the general data protection regulation (GDPR), which comes into force on May 25th, 2018, will be directly applicable to blockchain-based platforms in all E.U. member states. As such, a public and permissionless blockchain would not work. It needs to be a private and permissioned blockchain that is operated by one or more entities who set up the terms of use, and these entities serve as controllers that are responsible and liable for the lawful processing of personal data in compiling with the regulation.

system needs a wider range of participants) and centralization (but only a small set of agents with expertise are able to provide high-quality inputs), and constitutes a direction for future policy discussions concerning blockchain applications.<sup>43</sup>

## 4.2 Imperfect Consensus

In Section 3 we have assumed that an infinite number of blockchain participants are contacted as record keepers ( $K \rightarrow \infty$ ), rendering perfect consensus. Suppose now there is a finite number of blockchain participants serve as record keepers, so that  $|\mathbb{K}| = K < \infty$ . Then the resulting imperfect consensus has probability  $\psi$  to correctly record the delivery status, where  $\psi = \sum_{k \in \mathbb{K}^*} w_k \leq 1$  and  $\mathbb{K}^* = \{k \in \mathbb{K} : b_k w_k < h_k\}$  as derived in Equation (3).

The precision  $\psi$  essentially captures in reduced-form the quality of consensus when consensus generation is imperfect, and is consistent with many alternative protocols.<sup>44</sup> In words, a successful (failed) delivery might be recorded as a successful delivery with probability  $\psi$  ( $1 - \psi$ ). Given the imperfect consensus, can the authentic type still enter the market with the help of blockchain with smart contract ( $p^s, p^f$ ) and separate from (instead of pool with) the fraudulent type?

We introduce the entrant's capacity to bear its initial loss  $L \geq 0$ ; this loss capacity helps authentic entrants separate from fraudulent ones, and is a relaxation of the condition to exclude aggressive pricing strategy in Footnote 33 in Section 3. The authentic seller in the separating equilibrium of stage game solves the following:

$$\begin{aligned} & \max_{(p^s, p^f)} \quad \psi p^s + (1 - \psi) p^f \\ \text{s.t.} \quad & \psi p^s + (1 - \psi) p^f \geq \mu, \quad -p^f \leq L, \quad \text{and} \quad (1 - \psi) p^s + \psi p^f < 0, \end{aligned}$$

where the inequalities are the authentic type's participation constraint, limited loss capacity, and the fraudulent type's no-mimicking constraint, respectively. For instance, in the last inequality, the fraudulent entrant who never delivers the good has probability  $1 - \psi$  of being recorded as having a successful delivery and paid by  $p^s$ , and with probability  $\psi$  of being

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<sup>43</sup>According to Chapman, Garratt, Hendry, McCormack, and McMahon (2017), sufficient decentralization among the record keepers who are not users may still preserve the blockchain advantage of resilient and effective consensus.

<sup>44</sup>Consider the situation with noisy observation of the true state  $\tilde{\omega}$ , but no misreporting (say the misreporting benefit  $b$  is small). Suppose that all symmetric record keepers correctly observe the delivery outcome with probability  $\theta > \frac{1}{2}$ . If the consensus on successful delivery is based on unanimity rule, then  $\psi = \theta^K$ . Similarly, the majority rule says  $\psi = \sum_{k=\lceil \frac{K}{2} \rceil}^K \binom{K}{k} \theta^k (1 - \theta)^{K-k}$ .

recorded as failed, receiving  $p^f$ . The above program admits a solution when  $\psi > \frac{\mu+L}{\mu+2L}$ , which allows the authentic type enter for some positive profit without imitation by the fraudulent type, yielding the following proposition.

**Proposition 4.1.** *The use of smart contract on blockchain facilitates entry of the authentic type if the consensus quality is sufficiently high, i.e.,  $\psi > \frac{\mu+L}{\mu+2L}$ .*

In the limit that  $\mu = 0$ , we get that smart contracting facilitates entry as long as the consensus is slight informative of the true state ( $\psi > \frac{1}{2}$ ).

In our model, there is a continuum of consumers upon arrival, which implies that there is a continuum of transactions to be verified. If each verification process draws record keepers in some independent way, then the law of large numbers across transactions reveals the aggregate state of customer arrival, even under imperfect consensus. Therefore, imperfect consensus does not affect the collusive equilibria supported. Overall, it weakly reduces entry and competition, and it is in this sense weakly welfare improving to have perfect consensus.

As we mentioned, the key to reducing collusion is to separate sellers from record keepers and reduce directly contacting the former. To model this exclusion of sellers, suppose for each delivery, a seller is contacted with probability  $\hat{\zeta}$ ; then the probability that a seller is completely unaware of the aggregate service activity conditional on consumers' arriving is  $1 - \zeta \equiv (1 - \hat{\zeta})^n$  where  $n$  is the number of transactions. In the collusion-phase, a deviation is detected with probability of  $\zeta$  instead of with probability one, triggering less punishment and making the collusion equilibrium harder to sustain. That said, if the number of transactions is large, the equilibrium approaches the one with perfect public monitoring unless the sellers are strictly prohibited from acting as record keepers ( $\hat{\zeta} = 0$ ).

