M.A Economics 2nd Semester

ECOPG – 201: Economic growth and development

Module –3: Social and Institutional aspects of Development

ECONOMIC DEVELOPMENT AND INSTITUTIONS

We know that markets can play an important role in allocating resources efficiently and also in providing incentives for growth. But do they work always? Or are they sometimes, in certain circumstances, prone to failure? Why does the government need to intervene sometimes? All these questions are taken up for discussion in this study material.

The basic thrust of this module is to present a discussion about the impact and influence of institutions on the process of development. Traditionally in microeconomics and macroeconomics analysis has been conducted as if in an institutions-free environment. But institutions matter. Two points are being suggested here. First there are more variables that have to be taken into account when analysing economic processes. There are even non-economic factors that impinge on economic process— political, social and cultural factors. The second assertion is that institutions vary across space and over time. Institutions are neither static nor uniform. In developing nations, social institutions and the community impinge on the economic processes a good deal. Hence any study of developing societies need to take this into account. The unit thus has a discussion on role of social norms and of the community on economic development. It also discusses the importance of governance in its impact on policy-making and economic transactions, and hence on development.

Sometimes it is observed, and not only in developing countries, that outcomes less look inefficient and sub-optimal not only emerge but also tend to persist. It is as though society has chosen inefficiently an entire path of development and that has got historically locked –in.

❖ MARKET FAILURE

Adam Smith, in his classic work *An Inquiry into the Nature and Causes of the Wealth of Nations* published in 1776 argued that individual pursuing their private ends would, through competition, be led to promote the public interest as though led by an 'invisible hand'. Ever since then, economists have widely agreed that competitive markets do lead to efficiency, but later on, economists realized that competitive markets promote efficiency if certain conditions are met, and there may be situations where the competitive market does not perform well or work perfectly.

The question is, what do we mean by efficiency, and what are these conditions that have to be fulfilled if the market is to promote efficiency? The basic answer is provided by what are called the two fundamental theorems of welfare economics.

❖ The Fundamental Theorems of Welfare Economics

The first fundamental theorem says that under certain conditions, competitive markets lead to an efficient allocation of resources. Efficiency here means the allocation is Pareto-efficient and the situation is one of Pareto optimality. Pareto optimality means a situation where

it is impossible to make someone better off without at the same time making someone else worse off. It may be possible to make someone better off. But at the same time, someone else will necessarily end up being worse off. If there is a situation where someone can be made better off but no one else ends up being worse off, the economy or the society in question has not yet reached a situation of Pareto optimality. When economists speak of efficiency they usually mean Pareto-optimal situations. When an economy has reached a Pareto optimal state, it reaches a point on its utility possibility frontier and does not lie below the utility possibility frontier.

The second fundamental theorem states that given the proper initial distribution of resources, a decentralized competitive economy will attain some point on its utility possibility curve. Of course, any point on the utility possibility curve can be attained but the important thing is that it will be a point on the frontier and not below it. Of course, Pareto optimality says nothing about equity or the distribution of resources. Even under Pareto optimality there might be gross inequality. Even if the resulting income distribution is not acceptable, we need not abandon the competitive market mechanism. We merely have to redistribute the initial wealth. At some specific distribution of the initial wealth, there will be the decentralized market mechanism at work at will help to attain the desired outcome.

The fundamental theorems of welfare economics make a powerful case for the market mechanism. What it says is that if decision –making is decentralized, that is, individual decision makers independently make their own decisions based on their own self-interest and there is competition at work, we do not need any centralized resource allocation mechanism like a planning agency. The second fundamental theorem gives a modern touch to Adam Smith's principle of the invisible hand. The reason the second theorem works, that is, the reason a decentralized competitive system ensures Pareto optimality is that individuals, in making decisions to make optimum gains, equate their marginal benefit to the marginal cost. You have come across decision-making using marginal concepts in your microeconomics course. Of course, the fundamental theorems of welfare economics talks about a situation where there is no change, things are static, and firms are small and cannot influence prices. It gives quite a narrow perspective of competition. Sometimes, people have made a case for the market mechanism with quite a different perspective of the competitive system in mind. When you come to Schumpeter's theory, you will be better acquainted with these themes.

❖ Situations when market failure emerges

We have seen that the fundamental theorems of welfare economics assert that if certain conditions are met, the economy will be Pareto-optimal. There are circumstances or situations where the market is not Pareto-optimal or Pareto efficient. These situations are called situations of market failure and economists have suggested that these situations provide a justification for government intervention and activities. What are these situations? The main ones are:

❖ Markets that are not competitive

Pareto optimality is attained only under situations of perfect competition. In some industries there may be a few large firms dominating the market. These situations may not be so bad if there are many potential entrants waiting to enter the market and provide competition. Pareto optimality will be much harder to attain if there are barriers to entry. If entry into a market were costless and easy, even the existing firms might behave in a competitive manner. Sometimes barriers to entry are created through government regulation, like giving a firm or at best a few firms some contract, and sometimes firms use the possibility of reaping scale

economies, that is, increasing returns to scale to bar entry. Increasing returns to scale implies average cost of production declines with the scale of output. The government does sometimes regulate monopolies.

