

Valentinov, Vladislav; Baum, Sabine

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THE INSTITUTIONAL ECONOMICS OF RURAL DEVELOPMENT: BEYOND MARKET FAILURE

Vladislav VALENTINOV, Sabine BAUM

Leibniz Institute of Agricultural Development in Central and Eastern Europe
Theodor-Lieser-Str.2, D-06120 Halle (Saale), Germany,
Telephone: + 49-345-29-28-228, Fax: + 49-345-29-28-399, E-mail: valentinov@iamo.de

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ABSTRACT

This paper examines and compares institutional arrangements addressing market failures endemic to rural areas. It argues that rural market failures cannot be satisfactorily addressed by for-profit firms and thus require the operation of third sector organizations, such as NGOs, cooperatives, and associations. The important role of these organizations in rural development is explained by the particular severity of rural market failures that inhibit the development of rural markets and thus constrain the operation of rural for-profit firms. This argument is applied to the development of rural tourism in Central and Eastern Europe. The rural tourist markets in this region are shown to fail in a number of ways that require recourse to tourism associations and other relevant third sector organizations. The paper concludes with calling for further research on developing the institutional economic theory of the rural third sector.

Key words: rural development, market failure, third sector, rural tourism, Central and Eastern Europe

INTRODUCTION

In all regions of the world, rural areas are facing many similar challenges. Compared with urban territories, rural areas are often marked by low per capita income levels, low employment opportunities, unfavorable demographic situation, low population density, and poor infrastructure [1; 13]. Consequently, the level of economic development of rural areas has often lagged behind that of urban ones. Economists traditionally conceptualize the problems of rural development in the neoclassical framework of market failure [5; 11]. The value of this framework lies in the indication of the importance of well-functioning markets and in the suggestion of governmental regulation measures aimed at ensuring the optimal allocation of resources through the operation of markets [15]. The market failure framework has provided the key theoretical basis for the formulation of rural development policies in the Western countries.

However, the traditional conceptualization of the rural development problems as resulting from market failure is not unproblematic. It can be questioned in two interrelated respects, empirical and theoretical. In the empirical respect, this traditional conceptualization is hard to reconcile with the recent 'shift from government to governance' in rural development in the Western countries, meaning the increasing transfer of responsibilities from the government to the private for-profit and the third (nongovernmental) sectors [8]. In particular, the support for rural partnerships within the LEADER program of the EU cannot be justified within the market failure framework emphasizing the role of markets and for-profit firms. In the theoretical respect, which is of particular relevance to the present paper, market failure must be recognized as a cause of the emergence of a wide variety of institutional arrangements, most importantly for-profit firms. Indeed, institutional economists have explained the very existence of for-profit firms in terms of their market failure-addressing role [4; 23]. Yet, rural development problems consist precisely of the lower presence of for-profit firms in rural areas as compared to urban ones. For-profit firms thus appear to fulfill their market failure-addressing role in urban areas more effectively than in rural ones. This fact, however, is paradoxical. So far, it has remained unclear why rural market failures could not be effectively addressed by for-profit firms and what alternative institutions could perform this task.

This paper will adopt an institutional economics approach to resolving this theoretical challenge. A major feature of institutional economics, particularly relevant to the present paper, is the consideration of markets as historically and functionally bounded institutions rather than as a natural social order [9]. An institutional economics approach

requires to see markets as interacting with other real-world institutional arrangements. In the rural development context, the crucial institutional arrangements, in which markets are embedded, include the government and the third sector, consisting of organizations such as NGOs, farmer associations and cooperatives, local community organizations, and self-help groups [18; 22]. More specifically, the objective of this paper will be to explain why rural market failures cannot be effectively overcome by for-profit firms and what role can be played by third sector organizations (TSOs) in rural development. Achieving this objective will clarify the above mentioned theoretical and empirical problems with the market failure approach to conceptualizing rural development.

The paper proceeds as follows. The next section sets out the general logic of the institutional response to market failure, thus identifying the differences in the market failure-addressing roles of for-profit firms and third sector organizations. The following section discusses the rural areas' characteristics that make third sector organizations more effective in overcoming rural market failures than for-profit firms. Finally, implications for further research and conclusions are presented.

