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MARKETS, GOVERNANCE, AND INSTITUTIONS

IN THE PROCESS OF ECONOMIC DEVELOPMENT

EDITED BY

AJIT MISHRA AND TRIDIP RAY

Markets, Governance, and Institutions in the Process of Economic Development

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A Festschrift in Honour of Kaushik Basu

Kaushik Basu turned 65 earlier this year, on 9 January 2017. We are using this occasion to bring out this volume to celebrate his contributions over the last four decades. This book contains contributions from his present and past collaborators, and research students. He has been an inspiring intellectual and a dear friend; we are delighted to be able to honour him with this collection of essays.

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Foreword: Early Kaushik and the World Lately

Amartya Sen

1

It was in the autumn of 1972 that I first met Kaushik Basu at the London School of Economics, where he had just arrived to do a Master's degree in Economics, to be followed by a doctorate. LSE, which I had joined only a year earlier, was a new base for me too. I had moved from the Delhi School of Economics where I had wonderful students, and my predatory inclination to look for talented and motivated students had been, by then, only partly met. As I chatted with Kaushik, it rapidly became clear to me that he had a brilliant mind. It was also easy to see that he was deeply interested in economics of a kind that would both demand analytical sophistication, and could make a big difference to the world.

Kaushik came to my LSE room in the company of Siddiqur Osmani from Bangladesh (they were close friends already), and we chatted together. It did not take much time to see that in Kaushik and Siddiqur we had two of the cleverest and best-motivated economics students we could possibly find in the academic world. After their shining performances in the MSc, both Kaushik and Siddiqur went on to do imaginative and powerful work for their doctorate degrees (the two theses were published respectively by Cambridge University Press and Oxford University Press). I was privileged to supervise their research.

In this Festschrift for Kaushik, I pick up the story from the early days of his doctoral research—this would have been during the academic year 1974–75—in Kaushik's first year as a PhD student. A lot of work was going on already by then, on how to get information about a person's preferences—and priorities and inclinations—from the choices he or she makes when there are several alternatives to choose from. Kaushik investigated a fresh set of probing questions (indeed a new field of systematic enquiry—going beyond individual choices to governmental decisions): what can we read from the choices that a government makes? What can we infer from them about the government's preferences and values? What can we say about the 'revealed preference of government'?[1]

To be sure, at an implicit—and often rather casual—level, people were used to commenting on what the 'government really prefers'—basing their reading on the observation of public decisions. But as Kaushik noted, simple connections between choices and priorities are even more difficult to draw in the case of governmental choice than with individual choices, and it is notoriously difficult to decide what the government 'really wants'. Kaushik discussed many difficulties that would be present in trying to jump from governmental choices to the 'preferences' of the government. And each of these difficulties turned out to be important issues to investigate.

To consider a few of the problems, first, the government has different departments taking distinct decisions, and their priorities need not all be the same. There could be internal dissensions—even battles—within a government and the actual decisions may be a compromise—explicitly agreed or implicitly emergent.

Second, there are many different people involved in the decisions taken even by one department, and their respective inputs can, at least to some extent, conflict with each other. 'Power', as Kaushik put it in *Revealed Preference of Government*, 'is diffused in many quarters and the government is a nebulous organisation' (1980: 6).

Third, the information on the basis of which government agents make their decisions may not be very precise, and this lack of precision can make reasoned decisions imprecise as well.

Fourth, to the extent that a government can be assumed to be maximizing aggregate welfare of the people involved (as is often assumed in 'public finance' and more generally 'public economics'), there are problems of interpersonal comparison of well-being of which note has to be taken, and they may reflect inescapable ambiguities in comparing different persons' well-being.

Fifth, when information is incomplete, there can be decisions to be taken about investing in getting better—or fuller—data, which would involve an incurring of costs even as the resulting expansion of information may allow better decisions to be taken. There are real difficulties in deciding on how much to invest in informational explorations with uncertain rewards.

Sixth, going more towards the foundations of the discipline of revealed preference, Kaushik also asked whether a government can be taken to be a coherent 'agent', as the discipline tends to demand from decision takers. There

[1] Kaushik Basu, *Revealed Preference of Government* (Cambridge: Cambridge University Press, 1980).

may be serious doubts on whether a government has, as he put it, 'a unitary interest motivating its decisions' (1980: 57).

These are examples of some of the difficulties that Kaushik addressed (there were also other identified problems which he took on). What is truly remarkable is the way he pursues each of the problems, sometimes with informal reasoning, but quite often with extensive formal analyses. As it happens, many of these difficulties arise in one form or another even for individual decisional choices. As a result, in the process of examining the 'revealed preference of government', Basu ended up significantly illuminating the general exercise of relating observed choices to underlying valuations—for individuals, or groups, or entities (like a government). A large area of choice theory, and also what can be called utility theory (under a broad interpretation), in general, gets powerfully explored in this thesis ostensibly confined to 'the revealed preference of government'.