### 4.3 Information Asymmetry and Private Qualities

In our analysis so far,  $\mathbf{q}$  is publicly known. In this section we allow privately observed qualities. Collusion with private information in general is complex (Athey and Bagwell (2001) and Miller (2011)), therefore our focus is on the competitive equilibrium (and competitive stage games in the punishment phase of a collusion.) We characterize how smart contracts can help mitigate allocative inefficiency beyond entry, and derive the equilibrium form of smart contracts under market equilibrium.

## Allocative Inefficiency in the Traditional World

Suppose that in addition to uncertainty on authenticity, quality  $q_i$  is also privately known to seller  $i$ . Without smart contracts, the entrant would always claim it is authentic and has high quality (cheap talk). Similarly, incumbents cannot separate themselves either. Following the same logic as above, the lemons problem prevents entry and separation cannot occur even among incumbents with different qualities. We have

**Lemma 4.2.** *In the traditional world, sellers post the same price  $p_i = \mu$ , and each buyer selects (randomly) one of them. Each period the buyer's surplus and social welfare is  $\mathbb{E}[q] - \mu$ .*

## World with Blockchain and Equilibrium Smart Contracts

Smart contracts enlarge the space of price quotes that sellers can use. Recall that  $1 - q$  can be interpreted as the probability that the goods delivered are defective. Consider an offer  $\mathbb{P} = (p^s, p^f)$ ; we further impose that  $p^f \leq p^s$  so that payment to the seller is higher upon success, a standard monotonicity assumption in the security design literature.<sup>45</sup> Then, the type  $q$  seller, upon getting customers, earns  $S_q(\mathbb{P}) = qp^s + (1 - q)p^f - \mu$ ; and the buyer gets a utility  $B_q(\mathbb{P}) = q(1 - p^s) + (1 - q)(-p^f)$ , where  $1 - p^s$  is the utility from successful delivery less the payment.

Sellers may offer a large variety of smart contracts; but only one particular class of contracts emerges in equilibrium, as shown by the following proposition (recall that  $\Phi$  is the cdf of  $q$ ).

**Proposition 4.3.** *There is a unique competitive equilibrium for each stage game, and sellers offer contracts of the form  $\mathbb{P}^* = (p, p - 1)$ . A seller of quality  $q$  offers  $(p_q, p_q - 1)$  with*

$$p_q = 1 - q + \mu + \int_{\underline{q}}^q \left[ \frac{\Phi(q')}{\Phi(q)} \right]^2 dq', \quad (11)$$

*which is decreasing in  $q$ . Buyers go to the highest-quality seller.*

Under the equilibrium contract  $(p_q, p_q - 1)$ , buyers are getting utility  $1 - p$  regardless of the delivery outcome. The competitive equilibrium essentially has a cash auction in which a bidder with quality  $q$  has a private valuation of his/her service opportunity  $q - \mu$ , and bids

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<sup>45</sup>See, e.g., Innes (1990), Hart and Moore (1995), and DeMarzo and Duffie (1999). Under a market mechanism where buyers shop sellers and choose the most favorable one, our setup has a natural reinterpretation under informal first-price auctions with security bids; e.g., DeMarzo, Kremer, and Skrzypacz (2005) and Cong (2017).

$p$ .<sup>46</sup> In equilibrium, buyers choose the highest quality seller, who gets the second highest valuation  $\mathbb{E}[q^{(2)} - \mu]$  in each period with customer arrival (the revenue equivalence theorem). Notice that the economic outcomes are exactly the same as in the case where  $\mathbf{q}$  is publicly known ((8) and (9)). Therefore we have,

**Corollary 4.4.** *Smart contracts fully resolve informational asymmetry in a competitive equilibrium, and welfare and consumer surplus are independent of whether seller qualities are private or not.*

That said, one can show that restricting the form of smart contracts can potentially increase the consumer surplus in a way similar to how security design affects issuer’s payoffs. For regulators concerned with consumer surplus, collusion and smart contract forms should be jointly considered — a topic for future studies.

## 5 Conclusion

In this paper we argue that decentralized ledger technologies such as blockchains feature decentralized consensus as well as tamper-proof algorithmic executions, and consequently enlarge the contracting space and facilitate the creation of smart contracts. However, the process of reaching decentralized consensus changes the information environment on the blockchain, potentially engendering welfare-destroying consequences by promoting collusion.

We analyze how this fundamental tension can reshape industry organization and the landscape of competition; it can deliver higher social welfare and consumer surplus through enhanced entry and competition, yet it may also lead to greater collusion. In general, blockchain and smart contracts can sustain market equilibria with a larger range of economic outcomes. We discuss regulatory and market solutions to further improve consumer surplus, such as separating agents generating consensus from end-users.

We have modeled in reduced-form the universal feature of blockchains and the key trade-offs of consensus generation and information distribution. Although beyond the scope of this paper, designing a robust consensus protocol and providing the right incentives for maintaining consensus on specific blockchains is interesting and likely requires the joint effort of computer scientists and economists.