Market failure and institutional environment

New institutional economics explains the basic institution of the for-profit firm in terms of its ability to address market failure. In his seminal 1937 article, Coase showed that for-profit firms address transaction cost-related market failures by substituting hierarchical organization for coordination through market exchange [4]. Since then, his insights were extended to take account of the fact that for-profit firms not only reduce the costs of processing information, but also align economic actors' incentives in such a way as to minimize opportunistic behavior. The market failure rationale of the for-profit firm implies that the broader occurrence of market failure necessitates the greater role of hierarchical organization as compared with coordination through market exchange.

Paradoxically, though, the new institutional economic theory of the for-profit firm is not explicit about the relationship between this firm and the institutional environment in which it is embedded. This point has recently been made by Dorward et al. who argued that markets in developing countries are often characterized by 'weak institutional environment' which means high transaction costs, significant business risks, weak information flows, poor infrastructure, and weak enforcement of property rights [5]. Under these restrictive conditions, for-profit firms may indeed be hardly able to address market failures, in contrast to their operation in 'strong' institutional environments that are characteristic of well-developed market economies. To the extent that

the institutional environment is weak, addressing market failures requires non-market institutions, of which the TSOs are a major example. In this vein, Dorward et al. emphasized that 'competitive neoclassical markets should be seen as only one set of institutional arrangements (albeit very important ones and often effective) by which resource, production and consumption are allocated, coordinated, and exchanged in an economy' [5, p. 6].

Hence, the argument that market failures can be addressed by for-profit firms exhibits certain circularity as it overlooks that for-profit firms exist not in institutional vacuum but in precisely those markets that are failing. The actual ability of for-profit firms to address market failure therefore depends on the extent of severity of the market failures in question. Evidently, severe market failures, e.g. those summarized under the heading of 'weak institutional environment', hinder the development of markets and thus cannot be effectively overcome by for-profit firms. Less severe market failures, specifically those that do not prevent market from satisfactorily operating, can be addressed by for-profit firms in the form of partial replacement of market coordination with hierarchical organization. The overall implication is that the stronger is the institutional environment, the greater is the role played by for-profit firms in addressing market failures; and accordingly, the weaker institutional environment is associated with the greater role of TSOs. This implication is diagrammatically presented on Fig.1.

Peculiarities of market failures in rural areas

Market failures in rural areas are recognized as being particularly severe. Kydd and Dorward argue that rural

areas, by virtue of their rurality, often exhibit poor roads and telecommunications; lack of a well-developed and diversified monetary economy; thin markets for agricultural inputs, outputs, and finance; weak flows of market information; difficult and weak contract enforcement; high risk of opportunistic behavior of agricultural producers' contractual partners [11]. More generally, Terluin suggests that the level of transaction costs in rural areas is higher than in urban areas [20]. These characteristics of rural areas obviously inhibit the development of markets and constrain the for-profit firms' ability to address rurality-specific market failures. The limited scope for the operation of for-profit firms in rural areas thus results in the enhanced role of TSOs in the satisfaction of needs of rural dwellers.

Rural TSOs may take the form of mutual self-help groups, rural and agricultural cooperatives, rural partnerships, community-based organizations, producers associations, and NGOs. Their major difference from for-profit firms is that they ensure the satisfaction of particular needs of rural dwellers through collective action of the latter, rather than through recourse to profit-making motivation of for-profit entrepreneurs. While rurality-specific market failures constrain the operation of for-profit firms, they evidently present less obstacles for the mutual self-help and collective action initiatives of rural dwellers. In a sense, the institutional effect of rurality is similar to that of the weak institutional environment as characteristic of developing economies, since both rurality and weakness of institutional environment are associated with the enhanced relative role of TSOs as compared with role

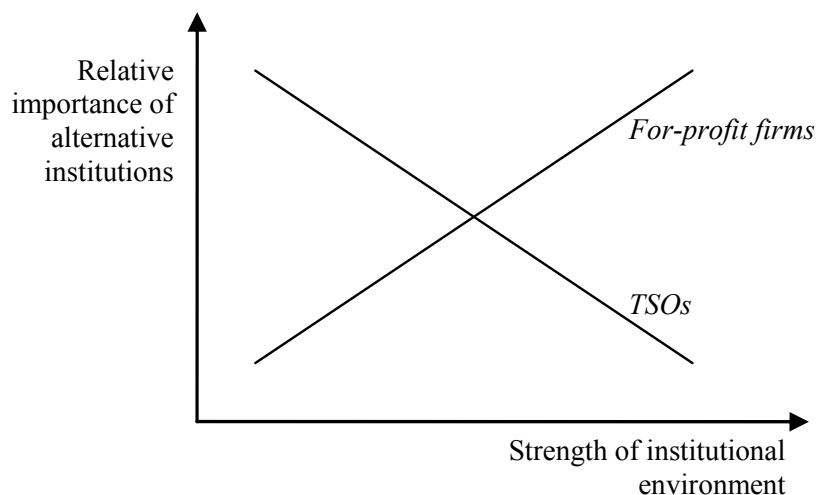


Fig.1 Relative roles of for-profit firms and TSOs in addressing market failures in various types of institutional environments

of for-profit firms in the economic development of the regions in question.

