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Preprint

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Journal of Advanced Research in Law and Economics

Suggested Citation: Todorova, Tamara (2016) : Transaction Costs, Market Failure and Economic Development, Journal of Advanced Research in Law and Economics, ISSN 2068-696X, ASERS Publishing, s.l., Vol. 7, Iss. 3(17), Summer

This Version is available at:

<https://hdl.handle.net/10419/157218>

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Transaction Costs, Market Failures and Economic Development

Abstract:

This paper relates economic development to transaction costs. It reveals the triad transaction costs-market failure-economic underdevelopment. Many scholars attribute the problems of development to the failure of markets to perform their role of resource allocation. Some deny market failure and blame government instead. Of those who trace the roots of economic backwardness to market failure, few, if none, investigate transaction costs in their linkage with market failure. This paper tries to bridge development economics with transaction cost theory and new institutional analysis.

Key words: transaction costs, market failure, economic development, opportunism, market power

JEL Classification: D02, D23, O10, P14

Introduction

Although the field of economic development is progressing, there still remains a gap between advanced and less developed economies. This gap seems to be widening during world recessions with large groups of people migrating or attempting to migrate to the developed west. The subject of economic development has also become important in view of the fact that former socialist countries previously considered developed have turned out to be or have become developing upon the start of transition to market reforms. The discrepancies between developed and developing countries remain and, opposite to expectations, convergence is not observed. The

early decades have been marked by the study of investment planning, differences in the capital stock and technological deficiencies in developing economies. Until the 1990s scholars largely believed that the lack of technology or technical progress in less developed countries is the reason for their backwardness, explaining their low productivity and income levels. Today it becomes clear that those models and approaches were somewhat incorrect. Applying the same technology turns out different output and is less productive in developing countries. While the same aggregate production function could be presumed, given sameness in technology, factor endowment and the resource base, the net production function is by far lower in developing countries. The difference between the gross and the net production functions is attributed to sizable aggregate transaction costs in less developed countries.

It follows that most problems of development lie not in mistakes in investment and macroeconomic planning but rather in the way markets operate and evolve with time. It is essential to study economic development properly, using the right instruments, in the right setting, with the right apparatus and applying logic which is specifically relevant to development rather than any general economic problem. North (1994, p. 359) emphasizes that some failures in the field of economic development stem from the fact that neoclassical theory is concerned with the operation of markets, not with how markets develop. The inability of neoclassical theory to understand how economies develop has thus created difficulties in prescribing policies in the developing world.

"How can one prescribe policies when one doesn't understand how economies develop? That theory... modeled a frictionless and static world. When applied to economic history and development it focused on technological development and more recently human-capital

investment but ignored the incentive structure embodied in institutions... It contained two erroneous assumptions: 1) that institutions do not matter and 2) that time does not matter."

It is evident that a new institutional approach to the study of markets and the development of different economies is more appropriate than the trivial coverage standard theory can provide. Many modern economists now stress that market institutions matter for economic development. At the same time, that institutions matter is a rather vague claim used by many who do not clarify what they mean by institutions, do not particularly understand the role of economic institutions or do not necessarily understand or share the ideas and framework of new institutional economics as the modern approach to economic institutions. When scholars speak of the importance of institutions they do not explain which types of institutions would help foster economic development in various contexts, countries, or sectors and how exactly this end is to be achieved. Different types of economic institutions (both market and non-market, private or public) can overcome specific problems of economic retardation since different types of economic institutions pair with different types of transaction costs underlying a particular institutional setting or infrastructure. It is not so much economic organization and institutions that matter for economic development but rather the magnitude and nature of these transaction costs as the costs of market operation (as defined by Coase, 1937) that precede institutions and predetermine the various institutional structures and forms to overcome transaction costs most suitably. By shaping economic institutions transaction costs in effect influence or completely block economic development.

It seems obvious that economic development is inherently related to transaction costs and cannot be analyzed outside of their context and separately from their types and levels. That transaction costs hamper and in some cases completely stop economic development was implied by some

authors who saw market failure as the reason for the misfortunes in economic development or the lack of economic prosperity in some parts of the world. Much of the welfare literature discusses economic development in relation to market failure. Few scholars though directly relate market failure and, hence, the mishaps of economic development, to transaction costs. Of those who saw market failure as the reason for economic underdevelopment and recognized that "institutions matter" very few took on a new institutionalist approach or studied the problems more deeply than what introductory textbooks in microeconomics reveal in their coverage of the different forms of market failure. Others, on the contrary, blamed government failure and government intervention, direct or indirect, for all misfortunes of developing as well as transitional economies where the two groups of countries seem similar in the degree of market failures experienced. Thus the true roots of economic backwardness were not sought or, if sought, remained insufficiently explained.