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<sup>46</sup>This mirrors the well-known result in the literature of security design that the sellers would offer the least information-sensitive security (“flattest” security in the language of security-bid auctions, e.g. DeMarzo, Kremer, and Skrzypacz (2005)).

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# Appendix

## A Consensus Generation: Alternative Specifications

We still denote the decentralized consensus on  $\tilde{\omega}$  on a blockchain by  $\tilde{z}$ , except that they can take on a continuum rather than binary values. The set of record keepers and effectiveness measure are as specified earlier. Upon contact, each record keeper  $k \in \mathbb{K}$  submits  $\tilde{y}_k$  taking a continuum of values, yielding a collection of reports  $\mathbf{y} \equiv \{\tilde{y}_k\}_{k \in \mathbb{K}}$ .

Depending on the specific blockchain protocol, the consensus  $\tilde{z}(\mathbf{y})$  is then a transformation of inputs collected from these contacted record keepers. Again we can write it as

$$\tilde{z}(\mathbf{y}) = \tilde{Z}\left(\sum_k \tilde{w}_k \tilde{y}_k\right), \quad (12)$$

which includes many well-known blockchains such as Bitcoin, in which the miner who solves a hard NP complete problem first (which is completely random if miners have homogeneous computation power) gets to make the record block. In the language of our model, the blockchain protocol randomly chooses one report from all contacted record keepers (all miners).

For simplicity, we examine a large class of linear model typically used in continuum-signal space.

$$\tilde{z}(\mathbf{y}) = \frac{1}{K} \sum_k \tilde{y}_k, \quad (13)$$

The decentralized consensus here is a simple average of all selected reports. It is easy to show that our results are robust to heterogeneous and stochastic weights on signals.

### Information Set of Record Keepers

To incorporate potentially noisy observation, we assume that each recordkeeper on the blockchain has a private signal  $\tilde{x}_i = \tilde{\omega} + \tilde{\eta}_i$ , where for simplicity  $\tilde{\eta}_i$  are i.i.d. with zero mean and variance  $\sigma_\eta^2$ .  $\tilde{\eta}_i$  captures noisy observations of the true state based on public information and off-chain information available on blockchain, as well as additional information recordkeepers have when generating consensus.

Denote by  $\mathbf{1}_k$  the event of recordkeeper  $k$  being contacted, upon which his/her signal turns to  $\tilde{x}_k = \tilde{\omega} + \tilde{\eta}_k$ , where  $\tilde{\eta}_k$ 's are with zero mean and variance  $\sigma_K^2$ . We have  $\sigma_K \leq \sigma_\eta$ , thanks to the additional (potentially encrypted) information. To summarize, the set of all information on the blockchain can be written as a tuple of  $\{\mathbb{K}, \{\tilde{x}_i\}_{i \notin \mathbb{K}}, \{\tilde{x}_k, \mathbf{1}_k\}_{k \in \mathbb{K}}, \tilde{z}\}$ .

### Misreporting and Manipulation

We modify the normalized utility of each risk-neutral recordkeeper who submits a report of  $y_k$  to

$$U(y_k; \mathbf{y}) = \tilde{b}_k \cdot (\tilde{z}(\mathbf{y}) - \tilde{x}_k) - \frac{1}{2h} (y_k - \tilde{x}_k)^2 \quad (14)$$

The first coefficient  $\tilde{b}_k \equiv \tilde{b} + \tilde{\varepsilon}_k$  is recordkeeper  $k$ 's bias in misreporting, which is known to the recordkeeper  $k$  before submitting his/her report. Here, the common bias  $\tilde{b}$  (among contacted recordkeepers) has zero mean

and variance  $\sigma_b^2$ , capturing the common bias on the blockchain, which can be interpreted as one institutional transaction party choosing validators within its proprietary network (peer selection on **Ripple** or notary choice on **Corda**), an attempt by holders of the crypto-currency to slow down the creation of inflation of the native currency, and/or a system-wide hacking motive. Such common bias is not alien in the traditional economy: Arbitrators in business arbitration are only rewarded if they are chosen by their clients and may systematically cater to major clients. The idiosyncratic part  $\tilde{\varepsilon}_k$  is i.i.d., with zero mean and has variance  $\sigma_\varepsilon^2$ .

The second term captures the private cost of manipulation, where  $h$  parametrizes how quickly the cost rises with the magnitude of misreporting, which depends on the consensus protocol design.