RESULTS

Application to the development in rural tourism in Central and Eastern Europe

This section demonstrates the rural for-profit firms' limitations in addressing market failures on the example of markets for rural tourist services in Central and Eastern Europe (CEE). It proceeds by highlighting the importance of rural tourism in this region, and identifying several rural tourist market failures that require recourse to TSOs.

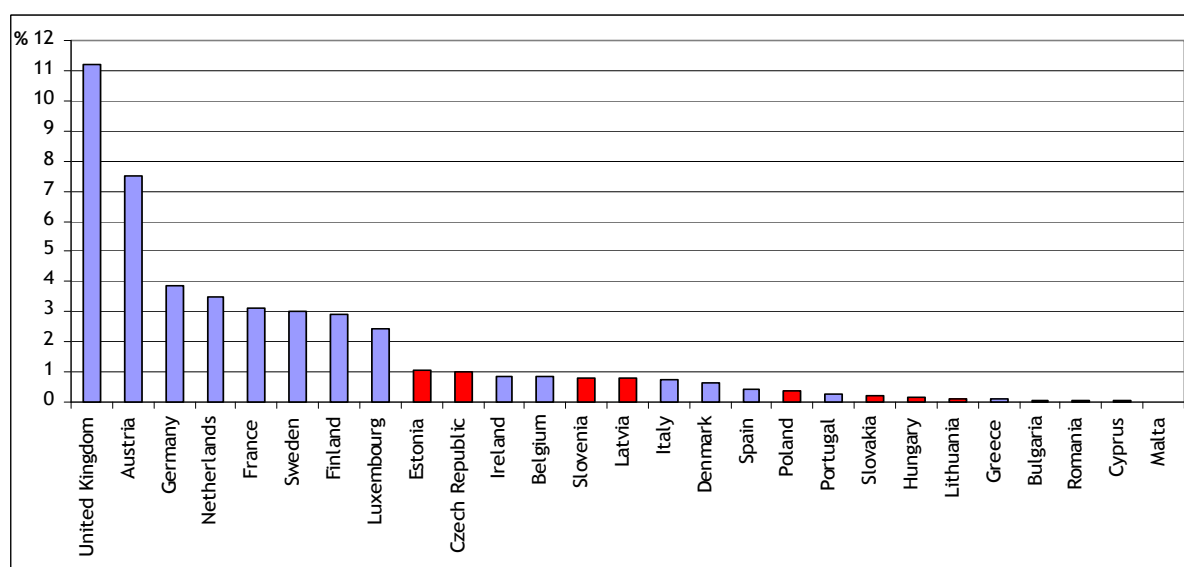
The importance of rural tourism in CEE

Rural areas in CEE face major challenges. Beside challenges, characteristic for rural areas in general, Central and East European rural areas have also been affected by problems related to the transition from socialist central planning system towards market economy. As a result, agricultural employment in most CEE countries decreased significantly since 1990, while the number of non-agricultural jobs in rural areas has remained rather low. Additionally, many rural commuters have lost their income through the closing of industrial enterprises in urban centres during transition. The creation of non-farm employment is therefore one of the most important issues in CEE rural areas. One potential new income source,

often cited as an opportunity for rural areas, is rural tourism. Nearly all CEE countries and regions, to various extents, have pinned their hopes for the development of rural areas on tourism, which is supposed to put the available natural and landscape resources to a productive use [6]. Whereas some countries in Western Europe have a well-established rural tourism industry with a substantial impact on rural economy, the significance of this sector in CEE has generally remained rather small (see e.g. [2] for Romania, [3] for Slovenia, [7] for Hungary, [16] for Poland). This fact is illustrated in Fig. 2 that shows the percentage share of agritourist farms in all farms for various EU member states.