Along with this general ground clearing, Kaushik went on to study and often resolve particular—sometimes well-known—problems related to these general concerns, such as understanding the consequences of repeated 'Prisoner's Dilemma', extending the reach of utilitarian reasoning in welfare economics, the use of trade-offs in the rights people respectively have, and the way 'fuzziness' can be systematically incorporated in representing—or reflecting—imprecise information and partly unclear priorities. Basu's works on these distinct problems came out—often after his dissertation was completed (through the 1980s)—in papers published in a variety of journals, varying from quite technical ones such as *Econometrica, Journal of Economic Theory*, *Review of Economic Studies, Theory and Decision*, and *Journal of Mathematical Economics*, to more general ones, such as *Economica, Quarterly Journal of Economics, Oxford Economic Papers*, and even *Explorations in Economic History*.

If Kaushik can be seen as spending most of his time in later years in being an applied economist, writing on such subjects as 'India's emerging economy', or working out the demands of being 'an economist in the real world', and serving as an economic advisor or decision taker (including being the Chief Economist of India, and later, of the World Bank), this followed an earlier part of his life as an innovative theorist, even what can be called (following Francis Edgeworth, the economist, or Hans Kelsen, the legal theorist) a 'pure theorist'. What is, however, particularly striking is that even in his pure theory work, Kaushik was typically being guided by his interest in practical problems in the world—research that would be important for his applied work many decades later. It is this combination of analytical force with practical motivation that I had found striking when I first came to know Kaushik at the London School of Economics, and it has been serving him very well through his illustrious professional life.

2

Well, that was a quick glimpse of early Kaushik. What about the world lately—a world in which Kaushik is a big player? Aside from the new and original work that Kaushik has continued to do throughout his very successful life as a teacher, researcher, advisor, and decision maker, with great relevance to the problems of the contemporary world, his early research too has remained closely relevant to problems today. I have already commented on why and how Kaushik's early works are of great use for addressing practical problems today, particularly in dealing with decisions taken by government—and other entities, including international institutions (like the World Bank). They are also relevant in understanding the demands of social choice and the pursuit of social welfare, involving complexities of the relation between choices and priorities.

I turn now to a less explored connection—and a less examined problem: that of interpreting a consensus which is a central issue for political economy and social choice. In a justly celebrated paper, Cass Sunstein, a leading philosopher and legal theorist, has argued that political consensus may often be reached on the basis of 'incompletely theorized agreements'.[2] There may be something somewhat deceptive in the agreement. Indeed, the consensus arrived at may actually break down if a theorized agreement is sought, since the absence of a shared theory may help people to arrive at the same conclusion. The presence of fragility in the agreement may well be effectively obscured by not insisting on a theorized agreement.

This is a very significant recognition, and its implications for political ethics can be quite extensive, as Sunstein has brought out with clarity and force. The questions I want to ask here are:

(1) what is the relevance of Kaushik's early analysis of 'revealed preference' to this issue?

(2) what implications does that analysis have for the political economy of the contemporary world?

Note, first, that while the form of Kaushik's investigation began with observed choices and involved the exercise of extricating preferences and priorities from these observations, the analytical transition can be viewed in exactly the opposite direction as well. We can begin with priorities and objectives and ask what choices should follow from them. But—it can be asked—wouldn't the reverse trajectory be plain sailing? Shouldn't the choice decisions be immediate and obvious: pick the best alternative on the menu?

[2] Cass R. Sunstein, 'Incompletely Theorized Agreements', *Harvard Law Review* 108 (1995).

In fact, the reverse move might not be quite so easy if there is no best alternative on the menu, which can easily happen if the preference ranking is incomplete. The issues of incompleteness and its underlying causation are important, along with the consequent distinction between maximality and optimality. I have, however, discussed the complications raised by incompleteness in a series of publications from 1970 onwards, and so has Kaushik Basu.[3] So let us overlook that problem in this paper. Is there any other problem?

The big problem that exists even when the issue of incompleteness of preference rankings is dropped is one that Kaushik aired in the context of going from choices to preferences, but it has relevance in the opposite direction as well. The issue is that several different sets of priorities and preferences may have the same best choice, but for quite different reasons. Kaushik linked this with the main motivation for his thesis on the very first page of his monograph:

> Clearly, the precise preference of the government cannot, in general, be deduced by observing a *single* choice, because there will usually be a whole set of preference patterns that could make the chosen project optimal. But it has been alleged that if we observe many choices, we can narrow down the possible preference patterns and may even be able to reveal the exact one. This issue forms the central theme of our discussions.[4]

Basu does indeed pursue the task of trying to get precise preference patterns from observing multiple choices, and shows varying feasibility related to the actual circumstances.

But how does all this relate to the Sunstein problem of 'incompletely theorized agreements'? The first connection is immediate. If a group of people have 'a whole set of preference patterns' that make a particular alternative optimal, then they have every reason to agree on what to ask for, even without *agreeing on the reasons* for that choice. The interpretation can, then, take the form not so much of an *incompletely* theorized agreement, but a *differently* theorized agreement (combining possibly well theorized disagreements on reasons, along with well theorized agreement on what to choose). And unlike in the case of incompletely theorized agreements of the kind to which Sunstein has drawn attention, there may be no lacuna of theorization in Basu's case.