This paper traces the problems of economic development to transaction costs where the latter cause market failures of different types. By causing market failure transaction costs in effect slow down or prevent economic growth. Although many see the linkage between market failure and development, few analysts relate market failure and the problems of development to transaction costs as the marketing costs of private transacting. This paper tries to shed light on the triad transaction costs-market failures-economic underdevelopment. If transaction costs lie at the root of all types of market failure, then transaction costs could be the reason and general explanation for economic slowdown. In an attempt to achieve this goal the paper reviews some key contributions to the field of economic development studying market failure and the obstacles to growth. Alternative views of government failure or the dichotomy market-government are discussed. Some new institutionalist views are also presented.

Market Failure versus Government Failure

Some authors overtly reject market failure as the cause of economic underdevelopment and blame government instead. Ann Krueger (1990) stresses government failure as the culprit of economic underdevelopment where government should not correct market failure. She does not see developing countries as essentially different from the industrialized world when it comes to the degree or kind of market failures experienced in them. The active role of government in the economy has led to “colossal government failures” outweighing those of the market (Krueger, p. 10). Most notable are the government failures of omission such as the deterioration of transport and communication facilities, exchange controls, import licensing, failure to maintain existing infrastructure facilities and the government failures of commission involving high-cost public sector enterprises engaged in manufacturing or other economic activities not traditionally associated with the public sector (Krueger, p. 10). Krueger correctly points out that governments are not omniscient, selfless, social guardians and corrections are not costless (Krueger, p. 11).

However she does not give a strict definition to government failure and leaves the question when government failure or market failure is worse unanswered. If government failure is the sum of all actions and failures to act which result in a less-than-optimal situation, then all market failures would be government failures. If the benchmark is not the Pareto optimum but the outcome under laissez-fair, there is no distinction between government failures to provide essential public goods such as law and order, which Krueger admits are the prerogative of government, and those which cause greater private departures from the first best. Krueger also seems to favor market failure (laissez-fair) to government failure (government participation in the economy) in both cases but particularly in the second one of private departures. In her view laissez-fair is not so

growth hampering in third-world countries while government policies have not turned out to be so growth promoting.

Institutional design is suggested as a possible solution where the best set of institutions and incentives should be sought which would achieve a least-cost outcome. It does not become clear how institutions would correct market failure, neither what specific types of institutions should be used to address the different forms of market failure. It is also not clear when private market institutions should correct market failures and when it is the government that should play that role. The confusion comes from the fact that Krueger is inconsiderate of the existence of transaction costs where transaction costs should be the separating differential as to when government should or should not intervene. There is no reference to the types of market failures existing in developing countries and particularly to the institutional impediments to growth, neither there is reference to transaction costs as the source of various externalities, market power or informational asymmetries in those countries.

Datta-Chaudhuri also studies economic backwardness in relation to market failure but separately from transaction costs. Unlike Krueger he recognizes that market failures are more prevalent in developing countries and is somewhat neutral in the choice between market failure and government failure. He admits that the market is necessary since it disciplines producers against wasteful use of resources where even centrally planned economies cannot do without market institutions when it comes to cost and quality consciousness in production (Datta-Chaudhuri, p. 26). On the other hand, prices do not carry sufficient information for economic decisions and institutions matter. He as well does not reveal how exactly institutions matter and help resolve the problem of market failure. He emphasizes that earlier studies of economic development were "rich in their specification of technology and interindustry linkages, but hopelessly deficient in

their specification of behavioral and institutional issues" (Datta-Chaudhuri, p. 27). Datta-Chaudhuri considers several types of market failure - externalities, pecuniary external economies, information costs, incomplete markets, etc. Market failures present serious obstacles to the growth process of a backward economy. It is not enough to have physical capital installed and investment decisions made in order for the problems of production and productivity improvement to be resolved automatically.