## Information Distribution and Quality of Consensus

Each contacted record keeper chooses  $y_r$  to maximize  $U$  in (14), which gives

$$\tilde{y}_k^* = \tilde{\omega} + \tilde{\eta}_k + \frac{h}{K} \tilde{b}_k. \quad (15)$$

The equilibrium consensus then is (recall  $\tilde{b}_k = \tilde{b} + \tilde{\varepsilon}_k$ )

$$\tilde{z} = \frac{1}{K} \sum_k \tilde{y}_k^* = \tilde{\omega} + \frac{1}{K} \sum_k \tilde{\eta}_k + \frac{h}{K} \left( \tilde{b} + \frac{1}{K} \sum_k \tilde{\varepsilon}_k \right), \quad (16)$$

with the resulting quality of the decentralized consensus:

$$-Var(\tilde{\omega} - \tilde{z}) = - \left[ \underbrace{\frac{\sigma_K^2}{K}}_{\text{signal quality}} + \frac{h^2}{K^2} \underbrace{\left[ \sigma_b^2 + \frac{\sigma_\varepsilon^2}{K} \right]}_{\text{manipulation}} \right]. \quad (17)$$

The first term relates directly to signal quality. For instance, contacting for verification by sharing some details of the transaction information may reduce  $\sigma_K$  and hence is quality-improving. Additionally, the first term in (17) shows that the average over a greater sample size  $K$  smooths out the observation noises  $\tilde{\eta}_k$ 's, and hence leads to a better consensus.

The second channel is more novel and is rooted in the process of decentralized consensus generation. When the blockchain contacts more and more recordkeepers, i.e., a greater  $K$ , each understands that each individual has less influence on the final consensus outcome. The resulting reduced manipulation in report  $\tilde{y}_k^*$  in (15) translates to a higher consensus effectiveness. This effect is reflected in the scaling of  $1/K^2$  in the “manipulation” terms in (17). This is the key economic reason why blockchain is deemed more secure, in addition to its technical improvements on cyber-security. Of course, aggregation certainly helps reach a better consensus by reducing the idiosyncratic components of misreporting, as reflected in the denominator of the second term in “manipulation” in (17).

However, contacting more recordkeepers affects the information environment in which the agents reside on the blockchain. First, depending on detailed blockchain protocols, soliciting reports involves transferring certain transaction information to contacted record keepers, changing  $\sigma_K$ .<sup>47</sup> Second, even with encrypted content information, the act of contacting conveys information (denoted by  $\mathbf{1}_k$ ). In the context of an

<sup>47</sup>Recall the example of **Corda**'s validating model in Section 2.4.

industrial organization framework analyzed in Section 3, this renders the aggregate economic activities public information if all agents are contacted, which makes collusion easier and jeopardizes competition.

In conclusion, we have demonstrated the robustness in a large set linear models of the tradeoff between greater decentralization to improve consensus quality and lesser decentralization to reduce information distribution.

## B Derivations and Proofs

### Proof of Proposition 3.1

*Proof.* In a competitive equilibrium, each seller lowers its price until its competitors quit. If  $\pi q_C < \max\{q_A, q_B\}$ , at least one of the incumbents always competes to lower the price to  $\mu$  to get the customer this period and prevent the enhanced future competition had C entered in this period. Without a reputation of being authentic, an authentic C can only get a customer if buyers show up and  $\pi q_C \geq \max\{q_A, q_B\}$ .

Because C does not have a capacity to bear loss at the point of entry, C cannot charge a penetration price below production cost  $\mu$  and get customers when  $\pi q_{C,t} \mathbb{1}_t < \max\{q_{A,t}, q_{B,t}\}$ . Even when  $\pi q_{C,t} \mathbb{1}_t \geq \max\{q_{A,t}, q_{B,t}\}$ , C may not be able to enter if the incumbents have deep pockets and can engage in predatory pricing. □

### Proof of Lemma 3.2

*Proof.* Let  $V^+(q_i, q_{-i})$  be the present value of payoff to a seller with realized quality  $q_i$  in the collusion phase. In the collusion phase, buyers are indifferent between different sellers.

Let  $V^-$  be the present value of payoff to a seller before the realization of type in the first period of punishment phase. According to the collusion strategy, the continuation values satisfy:

$$V^+(q_i, q_{-i}) = \lambda(f(q_i, q_{-i})(q_i - \mu) + \delta V^+) + (1 - \lambda)\delta V^- \quad (18)$$

$$V^-(q_i, q_{-i}) = \lambda E[(q_i - \max_{j \neq i} q_j)^+] \frac{1 - \delta^T}{1 - \delta} + \delta^T V^+ \quad (19)$$

For the strategy to be an equilibrium, we need to verify, by the one-shot deviation principal, that a seller does not have incentive to unilaterally deviate. This is obvious in the punishment phase, since it is a Bertrand equilibrium. In the collusion phase, to prevent deviation, we need

$$\forall q, V^+(q) \geq \lambda((q - \mu) + \delta V^-) + (1 - \lambda)\delta V^- \quad (20)$$

Denote  $V^+(q_i) = E_{q_{-i}}[V^+(q_i, q_{-i})]$ ,  $f(q_i) = E_{q_{-i}}[f(q_i, q_{-i})]$ . Integrating (18), we have

$$V^+(q) = \lambda(f(q)(q - \mu) + \delta V^+) + (1 - \lambda)\delta V^- \quad (21)$$

$$V^+ = \lambda(E[f(q)(q - \mu)] + \delta V^+) + (1 - \lambda)\delta V^- \quad (22)$$

With (20) -(22), we have

$$\delta(V^+ - V^-) \geq (1 - f(q))(q - \mu), \forall q \in [\underline{q}, \bar{q}] \quad (23)$$

