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## Role of Institutions in Economic Development

**Abstract:** The role of institutions in decision making may be considered from two points of views. The normative approach explains what the institutions should do, while the positive approach investigates what the institutions actually do. When these two approaches fell apart, the process of decision-making diverges from its optimum path. Given this, it is essential to understand both positive and normative approaches to the role of institutions in the process of decision-making.

From theoretical point of view, the discussion regarding the role of institutions in the process of decision making is, in fact, a discussion about the rights of individuals and the legitimacy of their preferences in the community. Along this line of approach, measuring the role of economic approaches in fulfilling individual preferences in the society becomes very important. This means that there is an association between the rights of individuals and the ideology of the community.

From classical point of view, any assessment of preferences should be carried out within the framework of utility maximization. Given the utility of all items, one may rank each case. Hayek, Rawls and Sen each explain this point clearly in their writings. They all agree that ultimately liberty and freedom is a clear choice of all individuals in the process of development. However the utilitarian views underestimate the importance of this prefer-

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National Interest • 1:1 pp 113-119

National Interest ■ Winter 2005

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ence. Hence one might come across cases where the adoption of utilitarianism would lead to underestimation of liberty.

**Freedom as a central point of economic development**  
**Amartya Sen considers economic development as a process where the people feel they are free in various aspects and including the following cases:**

- **The freedom to avoid poverty;**
- **The freedom to escape shorter life and to choose longer life and better living standards;**
- **The freedom to access all types of education**

**The choices based on the above criteria should lead to empowerment of human beings. This means that all economic policies should aim at enhancing the above choices and reducing exclusion and deprivation to minimum possible level.**

**The basic freedom that becomes available to individuals during development includes the availability of political rights, access to economic facilities, attaining equal social opportunities, obtaining transparency in behavior and enjoying a global and wide spread social protection and safety net. All development processes should help the individuals to attain a quality of life as close as possible to the above standards.**

**Keywords:** *Institutions, Economic Development, Decision making, Freedom.*

## **State, Government and the Standards of Living**

No matter what the nature of the State and the Government, the fact is that the ties between the Government and the Government is a social contract whereby all those who sign it, agree to lose some of their individual right hoping to gain more in other directions. Any evaluation of net gains of the individuals would mean an evaluation of the desirability of social contract.

According to Rousseau the only when the individuals can obtain benefit from the existence of a society that they would not be able to obtain as individuals, they move along to establish such civil society. This means that the society should be a means of attaining excellence that would not be reached as individuals. Along the same line of argument, a free society would be formed on a legal framework and a collective body would come into being.

In short, the mere fact that a government is established should mean that the individuals living under such government may enjoy a level of welfare and well-being that they could not otherwise attain. All institutions established by the collective

body of government should be protected by it and should be targeted towards enhancement of the welfare of the individuals.

When this meaning of government is accepted, all shortcomings and misunderstandings that are mostly observed would be removed. As an example, considering privatization and the discussions regarding the optimum approach to privatization, the defenders of such action claim that the presence of the government in economic activity would reduce market efficiency. Hence in order to attain the desired market efficiency, it is essential to remove the government from the market. On the contrary, the defenders of the role of the government claim that privatization is wrong as it leads to denial of justice. Given that for the sustainability of the society, some sort of rule of justice should prevail, it is essential not to allow the market mechanism to act freely.

If, however, the new approach explained above, is adopted, market mechanism would be considered as one of the essential tools used by the society to help individuals act in the direction of general interest. At this stage, the structural inconsistency between the market and the government that existed in the orthodox approach disappears entirely. A closer look at the problems related either to the market mechanism or to the government actions shows that neither of these is inherently dependent either to the market mechanism or to public systems.

On the government side, the problems arise out of ignoring the nature of the government. Study of the behavior of the governments shows that in general, the governments are able to act on the basis of one of the following approaches:

- Two private-sector approaches: one based on the business pattern and the other on non-profit making pattern.
- One mixed public-private approach where the government acts as a corporation with all commercial measures being used for assessment of the condition of the business.
- One inter-generation approach which is used only by the governments, where the government acts the same way as the individual who wishes to leave something as bequest for his children.

There are three reasons for distinguishing public sector pattern of behavior from the private sector. These are as follows:

- The absolute essentiality of demonstration of public behavior and decisions in the most transparent way,
- The tendency of the governments to provide their financial needs in the mid-term, and
- The presence of the government as the representative of the state.

In short, given that the existence of the government should be an element of raising the quality of living, all those institutions and organizations established by the

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government should also be targeted to help the individuals enhance their quality of living. Hence market mechanism should be considered as one of such institutions that would help the individuals reach a better position in life. It is very natural to consider any relationship between the government and the society in the same light.

Given the above structure, the government would undertake three different functions:

- As a representative of all generations: Here the government should be forward-looking.
- As a governing body running the business for the welfare of the living generation: Here the government is a symbol of civil society.
- As an entrepreneur acting to run its enterprise: Here the government should be treated as an individual like any other private sector enterprise. The domain of government activity in this role is very restricted.

Studies indicate that where the governments have attempted to mix their entrepreneurial function with other functions, the result has been a mal-functioning of the market mechanism. Perhaps due to observing this inconsistency, most often the final decision is that one of the parties should be removed.

