Alternative Approaches to Development Economics

"The ideas of economists and political philosophers, both when the are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else." J. M. Keynes

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Basic concepts

- Economic Rationality
- Bounded Rationality
- Efficiency
- Coordination
- The Neoclassical market model

Development Planning Approach

- Development viewed as a sequence of stages
- Government intervention justified by **market failures**:

$\hookrightarrow$ Market Power

$\hookrightarrow$ Externalities

$\hookrightarrow$ Missing Markets

$\hookrightarrow$ Coordination Problems

- Intervention scaled back as economy develops
- Criticisms of the Development Planning approach

Economic Institutions

- The humanly–devised constraints that structure incentives in economic transactions
- They consist of
  1. formal rules (statute law, common law, regulations)
  2. informal constraints (conventions, norms of behavior)
  3. the enforcement characteristics of both.
- Determined by domestic/global, politics, religion, nature, etc.
- Change only gradually in response to economic/politicial pressures
- Examples

Chicago School Approach

- Although "institutions" often replace pure markets, they achieve the same **efficient** outcomes as predicted by neoclassical theory

- Private–sector creates institutions to minimize **transactions costs**:

$\hookrightarrow$ costs associated with risk

$\hookrightarrow$ coordination costs

$\hookrightarrow$ motivation costs

- Intellectual basis for pure *laissez faire*

$\hookrightarrow$ implies that policy-makers should largely ignore institutional details

$\hookrightarrow$ but need well–defined property rights

- Criticisms of the Chicago School approach

Asymmetric Information

- Moral Hazard (hidden actions)

$\hookrightarrow$ one party cannot observe or infer the actions of another

- Adverse selection (hidden information)

$\hookrightarrow$ one party cannot observe/infer characteristics of another

- Design of institutions governing transactions reflects these problems

New Institutional View

- Emphasizes the role and endogeneity of institutions

$\hookrightarrow$ develops a positive theory of economic institutions

- Asymmetric information results in fundamental market failures

$\hookrightarrow$ private sector creates "institutions" to deal with them, but still inefficient

$\hookrightarrow$ standard forms of government intervention may fail

- Outcomes depend on institutional arrangements and the distribution of wealth

The Culturalist Position

- **Economist's view:** variation in socio–economic outcomes due to variation in **incentives**

$\Rightarrow$ change underlying institutions $\longrightarrow$ change individual behaviour $\longrightarrow$ better outcomes

- **Culturalist's view:** variation in socio–economic outcomes due to social conditioning

$\Rightarrow$ change underlying culture of society $\longrightarrow$ achieve better outcomes for given institutions