In the world in which we live, differently theorized agreements can be both frequent and perfectly fine. Consider the recent elections in France for the choice of a president. In the second round—that of the 'run-off' between Marine Le Pen and Emmanuel Macron—a vast majority buried their political differences and voted for Macron to keep Le Pen out of the presidency. Their

[3] See in particular Amartya Sen, *Collective Choice and Social Welfare* (San Francisco: Holden-Day, 1970; Amsterdam: North-Holland, 1979; extended edition, London: Penguin, and Cambridge, MA: Harvard University Press, 2017); and Basu, *Revealed Preference of Government* (1980), chaps 1 and 6.

[4] Basu, *Revealed Preference of Government* (1980), p. 1.

reasons for wanting to keep Le Pen out might well have differed greatly, but the legitimacy of their agreed choice is not diminished as a result. In fact, to look for a theorized agreement on voting Le Pen out may well be both otiose and frustrating.

It is, of course, also true, as Eric Maskin and I have argued in pleading for a pairwise majority contest,[5] if we had a proper majority rule in France, each of a number of candidates (Macron, Melenchon, Fillon) would almost certainly have defeated Le Pen in a head-to-head contest. And there could also have been pairwise contests among the ones other than Le Pen, which would have brought out the differences between a very left-wing Melenchon, a moderate Macron, and a firmly right-wing Fillon. But given the French system, Macron being chosen over Le Pen in the run-off, while reflecting a differently reasoned agreement, cannot be taken to be incompletely theorized, or seen as revealing any lack of the backing of reason. I expect Macron would have been the winner as well in pairwise majority contests, even though the French system does not resolve that issue. But what it does resolve need not await completion through further theorizing.

Something similar can be said about presidential elections in the United States. Donald Trump did not get a majority in the first seventeen of the Republican primaries, and very plausibly could have lost to one or more of the other candidates had there been pairwise majority votes (easily ascertainable by all the candidates being ranked). Had there been a French-type system of a 'run-off', it is quite plausible to expect that one of the other candidates would have defeated Trump in a head-to-head contest, because of the desire of many of the voters to keep Trump out—for possibly very different reasons.

A similar problem arises in India, where the Hindutva-oriented Bharatiya Janata Party (the BJP) led by Mr Modi got 31 per cent of the votes in the general elections of 2014, but a majority of the seats in the Lok Sabha of the Indian Parliament. They were all multi-cornered fights, and even though a large majority were against the Modi-led BJP, it could still prevail. Had there been a coalition of the other parties, it is plausible to expect that the BJP would have been defeated, as happened in the following year in Bihar, even though the non-BJP voters, coming from different parties, would have differently theorized their votes. That possibility was present even in the Uttar Pradesh (UP) elections, in which BJP had a sweeping victory on the basis of a minority of votes in a field lacking in critically important coalitions. This issue will be engaged in, again in the general elections to come in 2019, where coalition building would be central to the electoral outcome. The many-one connection

[5] Eric Maskin and Amartya Sen, 'A Better Way to Choose Presidents', *New York Review of Books* 64(10) (8 June 2017).

between preferences and choice, extensively studied by Kaushik in his first book, is an important point for reflection in Indian politics today.

In the world lately, whether in India, or in Europe, or America, the presence of many-one relations between preferences and choice remains a central diagnosis. It has practical importance, but also analytical significance in helping us to distinguish between *differently theorized* agreements and *incompletely theorized* agreements. It is interesting that Kaushik Basu's research on preference and choice remains so relevant more than forty years after that work was undertaken.

1

Introduction

Ajit Mishra and Tridip Ray

When we started planning for this book to honour Kaushik Basu in his sixty-fifth year, we were unsure on several fronts. First, it wasn't clear whether we would focus on development or on game theory or on normative economics. Basu's range of contributions made it difficult for us. Second, Basu is a much loved and admired scholar and the set of potential contributors to a volume in his honour would simply be too big for us (two editors with little experience). The solution to the second problem was simple: we chose to make our task easier by inviting his collaborators, past and present, and his research students to contribute. The response has been amazing. For the first problem, we have left the canvas quite broad; a true reflection of Basu's work.

Beginning with his early work on interlinked markets and usurious interest rates, to the recent work on child labour and shared prosperity, Basu's research over the last four decades has contributed immensely to the way the field of development economics has been transformed. In fact, his book *The Less Developed Economy: A Critique of Contemporary Theory* (Basu, 1984) changed the way development economics began to be taught in many universities. He has been one of the leading scholars responsible for reshaping development economics as a rigorous and theoretically well-founded discipline. The collection of papers in his *Development, Markets, and Institutions* (Volume 3, Collected Papers in Theoretical Economics, 2005) is a reflection of this. The current book takes inspiration from this and looks at the complex interactions between markets, governance, and institutions in the process of economic development.