The main reason monopolies are viewed with suspicion is that a monopolist will generally restrict output to raise prices with a view to making profits. A monopolist, just like a firm under perfect competition, produces till the point where his marginal revenue equals his marginal cost. Under monopoly however, the prices are higher and equilibrium output is lower than under competition. Moreover, under monopoly, the monopolist takes off part of the consumer surplus. But there is a certain portion that accrues neither to seller nor to the buyers. This is called the deadweight loss under monopoly. It is for these reasons that markets with monopolies do not attain Pareto optimality and the situation is one of market failure.

- **Public Goods**

There are goods that have two specific characteristics:

1. It is difficult to exclude anyone from consuming these goods. Light going out to ships from a lighthouse, or rather, the lighthouse itself is a classic example of this kind of a good in economics.

2. The other characteristic is that there is no rivalry in the consumption of a good. Consumption by one person does not diminish the amount to be consumed by anyone else. The marginal cost to the additional individual enjoying the good is zero. A classic example is national Defense. An example of a good showing rivalry is a shirt.

These types of goods displaying rivalry and exclusion-ability are called **pure public goods**. The market will not supply, or will under-supply public goods, that is, supply in insufficient quantities.

- **Externalities**

These are situations where the actions of one individual or firm affect other individuals or firms. There may be situations where one firm or individual imposes costs on others, that is, imposes social costs, but does not adequately compensate for these. Alternatively, an individual or firm may provide benefits to others but does not reap the rewards. All these are situation of **externalities**. A recent example is air pollution created by factories and vehicles.

In situations of externalities, allocation by market mechanism may not be very efficient since there is a divergence between private and social costs, and between private and social benefits. Those who impose costs on others but do not compensate others might undertake too much of these activities, while those who do not get to reap the full benefits of their actions might produce too little of it. The government often responds in such situations by stepping in either through regulation or by using the price system to impose penalties or give rewards.

- **Incomplete Markets**

There are situations where markets fail to provide a good or service, even though the cost of providing it is not more than what consumers are willing to pay for it. We call this a situation of **incomplete markets**. This sort of situation is often encountered in financial markets, particularly in markets for credit and insurance. There is the related case of absence

of complementary markets missing in some cases, or coordination failures. All these are situations of market failure. Many people advocate a strong government intervention in such situations.

❖ Information Failures

Sometimes there is the presence of imperfect information in markets, and this provides a rationale for government intervention. In these situations the fear is that in the absence of government intervention, the market will provide too little information, so that some parties to a transaction can get too much benefit. Collection and obtaining of information ought not to be too costly.

There are other roles that have been put forward as legitimate for the State to intervene and act in the economy, even in a market economy. The first of these is to combat inflation, unemployment, and situations of disequilibria in some markets, that is, to smooth out the ill effects of business cycles. Macroeconomic stabilization policy has long been an activity of the state, even in developed nations, particularly since the Great Depression of the 1930s. You can read about these policies in your macroeconomics course.

Two other important areas for the government to intervene in market economies are

1. To improve the income distribution which might emerge as an outcome of the working of the market economy;
2. To compel people to consume certain goods that the state thinks is in the best of the consumers themselves, or goods which consumers otherwise does not choose to consume even though they know it is in their own best interests. These goods are called **merit goods**.

Private firms may provide these but also because the government has compelled the people to consume these. Examples of such merit goods are helmets for scooter riders or seat belts in cars. Some have viewed this action by the government as stemming from the government purporting to decide on behalf of consumers as a philosophy of paternalism. Critics feel a section of society is imposing its will on others.

One basic role of the government that everybody agrees is necessary is the government providing the legal framework and protecting property rights. This, it is felt will provide the necessary incentives and assurance to private markets to function smoothly and work efficiently.

❖ GOVERNMENT FAILURE

We saw there are certain situations where the government intervenes are required in the market to correct market failures. Also, government might itself engage in production and supply of certain goods. Other than this, the government provides administration. In certain societies the government undertakes economic planning. The government undertakes monetary and fiscal policy and incurs expenditures, generates revenues, provides subsidies and transfers, and imposes taxes. Thus, the state performs many functions. But if we limit ourselves to government intervention to correct the malfunctioning of the market, we find that there are situations where the government may not in practice be able to realise its intentions. Very often political factors come into play and the intention of the government gets lost in rhetoric.