According to Datta-Chaudhuri the process of learning is crucial to the success of a developing economy but there are serious market failures related to learning in those countries. He defines several levels of learning: how to operate new techniques of production, how to introduce cost-reducing and quality-improving innovations, how to change the product mix quickly in response to a changing environment. Different countries learn to integrate new technologies and production techniques at a different rate. The state can play an important role in helping the economy to acquire such learning skills. In those spheres where market signals are not effective guides to desirable action, appropriate non-market institutions are required to be created. Contrary to Krueger, Datta-Chaudhuri is more welcoming of non-market institutions, although he does not clarify whether he means private or public non-market institutions where the two types are essentially different in resolving market failure problems or reducing transaction costs. He feels that developing countries need a mutually supportive structure of market and non-market institutions, which is well-suited to promote economic growth. The role of the state should be supportive, secondary. Again, there is no separating differential or grounds for a selective approach as to when the government should be proactive and when resource allocation should be left to the market, when markets are effective and when not, how

to judge about the efficiency of markets and market signals as “effective guides to desirable action” and, furthermore, if markets fail, when is it the task of government to come in their place.

Transaction Costs at the Root of Economic Backwardness

Bardhan is the only one in the economic development literature who directly relates economic development or lack of it to transaction costs. In his review of new institutional economics and development theory Bardhan (1989) relates transaction costs in their standard definition as the costs of market exchange to market failure. He draws a parallel between transaction cost economics and the theory of imperfect information. Ownership structures and property relations determine the terms and conditions of contracts which directly affect the efficiency of resource allocation (Bardhan, p. 1389). Market failure and incomplete markets often result from the substantive presence of transaction costs and information problems where information costs constitute an important part of transaction costs and the imperfect-information theory of institutions is closely related to transaction-cost theory (Bardhan, p. 1390). Development economics thus provides hospitable territory for the institutional analysis of transaction costs (Bardhan, p. 1389). Opposite to Bardhan's expectations though development theory and welfare economics have not merged with new institutional analysis, transaction cost economics or property rights theory or, if there have been such attempts, they are rather meager.

Bardhan considers institutional devices such as long-term contractual relations or integration within firms transaction-cost reducing. Hence, long-term implicit contracts and personalized, less-than-arms-length transactions are quite common in developing countries (Bardhan, p. 1390). Thus Bardhan stresses the relative importance of informal rules, social relationships and social

norms as forms of collective action in less developed countries where, opposite to developed nations, transactions are not always faceless but quite interpersonal and where society or the local community penalize opportunistic behavior. It follows, therefore, that corrective measures and collective action as social control mechanisms differ in developed and in developing nations. According to Bardhan transaction costs, by raising barriers to entry and exit, reduce pressures from any social selection process; sunk costs and asset-specificity insulate internal governance structures from market forces, thereby preventing competition. The market equilibrium under imperfect information and incomplete markets is constrained Pareto inefficient and even bilateral relationships may not be efficient on account of complexity of private bargaining. Although Bardhan is among the few scholars who relate transaction costs to the problems of economic development and who bridge transaction cost theory with development, he does not explain the exact mechanism by which transaction costs precede the different types of market failure.

Proper treatment of the market failure roots of economic underdevelopment in less developed countries is given by Joseph Stiglitz. He criticizes neoclassical theory in that transfer of human and nonhuman capital to less developed countries has not increased productivity rates, neither have growth rates in per capita income converged around the world. Stiglitz emphasizes that less developed countries differ from the developed countries in one or more important respects, other than savings rates and reproduction rates. The differences can be attributed to differences in economic organization, to how individuals (factors of production) interact, and to the institutions which mediate those interactions. Market failure is more prevalent in developing countries (Stiglitz, p. 197); they learn less and more slowly than developed economies.

Stiglitz detects the roots of market failure mostly in informational asymmetries - markets are mostly imperfect with knowledge and information; market failures could stem from price effects, imperfect competition and monopolies arising out of imperfect knowledge spillovers. Low-level equilibria and problems with adverse selection, moral hazard and contract enforcement result from imperfect and costly information. Greenwald and Stiglitz (1986) stress that with incomplete markets (and imperfect information) even competitive markets fail to optimally perform the required risk-sharing function. Competitive equilibria for such an economy are not constrained Pareto-efficient and there exist schemes of government intervention which can induce Pareto-superior outcomes. It follows, therefore, that with high transaction costs, information costs being a subset of those, even competitive industries may show signs of failure and, thereof, provide grounds for government participation of some kind, be it regulation or direct ownership. Stiglitz proves to be in the group of economists who believe that markets do not function in developing countries and market failures are more strongly exhibited there. These market failures are different not only in degree but in kind so they make developing countries different from the industrialized western world.