Basu's range of contributions is evident in the four-volume set of collected papers (Basu, 2005) published by Oxford University Press. At one level, he has been involved in deep philosophical issues in welfare analysis and decision making, and theoretical analysis of human behaviour in different settings and contexts. By his own admission, he has always been fascinated by the abstract, logical foundations of economics.[1] The sheer beauty of deductive reasoning lured him to abandon his plans for a legal career in favour of a career in economics research. Our discipline, with its unique blend of positive science and normative philosophy, has certainly benefited from the legal profession's loss. Several contributions in this book share his love for scientific pursuits.

However, at the same time, he has been deeply concerned, both as a researcher and as a policy advisor, with several policy issues such as rent control, child labour, labour laws, harassment, shared prosperity, and gender empowerment. His compassion for fellow human beings and his desire to contribute to society has been evident in his working life. He mentions how he was in a quandary when he was invited to be Chief Economic Advisor to the Indian Government, as it was going to take him away from his research life; but he felt the need to give back to society.[2] He has always contributed to society through his research, teaching and institution building;[3] but this was his modest way of accepting the role of a responsible public servant, which after a few years he continued in the World Bank. The contributions from authors in this volume, theoretical as well as empirical, reflect this range of interests in some of the pressing and practical issues of development.[4]

The book has three parts. In Part I, contributors look at various foundational and measurement issues associated with economic development. Part II deals with the functioning (and non-functioning) of markets in the context of development. In the final part, Part III, contributors look at various issues related to governance and institutions.

Joseph Stiglitz (Chapter 2) provides an overarching framework which explains the evolution of our thinking on markets, states, and institutions—from a single-minded focus on markets to a broader inclusion of institutions. Markets do not operate in a vacuum; they need well specified rules of the game, strong institutions including the state, and societal goods like trust. These institutions interact among themselves to create the right checks and balances. As we have seen, market economies, left untampered, lead to

[1] He used to take groups of students from his development class in the Delhi School of Economics for 'field surveys' in Hazaribagh district and both of us were fortunate to be part of such a trip. It was a unique opportunity for students to learn about the real issues in development. After a whole day's work in the neighbouring village, we would return to the base camp and, as if he had had enough of the real world, in the evening Basu would initiate discussions and debate on some really deeper philosophical issues in economics!

[2] This was eloquently communicated by him during his acceptance speech at the University of Bath, which honoured him with the degree of Doctor of Laws, 2016.

[3] The Centre for Development Economics at the Delhi School of Economics was his brainchild and he was the first Executive Director. One of the editors has a personal account of the huge amount of effort that went into the establishment of this centre.

[4] We have been mindful of his strong interests in abstract analysis and geometry; as a result, this volume has more figures than tables!

forces which may threaten their own survival. Too often they lead to greater inequality and injustice, erosion of trust, and weakening of the state. The institutional checks and balances, so vital for the functioning of institutions and markets, may not work when there is excessive inequality.

Prasanta Pattanaik and Yongsheng Xu (Chapter 3) discuss the conceptual foundations of the notion of freedom. Individual freedoms have received much attention in recent times both in welfare economics and in the context of development, following Sen's capabilities and functioning approach (Sen, 1985). Developmental success has to be viewed not just in terms of what individuals achieve but also of what they are capable of achieving. However, as Pattanaik and Xu demonstrate, there are conceptual problems in arriving at a precise formulation of freedom. In fact, this is related to Basu's earlier contribution (Basu, 1987) where he raises similar concerns and points out the difficulties that lie in measuring freedom.

A related issue in the developmental context is the measurement of well-being. It is argued that well-being cannot be captured by income alone and we have to consider non-income attributes like health, education, mental well-being, and several others dealing with quality of life. This has obviously influenced the way we conceptualize and measure poverty—a shortfall from some stipulated level of well-being. While it is widely accepted that individuals' shortfalls in these dimensions should be considered, it is not clear whether and how such information should be aggregated. A rich literature on multidimensional poverty measurement has sprung up recently following several key contributions.[5] An individual is identified as poor or deprived if he/she falls short of these poverty-line-like cut-offs along various dimensions.[6] A key assumption is that these shortfalls are non-comparable; a shortfall in one dimension cannot be compensated by a gain in another. The chapter by Bhaskar Dutta (Chapter 4) reviews some of these axiomatic treatments and questions some of these assumptions. As he points out, there are other ways one can identify poor individuals even within the multidimensional framework.

A similar measurement issue arises when we try to evaluate the well-being of society as a whole. A standard measure like per capita income or gross domestic product (GDP) may not be adequate as it does not capture distributional aspects of society which may be welfare relevant. Kaushik Basu (2001, 2006) suggested the use of the 'quintile income statistic', which is simply the mean income of the bottom 20 per cent, as an indicator of the well-being of society. The chapter by S. Subramanian (Chapter 5) offers different

[5] See, for example, Atkinson (2003), Bourguignon and Chakravarty (2003), Alkire and Foster (2011).