From (22) (19), we solve for  $(V^+ - V^-)$ , Plugging into the above equation, we get the range of discount factors that support the collusion strategy as an equilibrium:

$$\delta \lambda \frac{(1 - \delta^T)(M_1 - M_2)}{1 - \lambda \delta - (1 - \lambda)\delta^{T+1}} \geq M_3 \quad (24)$$

where  $M_1 = E[f(q)(q - \mu)]$ ,  $M_2 = E[(q_i - \max_{j \neq i} q_j)^+]$ ,  $M_3 = \max_q \{(1 - f(q))(q - \mu)\}$ .  $\square$

### Proof of Proposition 3.3

*Proof.* Since  $M_1$  is the expected stage-game collusion rent to a seller, and  $M_2$  is her payoff in a competitive stage-game equilibrium, we have  $M_1 > M_2$ . Moreover,  $M_1 + M_3 > \mathbb{E}[q] - \mu$ , thus  $\frac{1}{\lambda} \frac{M_3}{M_1 + M_3 - M_2} > \frac{1}{\lambda} \frac{\mathbb{E}[q] - \mu - M_1}{\mathbb{E}[q] - \mu - M_2} > 0$ . Because the least-upper-bound property (and its implied greatest-lower-bound property) holds, the infimum exists.  $\square$

### Proof of Proposition 3.4

*Proof.* Since the payment can be contingent on completion of service, the authentic type can be separated out from fraudulent type by the following smart contract: The buyer pays the seller  $p^s$  conditional on the success of service, otherwise pays zero (or an infinitesimally small negative amount). The fraudulent type can ill-afford imitating the good type, since she can never complete the service and get the payment. Consequently she does not enter and never gets any customer. For the authentic entrant to get buyers (if present), if  $q_C \geq \max\{q_A, q_B\}$ , she can charge payment  $p^s = \frac{\mu + (q_C - \max\{q_A, q_B\})}{q_C}$  contingent on completion of service, and zero upon failure, to break the fraudulent type's indifference, because there is a tiny cost for entry and the fraudulent type would never enter since she will never be paid.

Given the smart contract allows authentic C to costlessly separate. A, B, and C essentially compete based on  $\mathbf{q}$ . Any predatory behaviors would only incur losses for the current period without improving future continuation value as future  $\mathbf{q}$  is i.i.d.. Therefore there would not be any predatory (or penetration) pricing.

Finally for collusive equilibria, if A and B collude, they must be charging a weakly higher price, which enables C to get the first customer earlier.  $\square$

### Proof of Proposition 3.5

*Proof.* It is easy to derive,

$$V^+(q_i, q_{-i}) = \lambda(f(q_i, q_{-i})(q_i - \mu) + \delta V^+) + (1 - \lambda)\delta V^+ \quad (25)$$

$$V^+ = \lambda(E[f(q)(q - \mu)] + \delta V^+) + (1 - \lambda)\delta V^+ \quad (26)$$

$$V^- = \lambda E[(q_i - q_{-i})^+] \frac{1 - \delta^T}{1 - \delta} + \delta^T V^+ \quad (27)$$

$$\forall q, V^+(q) \geq \lambda((q - \mu) + \delta V^-) + (1 - \lambda)\delta V^+ \quad (28)$$

Collusion can be supported if

$$\frac{\delta \lambda (M_1 - M_2) (1 - \delta^T)}{1 - \delta} \geq M_3 \quad (29)$$

where  $M_1 = E[f(q)(q - \mu)]$ ,  $M_2 = E[(q_i - q_{-i})^+]$ ,  $M_3 = \max_q \{(1 - f(q))(q - \mu)\}$

Compared to tacit collusion without blockchain, the only difference in the above recursive equations is that the punishment phase is not triggered if the buyers do not show up, i.e., the corresponding part of the continuation value is  $(1 - \lambda)\delta V^+$  instead of  $(1 - \lambda)\delta V^-$ .

We show that whenever (7) is satisfied, so is (29). This is equivalent to showing

$$1 - \lambda\delta - (1 - \lambda)\delta^{T+1} > 1 - \delta \quad (30)$$

which is equivalent to

$$\delta(1 - \delta^T)(1 - \lambda) > 0 \quad (31)$$

Now for the second part of the proposition: Note that collusion being impossible when  $\delta < \delta_o^{Traditional}$  is already proven in Proposition 3.3.