This failure of the government to realise its stated objectives is broadly known as government failure. This concept has been put forward as a counter to those who point out the possibility of market failure. Roughly, the idea is that merely because there is market failure does not mean that the government can step in and make it better. There may be government failure, which might make the situation worse than what it was to begin with. Thus, government failure can mean either that the government fails to realize its objectives, or makes the wrong decisions. There are several reasons that have been suggested about why the government fails to realize its objectives.

The government has limited information. One of the advantages of the market system is that it seeks and provides information in a costless manner, unless there are market failures. No state can match the market when it comes to processing information. Moreover, the state sometimes cannot foresee future events and make correct expectations.

The government has limited control over the private sector, over private agents. The government may make decisions that require the citizens to do or not do certain things but the administrative and enforcement costs may be very high. For instance, in cities, the government may lay down rules about the size of extension that can be made to dwellings but these may be flouted with impunity. Also, considerations of democratic politics constrain government actions.

The government has limited control over the bureaucracy. Usually the legislature creates the Act and law, and the executive may conceive the decisions and actions, but it is the bureaucracy that has to implement these. The executive and elected people's representatives may have limited control over the bureaucracy, as there may be situations of asymmetric information here, and the issue of moral hazard comes in with the government as the principal and the bureaucracy as the agent.

There are constraints imposed by the political process. Actions and decisions of the government affect all people but in modern democracies these decisions are made by a small group of people. We have touched upon this point while discussing the second type of reason above. The party or coalition that emerged victorious in the previous election forms the government, and they have the next election to contest.

❖ Why do we observe government failure in developing nations?

Many years ago, the Nobel Prize winning economist Gunnar Myrdal had spoken of a 'soft state' to describe the state in developing nations. According to Myrdal, the state is not able to effectively implement its stated policy objectives. There can be several reasons for such widespread phenomenon of this inability to meet stated policy objectives.

1. Government functionaries, and politicians, may in many cases display a pursuit of self-interest. While pursuit of self-interest is much extolled in economics as we have seen in the previous section, in this case the self-interest of these individuals are add odds with the objectives of the organization, or the bureau or the executive. This pursuit of self-interest not only leads to venality and corruption, it also leads to sub- optimal results and inefficiency from the governments as well as from society's point of view.

2. Electoral pressures sometimes compel governments to take populist measures and undertake policies that do not lead to outcomes that promote efficiency. Naturally this

type of situation is likely to take place more on the eve of elections. This may be true of national governments as well as state-level governments.

3. The government often works with short-run perspective in mind. This is especially true about solutions that the government is trying to find about problems. Trying to find short-term solutions does not bring about structural changes in the economy. This leaves many problems un-addressed.

4. Government actions that are prompted by some specific policy objective or social goal sometimes lead to disincentive effects so that again, the optimal solution or outcome does not result. For example, the government may be driven by the desire to realize some social objectives but adopts a taxation policy that creates distortions in the economy and lowers revenue.

5. We had already mentioned the government lacks the total information required to solve entirely the coordination problem. The information structure is imperfect. The best solution for this is to decentralize government as much as possible, and make the decision-making process participative. We shall elaborate on this in the next section when we discuss governance.

6. Finally, there is a reason that is very significant as it exists in democratic societies but is constantly undermining the ideals of democracy. This is that certain special interest groups or pressure groups mange to capture the policymaking process and get policies made that are to their advantage. Special interest political groups like chambers of commerce, rich farmers' groups, professionals always try to influence the making of policies that will suit them. Even when there are regulatory activities of the government to regulate the prices and activities of monopolies, some business groups often take actions that influence the regulatory process itself so that they actually benefit from the regulatory processes as compared to other smaller firms. This is sometimes described in the literature as 'regulatory capture'.

❖ INSTITUTIONS AND GOVERNANCE

In the previous two sections we looked at how the markets sometimes fail to function efficiently, and how, as the government tries to correct these market failures, the possibility exists that government actually makes things worse. These situations of government and market failure suggest to us that it is important to consider the institutional framework under which the markets function as also the structure of governance, the myriad of decisions and actions by the government and policymaking institutions which will provide the correct information and incentives to private agents in the economy to carry out optima decisions.

In recent times institutional economics has assumed considerable importance in the analysis of developing nations. Institutions were important topics of analysis earlier as well, as exemplified by the works of economists like Thorstein Veblen, but by and large neo-classical economics was conducted, assuming, in effect, an institution-free environment. Recently, the analysis of exchange using tools of microeconomics has been sought to be supplemented by institutional analysis. Another reason for institutions assuming importance is the interest in work on economic growth. We have studied several theories of growth. We saw recently there has emerged a group of theories that see growth as determined by processes that are endogenous. There are differences in factors and endowments among nations, and this is supposed to explain the differences in economic growth of nations. Some economists have

suggested that the factors which are supposed to cause economic growth, which are endogenous, are themselves not the causes of, or explanations of growth. They are actually the characteristics or features of growth. The main reason for differences in growth performance is differences in the structure of institutions in various countries. Institutions and differences in them can account for large differences in the performance of countries.