The New Institutional Paradigm

A group of new scholars imply the relationship between market failure and economic development or lack of it, thereof, in that their writings gravitate around the concepts of transaction costs. Arrow, Akerlof, Barzel and others hint at the transaction cost character of economic backwardness. Although tacitly, these scholars represent market failure properly searching for its behavioral or institutional origins. Williamson (1989, p. 227) affirms that transaction costs are positive in the real world and not only do all transactions incur some transaction costs but also the different forms of organization can be associated with different

levels of transaction costs, which makes the choice of economic institutions vital. Yet, as previously mentioned, it is not so much economic organization and institutions that matter for economic wellbeing but rather the magnitude and nature of the transaction costs that precede and predetermine those institutions and set the need for various institutional forms to overcome those costs optimally. Thus it is transaction costs which shape economic institutions (market or non-market) and impact economic development, rather than economic institutions themselves.

Since transaction costs are positive and their magnitude varies from system to system and from society to society, it is important to study them in various contexts and under different systems of resource allocation. Arrow (1969, p. 501) believes that the identification of transaction costs in different contexts and under different resource allocation systems should be a major item on the research agenda of the theory of public goods and the theory of resource allocation in general. It could be added that studying transaction costs in different contexts is relevant not only to the theory of public goods, but particularly to the field of economic development since economic development is greatly the result of transaction cost differences where the types, levels and effects of these costs differ in the developing world from those in the developed west.

In his discussion of market versus non-market allocation, Arrow (1969, p. 513) suggests that transaction costs are attached to any market and indeed to any mode of resource allocation. With market failure transaction costs are so high that the existence of the market is no longer worthwhile. Production costs depend only on technology and tastes and would, therefore, be identical in all economic systems, while transaction costs can be varied by a change in the mode of resource allocation. Hence, transaction costs influence the mode of resource allocation and sizable transaction costs could be overcome by collective action, either in the form of firms or as social rules and norms where “norms of social behavior, including ethical and moral codes... are

reactions of society to compensate for market failures" Arrow (1969, p. 516)¹. Transaction costs are not only positive and matter in the economic system, but they differ in different societies, sectors or spheres of life with societies facing prohibitively high transaction costs being more prone to market failure and, hence, backwardness. Although he does not overtly disclose economic underdevelopment as the result of transaction costs, Akerlof (1970) studies the special case of opportunism on quality and reveals how this outcome of market failure leads to economic underdevelopment. He investigates the statement that "business in underdeveloped countries is difficult" and formulates:

"Dishonesty in business is a serious problem in underdeveloped countries. Our model gives a possible structure to this statement and delineates the nature of the "external" economies involved." (Akerlof, 1970, p. 495).

It is not by accident that Akerlof gives examples from third-world countries such as India where credit markets and managing agencies rely on reputation, where local moneylenders lend at a high interest rate to avoid lemon borrowers or where quality is intentionally degraded and stones of the same shape and color are intentionally being added to rice so Indian housewives have to clean those (Akerlof, 1970, p. 496). Akerlof (1970, p. 496) finds that there is greater quality variation in underdeveloped areas than in developed ones and that "quality variation is a greater problem in the East than in the West." It seems that the East and the West differ in the degree of honesty where lack of honesty is a hindrance to economic development. Akerlof (1970) reveals the quality aspects of informational asymmetries and presents asymmetric information and

¹ Arrow (1969, p. 516) stresses the importance of trust in commercial dealings. Individuals should have trust in each other's word since "in the absence of trust it would become very costly to arrange for alternative sanctions and guarantees and many opportunities for mutually beneficial cooperation would have to be forgone." Banfield (1958) also views lack of trust as the reason for economic underdevelopment.

quality uncertainty as the reasons for the disappearance of certain markets. Inferior quality products invariably replace good products while sellers have more information about the quality of the products they are selling than the buyers. Since only lemon goods would be sold at some point, demand may be insufficient to meet supply on the given market ultimately leading it to a low-end equilibrium. Behind informational asymmetries is seller opportunism which is a behavioral type of market failure. Akerlof reveals complete market failure in the context of misrepresented quality. While he discusses the cost of dishonesty, he does not relate cheating on quality, asymmetric information and opportunism to transaction costs. Akerlof does relate dishonest, opportunistic behavior to underdeveloped countries seeing market failures in those as the result of contractual opportunism.

Of the new institutional economics school Barzel (1985, p. 8) directly relates cheating on quality with transaction costs. Barzel reveals the inability of the market to clear in a Pareto manner when sellers cheat on quality under maximization and the outcome is essentially different from that in the Walrasian world. The losses that accrue to society are not the cheating per se, but the resources actually devoted to cheating and its prevention. These resources representing transaction costs of handling quality deviation are significant.