To show there could be when  $\delta \geq \inf_f \{\delta_{(\infty, f)}^{Blockchain2}\}$ , we note again by the least upper bound property,  $\inf_f \{\delta_{(\infty, f)}^{Blockchain2}\}$  is well-defined and positive. To show one collusion equilibrium exists, we only need to search within the class of  $f$  such that  $f(q)$  is continuous function, i.e.  $f \in \mathcal{C}([0, 1])$ . Because  $\mathcal{C}([0, 1])$  is a locally convex Hausdorff space that is complete, there exists a sequence of allocation functions that gets infinitely close to the infimum. This means for any  $\delta \geq \delta_o^{Blockchain2}$ , we can find a  $(T, f)$  that can be sustained. This holds true for our later discussions on infimum and supremum as well.  $\square$

### Proof of Lemma 3.6

*Proof.*

$$V^+(q_i, q_{-i}) = \lambda(\hat{f}(q_i, q_{-i})(q_i - \mu) + \delta V^+) + (1 - \lambda)\delta V^+ \quad (32)$$

$$V^+ = \lambda(E[\hat{f}(q)(q - \mu)] + \delta V^+) + (1 - \lambda)\delta V^+ \quad (33)$$

$$V^- = \lambda E[(q_i - \max_{j \neq i} q_j)^+] \frac{1 - \delta^T}{1 - \delta} + \delta^T V^+ \quad (34)$$

$$\forall q, V^+(q) \geq \lambda((q - \mu) + \delta V^-) + (1 - \lambda)\delta V^+ \quad (35)$$

Note  $V^+ - V^- = \frac{\lambda(\hat{M}_1 - \hat{M}_2)(1 - \delta^T)}{1 - \delta}$ .  $\square$

### Proof of Theorem 3.7 and Discussion

*Proof.* Again,  $\frac{\hat{M}_3}{\hat{M}_3 + \lambda(\hat{M}_1 - \hat{M}_2)} \in (0, 1)$  for all  $\hat{f}$ . Therefore by the least upper bound property,  $\sup_f \{\delta_{(\infty, \hat{f})}^{Blockchain3}\}$  exists and is less than 1. When  $\delta > \sup_f \{\delta_{(\infty, \hat{f})}^{Blockchain3}\}$ , any  $(\infty, \hat{f})$  can be sustained, including the one allocating buyers to the highest quality seller and the one allocating to the lowest-quality seller. Note that for any realization of seller qualities, the best-quality seller with blockchain is better than the best-quality incumbent, we could attain higher or lower welfare; similarly, the worst-quality seller with blockchain and entry is worse than the worst-quality incumbent, so welfare could be lower. Moreover, since competitive stage game is always on the equilibrium path without blockchain, the consumer surplus is positive. With blockchain sellers can extract full rent, so lower consumer surplus is attainable. Moreover, by introducing some punishing on the equilibrium path or lowering the collusion price under blockchain, consumer surplus can be increased to be higher than that in the traditional world (for example, under perfect competition). Thus consumer surplus can also be higher with blockchain.

Note for the corollary, the most collusive equilibria maximizes welfare but sellers fully extract all welfare surplus. This equilibrium can be sustained and the results follow.  $\square$

We note  $\hat{M}_2$  is simply the payoff to a seller in a competitive stage game, and is almost surely less than  $M_1$  which is the expected stage game payoff under collusion. Therefore,  $\inf_{\hat{f}} \{\delta_{(\infty, \hat{f})}^{Blockchain3}\} = \inf_{\hat{f}} \frac{\hat{M}_3}{\hat{M}_3 + \lambda(\hat{M}_1 - \hat{M}_2)}$ . But  $\frac{\hat{M}_3}{\hat{M}_3 + \lambda(\hat{M}_1 - \hat{M}_2)} \in (0, 1)$  for all  $\hat{f}$ . Again, by the greatest-lower bound property of real-numbered set, the threshold is well-defined and smaller than 1.

When  $\delta > \delta_o^{Blockchain3}$ , the blockchain can support at least one collusion equilibrium that fully extracts consumer surplus (with no punishment phase on equilibrium path). This is because, again, there is a sequence of allocation function  $\hat{f}$  within in the complete function space  $\mathcal{C}[0, 1]$  that arbitrarily approaches the infimum. Without blockchain, consumer surplus is never zero as competitive stage game is always on the equilibrium path. Note that even with collusion, there has to be punishment on the equilibrium path. Thus consumer surplus is always positive. The conclusion follows.

### Proof of Corollary 3.8

*Proof.* For  $m > 2$  in general, the previous proposition's proof still applies and  $\delta_o^{Blockchain, m} < 1$ . For  $n \geq 2$ , when  $\lambda < \frac{n-1}{n}$ , we have  $\frac{1}{\lambda} \frac{M_3}{M_1 + M_3 - M_2} > \frac{1}{\lambda} \frac{\mathbb{E}[q] - \mu - M_1}{\mathbb{E}[q] - \mu - M_2} > \frac{1}{\lambda} \frac{\mathbb{E}[q] - \mu - \frac{1}{n}(\mathbb{E}[q] - \mu)}{\mathbb{E}[q] - \mu} > 1$ . Therefore there cannot be collusion with  $n \geq 2$  in the traditional world. The corollary follows.  $\square$

### Proof of Lemma 4.2

*Proof.* The information asymmetry here is that the buyer does not know a seller's type. Therefore the buyer makes his decision based on his perception of the type  $\hat{q}_i$  and the price charged  $p_i$ . To be specific, the buyer maximizes his payoff by choosing the seller who can deliver the highest expected utility:

$$\max_i \hat{q}_i - p_i \tag{36}$$

If the payoff by choosing any seller is negative, the buyer will step out of the market.