[6] The actual number of dimensions depends on the precise formulation. In the union approach, an individual is identified as poor if he/she is deprived in any dimension. In the intersection approach, he/she is identified as poor only if he/she is deprived in all dimensions.

interpretations of this concept and explores its implications for the measurement of poverty and inequality. This concept lies at the heart of the more recent notion of 'shared prosperity' promoted by Basu as one of the main goals of the World Bank during his stint as its chief economist.[7]

The next chapter by Tapan Mitra (Chapter 6) deals with the deeper foundations of the notion of 'sustainable development'. As he argues, sustainable development is not only recognizing the interdependence of resource use across generations, it is also about intertemporal social preferences which represent those of present and future generations. He shows how there is a fundamental difficulty in implementing such social preferences satisfying some notion of equity across present and future generations. This is related to his earlier work with Basu (Basu and Mitra, 2003). Despite its abstract nature, it has strong links with many real world problems dealing in intergenerational equity.

The final contribution in this part is an empirical chapter by Ranjan Ray (Chapter 7) evaluating the role of relative price changes in welfare comparisons, more specifically on poverty and inequality.[8] An interesting problem in welfare comparisons is the computation of a deflator to compute real incomes when people have different preferences leading to different consumption patterns. Using an average consumption basket (as is the practice) may not be ideal; Ray approaches this problem by assuming preference patterns to be homogenous within income quintiles within a region. He computes the intertemporal and spatial true cost of living index by estimating preference parameters for these region specific income quintiles through demand system estimation.

Part II, Markets and Development, has seven contributions addressing various allocation and distributional issues in the context of different markets. Some of the essays analyse the market outcomes in general settings, while others focus on more specific markets. Several of these chapters seek to identify the role of policies or non-market mechanisms in different contexts. So in some sense, these essays go beyond the standard market mechanisms (to borrow and compare with Basu's *Beyond Invisible Hand* [2011a]).

Jörgen Weibull and Jun Chen (Chapter 8) look at private and public monopoly in a situation where the monopolist has to spend resources on finding out what product varieties individuals want.[9] They analyse the monopolist's endogenous information acquisition and choice of product variety in different

[7] It refers to the maximization of the mean income of the bottom 40 per cent of the population as an important goal of the society. See Basu (2013).

[8] That this is related to Chapter 5 is no coincidence; both strands draw inspiration from Sen (1976).

[9] In an earlier contribution, Basu (1988) explains why a monopolist would produce a less durable good even when it can improve durability at no cost.

scenarios: a private monopoly maximizing profit and a public monopolist who maximizes a convex combination of profit and welfare under a budget constraint. They find that, broadly speaking, public monopoly is preferable in societies with a wide spread in income while private monopoly is better in societies with less inequity. This has clear implications for developing countries with greater inequalities.

In Chapter 9, Hodaka Morita looks at an important issue in the labour market: variations in employment practices in terms of labour mobility, wage structure, and in-house training. Morita proposes an explanation based on 'managerial capability', using the interconnection between firm dynamics, labour mobility, and specific human capital to explain the different employment practices in the US and Japan. While most of the existing literature relies on information asymmetry regarding workers' abilities, Morita's model uses the strategic complementarity arising from the connection between continuous process improvement and firm-specificity of human capital. Complementarities and subsequent multiple equilibria have a central role in many of Basu's theoretical contributions.

Complementarity is also the key theme in the next chapter by Patrick Emerson (Chapter 10). He looks at the effect of complementarity that exists between goods and services in the quality space. He suggests that consumers tend to desire goods of the same quality and thus the price producers can charge for their good depends not only on its own quality, but also on the quality of other goods that will be used with it. This can lead to 'quality traps' where any one individual producer might not find it in its own interest to unilaterally increase quality; however, if all producers of the other complementary products increased quality at the same time it would be in all of their interests to do so. Lower levels of development can be associated with a low-quality equilibrium trap.[10]

Namrata Gulati and Tridip Ray, in Chapter 11, explore how neighbourhood effects interacting with income inequality affect poor people's ability to access basic facilities like health-care services, schooling, and so on. They model the interaction by integrating consumers' income distribution with the spatial distribution of their location[11] and investigate the consequences of an increase in income inequality on the welfare of the poor in general, and their access to markets in particular. They find inverted U-shape relationships between income inequality and market access, and welfare of the poor owing to an

[10] This takes inspiration from earlier work by Kremer (1993) and several others. This has been used to explain underdevelopment in different dimensions; see Basu (1997).

[11] Kaushik Basu is quite fond of the spatial model of competition (see, for example, Basu, 1993: Chap. 8; Basu and Mitra, 2016).

interesting trade-off between the positive provision effect and the negative price effect of the proportion of rich living in the neighbourhood.