About traditional private goods that are excludable and rival, what the best institutional arrangement is happens to be well known: there should be the presence of strong property rights and anonymous markets. That's all you need. However, non-rival goods can create a problem because it is not clearly known what the right institutions are, and hence there is a lot of scope for innovation in institutional set-up. We need to know in more detailed form and in greater nuances, what the correct institutional set-up should be for a particular type of non-rival good. The optimal design of institutions is an unresolved problem.

- **What are institutions?**

Douglass North, a Nobel Prize winner in economics defines institutions by referring to them, as "the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction." He suggests that institutions shape the constraints in interactions among people. These interactions may be economic, social or political. Economic institutions such as property rights and the degree of perfection of markets influence the structure of economic incentives in society. Economic institutions also determine how efficiently allocations will be allocated in society. Thus it is important to realize that not only are institutions important but also that they are endogenous.

In the early history of economic thought, there have been theories of development that have sought to analyses institutions by considering them endogenously. In the next block, you will study about the theories of development of the classical economists. Among them Marx, for instance, gave a broad ranging theory of development where institutions affect each other. Forces of production, that is, technology, are the driving force behind institutions. Forces of production affect the production relations. These two constitute the mode of production. As the mode of production that is, the economic system changes, it affects the entire superstructure of political, legal and social relations.

In the microeconomics tradition of Walrasian economics, analysis was often conducted as though in an institution-free environment, as we mentioned earlier. Recently there have been two strands of economic analysis that has sought to extend the Walrasian paradigm to incorporate institution. One strand looks at changes in property rights and transaction costs having a great impact on economic development. This view is exemplified by the works of Ronald Coase and Douglass North. The other strand has sought to use the recent developments in information economics, like asymmetric information, imperfect information, moral hazard, adverse selection, signaling and screening, to understand how institutions affect development. They see institutions as filling in gaps in the economy created by missing and incomplete markets, presence of risk, and asymmetry of information. They have used this, for instance, to model agrarian institutions, for instance on these lines. This is seen in works of economists like George Akerlof and Joseph Stiglitz. Interestingly, all four economists have won the Nobel Prize.

The transaction costs school contends that as transaction costs change, institutions emerge to minimize these transaction costs. This is the basis of development. Transaction costs include costs of negotiation, monitoring, coordination, and enforcement of contracts. When

transaction costs are high, allocation of property rights becomes crucial. Contracts come to be determined by property relations when transaction costs are high. In the development process there may emerge a trade-off between economies of scale and transaction costs. In simple face to face interaction transaction costs may be low but production costs are high because specialization and division of labor is limited. The transactions cost school also believes that changes in relative prices cause institutional changes. The information economics school cast their theories in more rigorous terms and explicitly bring in notions of equilibrium.

It is important to understand why and how a certain institution emerges, and what purpose it may be serving. Even an institution that appears to be negative may be serving some purpose. It is important to realize this to explain its persistence. The institution may not be optimal, indeed, may be dysfunctional and may still persist. It is necessary to observe if there are regularities in the evolution of institutions, as this gives rise to conventions.

Questions :

1. *Define market failure and state its characteristics.*
2. *What is meant by government failure? Describe the possible reasons for Govt. failure in an economy.*
3. *Discuss the concept of Govt. failure. How does it differ from market failure?*
4. *Explains the major reasons for market failure in an economy.*
5. *Examine the impact of institutions and governance on economic development.*

SOME USEFUL BOOKS

1. Bardhan, Pranab. (2005). Scarcity, Conflicts and Cooperation: Essays in the Political and Institutional Economics of Development. Oxford University Press, New Delhi.
2. Bardhan, Pranab, and Udry, Christopher (1999) Development Microeconomics. Oxford University Press, Oxford.
3. Basu, Kaushik (1998), Analytical Development Economics Oxford University Press, Oxford.
4. Basu, Kaushik (2000). Prelude to Political Economy: A Study of the Social and Political Foundations of Economics. Oxford University Press, Oxford.
5. Douglass North (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, Cambridge.
6. Eirik G. Furubotn and Rudolf Richter (1997), *Institutions and Economic Theory: The Contribution of the New Institutional Economics*, The University of Michigan Press, Ann Arbor.
7. Elinor Ostrom (1990), *Governing the Commons*, Cambridge University Press, Cambridge.
8. Oliver E. Williamson (1996). *The Mechanisms of Governance*, Oxford University Press, Oxford.