Suppose there is a separating equilibrium where the pricing schedule is  $p(q)$  and the probability for a seller with type  $q$  to be chosen is  $f(q)$ . For a seller with type  $q$ , she can pretend to be type  $\tilde{q}$  by posting the

price  $p(\tilde{q})$ . The seller's expected payoff by doing so is

$$f(\tilde{q})(p(\tilde{q}) - \mu) \tag{37}$$

Every seller will choose the same  $\tilde{q}$  to maximize (37), which does not depend on  $q$ . Therefore, the separating equilibrium does not exist.

Since there is no separating equilibrium, we consider the pooling equilibrium. Without a reputation system, the buyer's perception of each seller's type is the mean  $\mathbb{E}[q]$ .

This is similar to Bertrand competition. Suppose the lower price of the two firms is higher than  $\mu$ , say,  $p_1 > \mu$ . Consider a deviation for the second firm to the price  $p_2 = p_1 - \epsilon > \mu$ , which increases the profit of the second firm. Therefore, in equilibrium, we must have  $p_1 = p_2 = \mu$ . Since we always assume the buyer's decision rule is non-discriminating, the tie is broken randomly. Therefore, the ex-ante consumer surplus and social welfare is  $\mathbb{E}[q_i u - \mu]$ , where the expectation is taken over the realization of  $q_i$ . This yields  $\mathbb{E}[q] - \mu$ . As a remark outside our parameter assumption, if the cost is so high that  $\mu > \mathbb{E}[q]$ , ex-ante utility for the buyer is negative, and the buyer will stay out of the market, i.e., the market breaks down.  $\square$

### Proof of Proposition 4.3

*Proof.* We first show that using  $\mathbb{P}^*$  is an equilibrium. We then prove that no other equilibrium exists. The proof resembles the argument in DeMarzo, Kremer, and Skrzypacz (2005) on how the flattest securities are always used in an equilibrium of informal auctions with security bids. However, because the sellers can always offer quality-insensitive smart contracts, we do not need to worry about equilibrium refinement. Readers who are familiar with DeMarzo, Kremer, and Skrzypacz (2005) should skip the detailed proof below.

With  $\mathbb{P}^*$ , buyers get utility  $1 - p$  regardless of the service outcome; in other words, the smart contract is quality-insensitive. Conversely, any quality-insensitive smart contract has to be of the form  $\mathbb{P}^*$ . Given that the buyer taking an offer  $(p, p - 1)$  gets  $1 - p$  utility, the setup is equivalent to a first-price auction where the buyers are the auctioneers who allocate the business opportunity, and sellers are bidders who bid cash  $1 - p$ . The buyers go to the seller with the lowest  $p$ . From the auction literature, a unique symmetric equilibrium with cash bids exists. Therefore, there is a unique equilibrium when restricting smart contracts to  $\mathbb{P}^*$ , implying that there is no profitable deviation using quality-insensitive contracts. The equilibrium offer of type  $q$  follows the solution of symmetric equilibrium of first price auctions (Krishna (2009)), and is given by the  $p_q$  that solves

$$1 - p_q = \mathbb{E} \left[ q^{(1),N-1} - \mu | q^{(1),N-1} < q \right] = q - \mu - \int_{\underline{q}}^q \left[ \frac{\Phi(q')}{\Phi(q)} \right]^{N-1} dq' \tag{38}$$

where  $q^{(1),N-1}$  is the highest realized quality among other  $N - 1$  sellers. We note the expression is increasing in  $q$ , thus buyers all choose the highest-quality seller. Substituting  $N = 3$  gives the expression in the proposition.

Now suppose this equilibrium breaks down when we allow for smart contracts beyond  $\mathbb{P}^*$ , then there must be a profitable deviation by a type  $q$  to a quality-sensitive smart contract  $\mathbb{P}_q$  such that  $Pr(B(\mathbb{P}_q))S_q(\mathbb{P}_q) > Pr(B_q(\mathbb{P}_q^*))S_q(\mathbb{P}_q^*)$ , where  $Pr(B)$  is the probability of getting customers when buyers believe that they can get utility  $B$ , and  $B(\mathbb{P}_q)$  is the buyers' perceived value of the deviation contract. Denote the set of types that find it profitable to deviate to  $\mathbb{P}_q$  by  $Q$ . Then  $B(\mathbb{P}_q) \in B(\mathbb{P}_q(Q))$ . Therefore,  $\exists q' \in Q$  (possibly  $q$ ) such that

$q' - S_{q'}(\mathbb{P}_q) = B(\mathbb{P}_q(q')) > B(\mathbb{P}_q)$ . Consider the deviation by type  $q'$  to  $(p', p' - 1)$ , where  $p' = 1 - q' + S_{q'}(\mathbb{P}_q)$ . Then the probability of winning is higher than  $q'$  deviating to use  $\mathbb{P}_q$ , and the payoff conditional on getting customers are both  $S'_q(\mathbb{P}_q)$ , implying that if it is profitable for  $q'$  to deviate to  $\mathbb{P}_q$  (which is true since  $q' \in Q$ ). It is also profitable for  $q'$  to deviate to a quality-insensitive contract  $(p', p' - 1)$ . However, this contradicts the fact that there is no profitable deviation using quality-insensitive contracts. Therefore, we conclude that the equilibrium described in the previous paragraph is an equilibrium even when we allow general smart contract forms.