On the other hand, where the markets have not functioned appropriately and have taken side, instead of correcting their misconducts and rationalizing the mechanism, the market mechanism has been blamed and the governments have been asked to interfere to stop the market mechanism. Clearly in such cases the problem has been lack of transparency, limited information and so on.

In sustainable development, the government is a collective body who uses all its power to prevent the failure of the market mechanism. The presence of the government should be associated with the facilitation of freedom of all private bodies. In other words, there is no conflict between legal presence of the government in the society and the efficiency of market economies.

Present analysis indicates that in social contracts between the government and individuals of any society, the principle of improvement in the standards of living has been taken as a prerequisite. It is impossible to imagine that a rational society would vote for the deterioration of the welfare of the individuals forming that society. It is clear that all institutions existing in the society shall be utilized to prevent the government from reducing the general public's welfare.

Scrutinizing the classic arguments in defense of free economies indicate that the main demand of these is the rule of law to be extended to economic activities as well. Ignoring this would lead to a situation where it would be impossible to understand why people like Adam Smith and John Stewart Mill have rejected the interference of the government in economic activity. Hence those who are not familiar with the foundations of the rule of law would easily confuse the real meaning behind the state-

ment of such economists. An investigation into the history of economic thought indicates clearly that many economists after Adam Smith have also arrived at such misunderstanding regarding what has been the true meaning of his statements.

In fact, the rejection of government interference in economic activity has been announced in a situation when it was expected that such interference would lead to loss of individual freedom. According to the rule of law, government has no right to disturb individual freedom. Smith and many other economists who understood this point rejected the interference of the government. This means that the basis of their rejection has been the fear regarding the possibility of the disturbance of the rule of law.

Smith and his followers have never claimed that the government should not enforce the law or should not enact new laws. They did not consider such acts as forcing people out of their freedom. Hence they accepted the presence of the government for enforcement of the law and modification of the legal system.

In final analysis, it should be said that there is a difference between those government policies that provides services to the society and those that creates coercion. Naturally when the private sector does not show any tendency to enter into economic activity, the government is permitted to enter into that activity as an entrepreneur.

The natural conclusion is that the condition to accept the presence of government in economic activity is that such presence should not lead to the reduction in the quality of life of the individuals. If government economic activity causes any reduction to the quality of life of the individuals, such activity should be considered an illegal presence of a collective body in the field of activity of a private body.

Similar conclusion should be drawn for the presence of government in legal system. When the law enacted by the government leads to considerable windfall gain or rent for a group of individuals or causes a distortion in economic activity of the private sector, the government right to enact that law should be restricted. As there is no general rule to say which law would cause such damage, it seems clear that before the enactment of laws, there should be a system to investigate if the distortion element is powerful or not. This leads us to the need to set an institution to observe the justice element in economic and financial laws.

### **Private Sector and Institutions:**

Given the need for making sure that the laws enacted by the government are not disruptive to the economy, the next point is to see who should observe the laws and at which stage should this be done? Here the role of private sector and corporations in formation of collective bodies become essential.

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From historical point of view, private sector approach to the society has undergone a considerable change. This has come about through opening the doors of private institutions and organizing a structure whereby the institutions are able to join various associations in their collective-body identity. Given this, the institutions are now able to claim a say in the decision-making process of their country.

In Iran, the private sector has shown a long-term tendency to obtain financial sources from traditional sources and to keep the institutions as closed as possible. There is very little tendency towards opening the doors and organizing a system of joining the institutions together. The Iranian private sector has shown little desire to accept membership of other organizations in their collective-body shape. Hence there are few instances where the private sector can join the public sector in decision-making and in the process of production of rules, regulations and laws. The result of such situation is the enactment of laws which are against the common interest of various private sector institutions and the instability of the economy. This is one reason why one of the largest uncertainties about Iranian economy comes from the uncertainty regarding economic policies. Iranian private sector has always remained very isolated with little share in the decision-making process of the country.

It is possible to estimate the cost of such isolation both in micro and in macro economic terms. One specific example is the lost of Iranian enterprises who had received foreign exchange from Iranian banking system prior to the massive devaluation of Iranian Rials. Here the private sector who had not settled the purchase prior to the devaluation was forced to pay back according to the new rates of exchange. This caused a great financial burden on this group and created a considerable rent for all those who had settled their debt prior to the devaluation. Had the private institutions a say in the legal decisions-making of the country, no such loss and such rent would have ever occurred.

Another example where the private-sector collective bodies could have created a great stability is the case of industrial and financial decision-making process. In money and credit council of the country the only collective-body of private sector is Iran Chamber of Commerce and Industry. Even then, this collective body cannot be considered to be either a collective body representing the entire private sector or the entire business sector of the country. The need for an institutional change in this collective body is apparent. Here the private sector of the country would suffer on macro level as the decisions are open to creation of rent and becoming unjust.

### **Concluding Remarks**

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Economic theory of sustainable development contains freedom of various aspects as the most inherent element of development. This freedom obliges individual bodies to

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organize themselves in collective bodies and to represent their preferences in various subjects and at different levels. Full representation only takes place when private sector is able to organize itself into different collective-bodies in collaboration with various public sector collective bodies to decide about economic issues. Only in this way the government would stand in its proper position and in economic issue the element of windfall gains, rents and all sorts of unjust redistribution of income and wealth would be controlled.

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