In a different but related context, John Ifcher, Homa Zarghamee, and Amanda Cabacungan (Chapter 12) study how subjective well-being of different age groups is affected by adverse economic shocks. They examine the subjective well-being effects of the 2007–09 recession on individuals aged 55 to 64 and find that individuals of pre-retirement age became significantly less satisfied with their lives compared to other age groups.[12] This again calls for identification and differential treatment of various groups with differing vulnerabilities.

Development discourses are incomplete without careful consideration of the states of children and women in these societies. In this context, both the marriage market and the market for child labour have attracted attention. A. V. Chari, Annemie Maertens, and Sinduja Srinivasan (Chapter 13) analyse the impact of changing income distribution on the marriage market. Using Indian data, they find that rising inequality at the top end leads to a delay in female marriage. Interestingly, this does not hold for rising inequality at the lower end of the distribution. The delay in female marriage has significant implications for poor countries, where early marriages and subsequent problems of health risks to both mother and child are serious issues.

Basu's work (Basu and Van, 1998 and Basu 1999) has spawned a massive literature on child labour and policies aimed at elimination of this practice. Garance Genicot, Anna Maria Mayda, and Mariapia Mendola (Chapter 14) analyse the impact of internal migration on child labour outcomes. As the authors point out, the impact of immigration on resident adults' wages and employment has been studied at length, but how immigration affects child labour has not received proper attention. Child labour is more likely to be affected by immigration because of its low-skilled nature and higher elasticity of supply compared to adult labour. They find, using data from Brazil, that unskilled immigration has a significantly negative impact on child labour, but skilled immigration has the opposite effect.

Part III has six chapters on governance and institutions. It is an area where Basu has written extensively in recent times. Governance has been a central concern in recent years, more so in the context of development. Avinash Dixit (Chapter 15) looks at relation-based governance and its potential implications. As he notes, relational governance works well when compliant behaviour (primary action as well as prescribed sanction against deviations) is well understood and more importantly, information regarding deviations from prescribed actions are quickly and accurately disseminated. For this reason,

[12] The authors draw attention to the significant boost in life satisfaction associated with those who enter the 65+ cohort—a club which Kaushik Basu joined this year!

relational governance works well in relatively small communities. Using a theoretical model, based on a spatial model of monopolistic competition, he explores the implications of relational governance. The requirement that firms should be close to each other for the effective spread of information limits their size and allows inefficient entry of too many firms, similar to the observation of too many firms in the informal sector of developing economies.

Clive Bell (Chapter 16) looks at agrarian contracts involving land, labour, and credit from a historical perspective. Using primary household data from two villages in Bihar, India, in the year 1970, Bell examines the prevailing contractual relations in the absence of well-defined and functioning markets. These data, collected by the author himself, have never been the primary basis of any previously published work. It is interesting to note that many of these practices (as discussed by Bell in these villages), attracted the attention of development theorists in later years.[13]

Moving away from information or agrarian institutions, the next chapter by Nirvikar Singh (Chapter 17) analyses the role of institutions of federalism in India in managing heterogeneity and preserving national unity over the last five decades. His contribution reviews the conceptual and analytical underpinnings of the role of federal structures in sustaining unity, and summarizes historical developments and current institutional structures of the Indian case. Using a broad canvas, Singh portrays the political, legal, bureaucratic, and fiscal aspects of federalism in the Indian context. In a country as diverse as India, the role of these 'holding together' institutions can hardly be overestimated.

The issue of 'diversity' is taken up in the next chapter by Ashwini Deshpande (Chapter 18) which argues the normative case for greater diversity in the workforce of private corporations in the specific context of caste disparities in India. Deshpande discusses in her essay how ensuring greater diversity, in addition to enabling social inclusion, would make good business sense. However, she finds that discrimination based on social identity manifests itself in different ways in different segments of the market depending on the size of the firm. For large firms, she finds evidence to support a positive association between profits and more diverse workforce teams. The same pattern is absent for small and micro-enterprises; such enterprises owned and populated by members of marginalized groups might face discrimination on account of their identity, adversely affecting their performance.

We need institutions to promote diversity and unity, as has been argued in previous chapters. At the same time, there is a need for institutional structure protecting and promoting individual rights. In a related chapter, Eduardo Zambrano (Chapter 19) proposes a framework for evaluating policy options

[13] Basu himself has contributed immensely to this literature on contractual practices; see his book *Agrarian Structure and Economic Development* (1990).

when these adopted policies are going to create winners and losers. He is concerned about the ranking of social states where priority (in the social evaluation) is given to the situation of those individuals who are being treated the most unfairly by policies, relative to what they have a right to. He goes on to examine how this is implemented in the more specific context of tax reforms. Combining liberal and libertarian principles of fairness, together with Pareto efficiency, he analyses the distributive impacts of taxation in the economy.

In the final governance related essay, Ajit Mishra (Chapter 20) looks at the possible trade-offs that anti-corruption policy faces. As is well known, corruption has several faces, ranging from petty corruption where ordinary citizens have to pay bribes to get goods and services, to high level political corruption.[14] It has been argued that attempts to control one form may promote another form of corruption. In such a context, petty corruption tends to be ignored. He argues that, despite its lower value and gift-like manifestation, petty corruption should not be ignored as it creates a 'culture' of corruption and raises the tolerance levels.