Next, we show that the above equilibrium is essentially unique for the game, i.e., all other symmetric equilibria have the same payoffs.

We first argue that if a smart contract  $\mathbb{P}$  is offered in an equilibrium and is quality-sensitive, then at most one type uses it. Suppose otherwise and more than one type use it. Let the lowest and highest types offering the smart contract be  $q_L$  and  $q_H$ , then  $B(\mathbb{P}) = B_{q^*}(\mathbb{P}_{q^*})$  for some  $q^* \in (q_L, q_H)$ . However,  $\mathbb{P}$  is increasing in quality because  $p^s > p^f$ . Consequently,  $q_L$  would find it profitable to deviate to offering  $(p, p - 1)$  where  $p = 1 - B(\mathbb{P})$ , contradicting that in equilibrium both  $q_L$  offers  $\mathbb{P}$ . Therefore, at most one type uses  $\mathbb{P}$ .

Let the type be  $q$ , then  $B(\mathbb{P}_q) = B_q(\mathbb{P}_q)$ . This implies the allocation and payoffs are unaltered if type  $q$  replaces the offer by  $(p_q, p_q - 1)$  where  $p_q = 1 - B(\mathbb{P}_q)$ . This is because,  $S_q(\mathbb{P}_q) = q - B_q(\mathbb{P}_q) = q - (1 - p_q)$ .

Because each type  $q$  is solving the same optimization problem as in the case where we restrict to  $\mathbb{P}^*$ , we have shown that any unrestricted equilibrium is payoff equivalent to the unique and monotone equilibrium with restriction of smart contracts to  $\mathbb{P}^*$ .

Finally, the smart contract  $(p_q^s, p_q^f)$  used by type  $q$  in such an essentially unique equilibrium gives type  $q$  the same value as  $(p_q, p_q - 1)$ . That is,  $qp_q^s + (1 - q)p_q^f = qp_q + (1 - q)p_q$ . Because in the equilibrium with  $\mathbb{P}^*$ , a seller's expected payoff is differentiable  $q$  for all  $q$ , by a standard envelope argument, taking derivatives in the unrestricted equilibrium yields  $p_q^s - p_q^f = 0$ . From this we conclude that all possible equilibria are payoff equivalent to the unique equilibrium when restricting smart contracts to  $\mathbb{P}^*$  and the smart contracts used are also in  $\mathbb{P}^*$ . This means that no equilibrium exists other than the one described in the second paragraph of the proof. □

## C Examples of Record Keepers

Network	Token	Keeper	Function & Objective	Governance Role & Development State
Maker	MKR (gov.) Dai (tx)	Arbitrage seekers, Dai borrowers, CDP closers	Seek arbitrage opportunities and thereby maintain Dai stable.	Indirect – Keepers don't earn MKR directly but the biggest MKR holders are also Keepers.
Polkadot	DOT	Validators, Nominators, Fishermen	Validate transactions and calls across blockchains/smart contracts as well as police validation.	Direct but undefined currently as the appropriate governance mechanism is still being researched.
0x	ZRX	Relayers	Liquidity provision, market making, arbitrage seeking	Direct on-chain <del>stake-voting</del> of protocol updates. Final design and testing
<u>Tezos</u>	XTZ	Miners	Stake-mining and governance of the protocol	Direct on-chain <del>stake-voting</del> of protocol proposals including upgrades and new applications. Final stage of testing.
<u>Dfinity</u>	DFINITY	Miners	Stake-mining and governance of the protocol through the Blockchain Nervous System (BNS)	Direct on-chain voting with AI inputs that evolves and learns over time.
<u>Filecoin</u>	FIL	Miners	File storage and retrieval considering persistence and latency	No direct governance of the protocol.
Raiden	RDN	Operators	Path-finding, channel monitoring, gateway, etc.	Governance mechanism is still being researched.
Truebit	TRU	Solvers & Challengers	Verifying computation and policing the system	Direct governance but undefined currently as the governance mechanism is still being researched.
1protocol	CRED	Operators	Stake-mining on behalf of Capitalists.	Direct but undefined currently as the governance mechanism is still being researched.
Cosmos	ATOM	Validators	Staking and validating transactions.	Direct on-chain <del>stake-voting</del> of protocol updates. Mid-stage design and testing.
Augur	REP	Reporters	Reporting on the outcome of events.	Indirect (for the time being).
Bitcoin	BTC	Miners	Confirming transactions and securing the network.	Indirect as Miners effectively have some control of the protocol updates (see BTC-BCH).

Table C. A List of Record Keepers' Functions

Source: KeepersWorkers that Maintain Blockchain Networks, Ryan Zurrer, *Medium*, Aug 5, 2017. <https://medium.com/@rzurrer/keepers-workers-that-maintain-blockchain-networks-a40182615b66>