Economic reality provides evidence that, except in gross domestic product levels and living standards, developing countries differ from developed ones in the ability of markets to function smoothly. Their markets seem to be failing in the way they provide information through price signals where prices do not fully capture external effects. In the conditions of high transaction costs it is harder to curb private monopolies. Prominent scholars stress that there is a great deal of dishonesty and opportunism in private dealings in developing countries. Opportunism is an essential source of uncertainty and transaction costs. Societies in which strongly

opportunistic individuals prevail are opportunistic societies experiencing high transaction costs and stronger market failures due to deviant human behavior. In developing, as well as in transitional countries, there is a high degree of contractual opportunism, high asset specificity paired with high market uncertainty, and incomplete information. Markets do not function smoothly or cannot clear, information is strongly asymmetric, there are more instances of market power, economic agents have no trust in each other or in markets, markets do not seem to evolve but rather regress with the passage of time and self-interest seeking in its strongest form is the usual commercial pattern.

It is reasonable then to consider development economics different from standard neoclassical theory like developing countries differ from developed ones. If the prescriptions of neoclassical economics are relevant to the industrialized developed west, then development economics is more suitable for developing nations where market failures are more strongly exhibited. These market failures are different not only in degree but in kind which makes the neoclassical tools and policy directions inappropriate. In their studies of market failure as the obstacle to economic growth few scholars base their theory on transaction costs. Some go as far as blaming the government and government failure for economic backwardness. Government is condemned even in countries where the market functions under a relatively liberal regime, government is noninterventionist or almost nonexistent and all resource allocation is left to the market solely. Transitional countries in Eastern Europe trying to shift to a free market economy from extreme centralism are examples of laissez-faire policies where the market is left to perform its task unbothered. Few industries prohibit entry or exit and the government has withdrawn from many activities which are traditionally prerogative of the state in western economies. Sectors such as healthcare, employment, education, etc. are entirely or almost

entirely left to the price mechanism to handle with little or no government participation. At the same time, adequate formal or informal market institutions, commercial customs and traditions in private exchange are missing. Excessive market failure and significant transaction costs render economic reforms futile and explain their failure in the prolonged period of transition.

With considerable market uncertainty, opportunism and transaction costs of private dealing, public non-market institutions may be preferable to private market or non-market ones. Transaction costs present, markets fail in allocating resources which cannot be traded freely so that to achieve their maximum value and be used most productively in the conditions of a free market economy. Due to high transaction costs in such societies a more efficient allocation of resources, greater output and total welfare occur under public ownership or with greater government participation overcoming thus the obstacles to development.

A separating differential or a guiding principle when it comes to government intervention is the level of transaction costs in various sectors or contexts. Analysis should be done in terms of comparative cost economies, i.e., the ability of every single system of resource allocation to perform its task more cheaply than other systems. This does not however mean that the system in question will be operating at no cost. There are the costs of the state machine as well as there are costs of operating (organizing) markets. In some cases the state performs its role better than the market and at less comparative cost while market failure exceeds government failure. Optimal allocation should be studied in relative terms and occurs where costs are lower or minimized to a greater extent. When the cost of transacting through the market are taken into account and the costs of running these opposing systems of resource allocation are compared it becomes obvious that 1) there is significant market failure present in developing and transitional economies stemming from sizable transaction costs in market exchange; and that 2) the government could

correct market failures either indirectly through regulation, legislative power, courts, taxes, subsidies, etc. or directly through state ownership over economic resources in industries and spheres where the market fails considerably.

Government thus should be used to correct market failure only with significant costs of private transacting. Government has no place in spheres or sectors where prices are non-monopolistic, there is serious competition with low barriers to enter or exit, intense competition leads to quality improvements or knowledge accumulation, economic agents trust each other or the market altogether, economic agents are fully or almost fully informed, markets operate swiftly and progress dynamically, opportunism is relatively low or nonexistent and certainty is nearly perfect. There is no room for government where private institutions, both market and non-market, allocate resources relatively effectively. Successful markets are those in which the costs of transacting through private dealing are negligible and there is little market failure present. Low-transaction cost sectors should remain untouched; high-transaction cost sectors invite government intervention. Control and participation are needed where the market fails.

Conclusion

In some countries markets operate relatively well and market failures are less manifested. Developing countries experience strong friction in the operation of the market mechanism where sizable transaction costs bring numerous market failures. Developing and transitional countries differ from developed in the degree and kind of market failures observed. Government could and should intervene substituting the market mechanism only when the transaction costs of using it are significant. It should be inactive in cases or situations in which markets operate at relatively

low cost and smoothly. Economic reality in such problem-tangled systems shows that market failures have a transaction cost origin and that transaction costs are at the root of economic underdevelopment.

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