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[14] Failure to recognize this has created misconceptions and unnecessary debates surrounding anti-corruption reforms, as was evident from the popular debate which followed Basu's suggestion that for certain kinds of bribes, bribe-paying may be legalized (Basu, 2011b).

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Part I

Development: Foundations and Measurement

2

Markets, States, and Institutions

Joseph E. Stiglitz

It is a real pleasure for me to participate in this festschrift in honour of my good friend Kaushik Basu, to recognize his intellectual contributions, his contributions as a public intellectual, and his contributions as both a national and global public servant.

The subject of my chapter is one to which Kaushik has made profound contributions: markets, states, and institutions. In particular, I want to highlight how our thinking about this subject has changed over the past third of a century; and to provide an overarching framework into which these changes can be placed—a framework that both helps explain why the approaches taken in the past have been less successful than was hoped in promoting development, and provides some guidance for policy reforms and research going forward.

Earlier work both at the World Bank and within the development community more generally focused on necessary reforms to policy frameworks. These 'reforms'—the now infamous Washington Consensus policies—mostly consisted of giving a larger role to markets in the allocation of resources.

When these reforms were less successful than hoped, there was a switch to a focus on institutions, including those of the public sector. It was recognized that the policy reforms had to be instituted by governments, and that governments often failed to do what was required. Thus, even if the overall agenda was to place a greater emphasis on markets, to accomplish that end one needed reforms in at least one key institution—the government—to bring that about.

There was a second rationale for a focus on institutions—there were pervasive market failures, and a hope that non-market institutions, on their own, would 'step in' to fill the gap. This belief was not based on any deep theory, but rather on the notion that with a market failure (say the absence of an insurance market) there was an opportunity for a Pareto-improving non-market action. A strong Hayekian belief in decentralized evolution suggested that such evolution would lead society to higher and higher levels of well-being—especially to Pareto improvements. These beliefs were reflected, for instance, in the idea that non-market life insurance, say provided by the family or burial societies, would be adequate to address market deficiencies. No government intervention would be needed. This particular line of research, sometimes associated with Douglas North's early work, was laid to rest when Arnott and Stiglitz (1991) showed that the Nash equilibrium with non-market institutions could be *worse* than without these institutions. There is an incentive for such institutions to be created, but they may actually displace the admittedly imperfect markets, in such a way as to lower welfare.[1]

Both markets and states are, of course, institutions—institutions through which we allocate resources. It used to be argued that, in thinking about the best way of organizing societal systems of resource allocation, one assessed in which sectors the market should dominate, and in which sectors the state. The perspective was that fully private goods should be produced by the private sector; those associated with the delivery of public goods should be produced by the state.

Today we see the interaction in a more complicated way: in many cases, the two interact, in a complementary way, within the same sectors. For instance, there is the possibility of the separation of finance from production; government could provide finance for a typically publicly provided service, like education, but the production would be done through private enterprises. In the provision of infrastructure, there has been great interest in public–private partnerships (PPPs). In the financial (and other sectors) which might have seemed to fall naturally within the private sector, there is an important role for government regulation. And in some areas, government has had to do more: underwriting mortgages, providing finance for small businesses, and—especially in many developing countries—providing long-term finance.

While in recent years there has been a great deal of hyperbole over PPPs, in practice, there has been disappointment. PPPs often entail the government taking the risk, while the private sector takes the profits. So too, the conditions under which government can delegate to a private body the fulfilment of public objectives have been shown to be extraordinarily restrictive (Sappington and Stiglitz, 1987).

[1] See also Stiglitz (2000) and World Bank (2001). This result only holds if non-market insurers have no better information than market insurers. Given the restrictive conditions under which Nash equilibria within market economies achieve Pareto efficiency, there was little grounds for the presumption that this broad Nash equilibrium, involving market and non-market institutions, would be efficient. For a broader critique of these naive evolutionary ideas, see Stiglitz (1994).

The standard argument for introducing a role for government began with the theory of market failures—the work of Arrow and Debreu identified a large variety of circumstances in which private markets do not lead to (Pareto) efficient outcomes. Subsequent work by Greenwald and Stiglitz (1986) showed that whenever information was incomplete (asymmetric) or markets incomplete—that is, always—markets were not efficient. The presumption that markets were efficient, which had reigned since Adam Smith, was reversed: the presumption now was that markets were inefficient. There was always a potential role for government.

But while there was a *potential* role for government, it was not always obvious that government could fulfil this role. Attention shifted to government failure. While the theory of government failure is not as well-developed as that of market failure, it is clear not only that governments often fail, but also that such failures are not inevitable: even imperfect governments can result in an improvement in resource allocation. They can help markets work better. Indeed, it is hard to find any country that has had successful development in the absence of strong government interventions.

But as our understanding of government failures has increased in recent years, so too has our grasp of the depth of market failures—highlighted by the financial crisis of 2008.