The failures of tourist markets

The development of rural tourism in CEE is hindered by several types of market failures that cannot be satisfactorily addressed by for-profit firms (such as agritourist farms). First, the markets for rural tourist services in this region are beset with high transaction costs related to the lack of information about the demand for these services. Small and medium sized enterprises, typically dominating the tourism sector in CEE rural areas, often do not possess enough resources and qualifications for conducting high quality market research and undertaking target group-oriented product development. Lack of relevant market demand information substantially hinders the development of the supply side of the tourist markets. Second, a major peculiarity of the tourism business is the



Source: Authors' calculation based on Eurostat Regio data

Notes: Denmark 2003. Values for Greece, Portugal, Romania and Slovenia include sampling error up to 20%. Values for Bulgaria, Cyprus, and Lithuania include sampling error above 20%.

Fig. 2 Percentage share of agricultural holdings with tourism as a gainful activity by country in the EU27, 2005

complex nature of tourist-related services. Indeed, tourists do not consume a single product such as one specific hotel accommodation, but rather a bundle of services including landscapes, cultural heritage, accommodation, gastronomy, shops, hiking trails, swimming facilities, etc. Some of these services (related to destination marketing, landscape conservation, provision of general infrastructure) exhibit significant public good attributes, thus resulting in the failure of for-profit firms to provide these in optimal amounts.

Third, and related, the complex nature of many tourist services implies the existence of substantial external effects of the activities of many rural dwellers on the attractiveness of tourist locations. Specifically, the development of rural tourism requires that rural areas have beautiful landscapes, comfortable climate, and sufficient tourist and general infrastructure. These preconditions can evidently be fulfilled only through concerted action of diverse local actors, by no means limited to the immediate for-profit suppliers of tourist services (such as agritourist farms). A negative international tourist image of many CEE rural areas testifies that this concerted action does not take place at an appropriate level [24]. The successful development of tourism is therefore predicated on cooperation between diverse stakeholders, such as agritourist farms, other local enterprises, political decision-makers, and local population [10, 12; 14; 17; 19; 21]. This cooperation is thus a crucial prerequisite for the operation of for-profit suppliers of tourist services.

The potential role of TSOs

The actual and potential roles of TSOs in the development of rural tourism in CEE follow directly from the three types of tourist markets' failure identified above. First, the information-related transaction costs of agritourist farms can be reduced by TSOs in the form of local and regional tourism associations. These associations would be engaged in jointly conducting market research in order to reduce uncertainty about the demand for tourist services of agritourist farms. Second, the complex nature of the tourist services requires the undertaking of joint marketing strategies which can again be developed by local and regional tourism associations. Joint marketing strategies are particularly important in view of the generally recognized fact that the true competitors in rural tourism are not individual agritourist farms in the same locality but rather different tourist localities [14]. In addition to joint marketing, regional tourism associations can define and enforce the quality standards and provide training opportunities for individual agritourist farms. These measures are crucial for enhancing these farms' competitiveness in the long term. Finally, the problem of substantial positive and negative external effects of local

actors' activities can be solved through TSOs comprising different stakeholders of local rural development, including local enterprises, media, local officials and politicians, and local rural dwellers. These TSOs would provide the arenas for internalizing the external effects and could take the form of local development partnerships (such as those within the framework of the EU LEADER program) and regional development associations. Their major task would be the coordination of activities aimed at ensuring the overall positive image of specific rural areas in the eyes of potential tourists.

Concluding remarks

This paper has re-examined the issue of institutional response to rural market failures from an institutional economics perspective. This perspective requires recognizing that market failures can be addressed by different institutions in different ways. In rural areas, market failures have been shown to be of such a nature that their addressing requires the operation of TSOs supplementing the for-profit firms. The reason is that the for-profit firms' operation in rural areas is due to particular severity of rural market failures in view of the characteristics of rural areas such as population scarcity, geographical dispersion, relatively poor infrastructure, and relatively low per-capita incomes. This argument reveals the institutional economics rationale behind rural TSOs and lends theoretical support to policies promoting these organizations' role in rural development, such as the Leader program in the EU.

At the same time, the paper has identified a research area that needs to be developed further in both positive and normative respects. This area represents the institutional economic theory of the rural third sector and is concerned with analyzing the role played by TSOs in rural development. In the positive respect, one needs both theoretical and empirical analyses of the effect of particular characteristics of rural areas (such as those mentioned above) on the emergence and operation of rural TSOs. In the normative respect, it is necessary to develop policy recommendations regarding the improvement of governmental regulation of rural TSOs in order to enable them to perform their market failure-addressing role more effectively.

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