More importantly, we have come to appreciate *markets as institutions that must be structured.* Markets do not exist in a vacuum. They are structured by public policy, by the rules of the game that are set by the government, for instance through laws that relate to corporate governance, competition policy, and labour market regulation.

These then are the central messages of this chapter:

(a) In any society, resource allocations occur within institutions, so that the rules governing the institution are critical, particularly the rules determining how decisions are made within it. Institutions consist of multiple individuals, with differences in preferences and beliefs. A critical issue is how these are 'aggregated', so that the institution reflects in some adequate way those within the institution. This was the central question posed by Arrow in *Social Choice and Individual Values* (1951). His results were deeply disturbing, for he showed that there was no way of aggregating the multiple preference orderings of the different individuals comprising an institution that had certain desirable properties (like transitivity), in the absence of some restrictions on preferences and/or the choice set—other than dictatorship, where the actions chosen were those that reflected the preferences and beliefs of a single member. This negative result poses one of the great challenges for governance.

(b) Societal resource allocations are the result of the interaction among these institutions. In recent years, economists have given a great deal of attention to 'mechanism design'; that is, to the design of allocation mechanisms with certain desirable (usually efficiency) properties. But the set of institutions in place in any economy is not the result of rational deliberation over alternative mechanisms (even if our politicians understood what that entailed). Rather, they have evolved, with adjustment of one set of institutions or another in response to changes in the world and changes in ideas, including learning from past successes and failures. As a result, there is no presumption that, in any country, the existing set of institutions or the rules governing their interactions are optimal in any sense, that they produce either efficient or equitable outcomes. A key concept in institutional design has been 'checks and balances': a recognition that within an institutional arrangement (say government), there is the danger of the aggrandizement of power in the hands of a subset of individuals, or even a single individual, resulting in decisions that reflect that individual's or those individuals' perceptions or interests. At the societal level, the same issues arise: we should see different institutions as providing checks and balances on each other.

(c) The functioning of markets (both the decisions made by individual institutions and the outcomes of the interactions among the institutions) depends on the rules of the game specified by the political process, which in turn depends on the rules of the political game and underlying characteristics of society, most importantly, the magnitude of economic inequality and the degree of solidarity and political cohesion. But the functioning of markets also depends on *trust*. No economy can rely on the enforcement of contracts through the legal system. Trust, especially as it relates to the functioning of market institutions, depends in part on perceptions of the legitimacy of the economic and political system, which in turn depends on perceptions of fairness and equity. In short, the functioning of the market depends on non-market institutions and beliefs and perceptions that reach beyond the market. By focusing too narrowly on markets, by creating markets that are seemingly disjointed from the rest of society, by taking excessively tolerant views of market abuses (of the kind that became rampant in financial markets before and during the 2008 crisis), market advocates may have actually undermined the success of markets.[2]

[2] That is, when markets are viewed as non-competitive, when they abuse the consumers that they are supposed to serve, when they are able to extract excessive rents, markets lose their legitimacy as mechanisms for allocating resources, and there will be less voluntary compliance

(d) If a system of checks and balances among institutions within society is to work—to ensure that societal resource allocations do not come to reflect the interests and beliefs of a certain subset of individuals—then there cannot exist excessive economic inequality. For if there is excessive economic inequality, there is at least a risk that this economic inequality will get reflected in political inequality—in inequality in key public institutions. The voice of the wealthy will predominate both public choices (public allocations of resources) and in the setting of the rules of the game. In short, the emphasis of the World Bank and development economists more generally on the governance of public institutions is correct, but good governance is, in part at least, an endogenous variable. Lectures about good governance won't succeed if the conditions for good governance aren't there. Policy discourse should focus not just on what is entailed by good governance (e.g. transparency and accountability) but also on the conditions necessary to create and sustain good governance, e.g. reforms in economic policies that lead to greater equality both in market incomes and in income and wealth after taxes and transfers.

(e) Everyone benefits from the good performance of the public sector—including having the rules of the economic game written in ways that support efficient and equitable outcomes. But since the public good is a public good, there will be an under-supply of efforts at maintaining good public governance, making it particularly easy for interest groups to capture the state. The rules of the game for the public sector have to recognize this and guard against it. We will discuss in Section 3 what this entails.

1 New Understandings of Markets

Since the development of the Walrasian economic model,[3] a particular view of the market economy has prevailed. It entails simplistic firms that maximize profits (or stock market value in a dynamic context), and households consisting of unitary actors, with households and firms interacting in competitive markets through a price mechanism. Economists celebrated the informational efficiency of prices, the ability of prices to provide requisite information from households to firms and vice versa: firms don't have to have knowledge

with the terms of (implicit or explicit) contracts. In *Freefall* (Stiglitz, 2010) I detail the host of abusive practices engaged in by the financial sector in the years surrounding the financial crisis.

[3] There were many key contributions over the more than a century during which that model evolved, including formalizations by Arrow, Debreu, and Samuelson.