

Government and the Economic Evolutions

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Abstract

In this paper we try to investigate relationship between government and economic evolution. In order to accept that the efficiency and inefficiency of a market depends on capabilities of the governments in reducing the transactional costs, guaranteeing the property rights, and removing the traditional market failures. Regarding the new institutional approach it is assumed that the persons (private or public agents) seek their maximum benefits in accordance with the limitations and obligations exacted by that institutional structure.

Concerning this assumption we may find out that the market of these services will go to its best status. Moreover, in case that the limitations and obligations enacted by those institution can regulate the behavior of the public agents in a manner that they could seek their maximum benefits in producing these services. These institutions are the rules arising from social culture (convention), formal regulations (such as constitution), and parties. Therefore, the history of economic evolution has had a tied with the historical evolution of these institutions.

Keywords: Institution, Government, Transactional costs, Third Party, Property right

1- Introduction

Institutions would not exist in a frictionless world where there is no uncertainty (North, 2003:1). The economic clear cited expectations towards the government's duties through the process of development are as follows:

To define and guarantee the property rights in an effective manner, to proceed with reducing transaction costs, to supply the public goods in their optimal level, to operate in the direction of making inner the externality of positive and negative activities, to control and regulate the natural monopolies and preventing the formation of monopole firms.

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The result of these actions will be an effective market and the expansion of a private sector. However, playing such a role requires the government's interference and strong supervision over the contracts. Now some questions may arise:

First: In what conditions does the government's intervention cause the expansion of private sector?

Second: How can we compel the government to behave as a third party and perform the control over the contracts and protect them fairly?

Third: In what conditions the government wouldn't use her monopolized power to guarantee the benefits of some specific players?

As a general concept, in what conditions the government should submit the services (protection for performing all contracts in an equal manner, therefore, making innate the costs and externalities of activities, controlling the monopolies, and so on) for those he is organized?

In fact, accepting such a role for the government means to accept a market in which the society, looking forward to increasing efficiencies, is an applicant for the services that are monopolistically supplied by a unit, named government.

Setting the goal of providing these services to their optimal level, as a complementary for the private sector's activities, requires some institutions preventing the government to be a discriminating monopolist and prevent its to prejudicially protect the contract instead of fairly protection of their performing, it means that the result of the government interference should coordinate the maximum private benefits of the government conductors, with the maximum benefits of the society.

Now first of all, the transactional costs, the institutions and their role in reducing these costs, the concept of government and its role in the society should be explained, and finally the role of institutions to increase the capabilities of the government performance in the manner of her powers and duties would be paid attention.

The Concept of Transactional Costs

In economics and related disciplines, a transaction cost is a cost incurred in making an economic exchange. For example, most people, when buying or selling a stock, must pay a commission to their broker; that commission is a transaction cost of doing the stock deal. Or consider buying a banana from

a store; to purchase the banana, your costs will be not only the price of the banana itself, but also the energy and effort it requires to find out which of the various banana products you prefer, where to get them and at what price, the cost of traveling from your house to the store and back, the time waiting in line, and the effort of the paying itself; the costs above and beyond the cost of the banana are the transaction costs. When rationally evaluating a potential transaction, it is important to consider transaction costs that might prove significant (Connolly&Munro, 1999, 14).

Ronald Coase (1960), explained the social costs, the neoclassical model will produce the claimed allocated results or would be in the optimum situation only if there are no transactional costs, but in the real world, the transactional costs always exist because obtaining the information, measuring the benefits of trade before performing of the contracts, and enforcement of the contracts always have costs.

The commodities, the private services and their operations, on one hand, have numerous characteristics whose intensity and infirmity can vary from one sample to another which measuring them exactly and perfectly is costly if it is not impossible. On the other hand, the information is also asymmetrically distributed among the economic players of the society.

Therefore, considering the behavior of profit maximization (Furubotn,2001, 2-8) and opportunistic behavior (Williamson, 1986, 190), will cause increasing of the transactional costs by reducing the mutual confidence to the level that the algebraic summation of the profits resulted from specializing the functionary workers (resulting in interchange) and transactional costs may be evaluated as negative. So the transactions could not reach to their final forms (or optimum level) as regarding the marginal values can be equal and the efficiency can be actualized.

Such a function, i.e. expenses involved in control and performance has caused the workers in the organizations based on chain of commands, could not earn their wages equivalent to their marginal product value of their works, but actually the equation implies a subtraction of costs of sources being paid for control and watching from the value mentioned (Jensen,1976)

2- The Conditions of Reducing the Transactional Costs

Performing the contracts will be definite in case the benefit of the interchanging party requires acting in accordance with the contents of the

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contract, and this depends on fulfillment of the following conditions (Monsef, 2003, 102):

2-1- The possibility of second – party retaliation

Fulfillment of the above mentioned condition will be actual when the

Interchange can be repetitive and the other party may not vary. In this case, the benefit of the second party requires the performance of the contract, since in case of not performing; if the other party has a chance to retaliate so the individual being involved in interchange cannot maximize his or her benefit through breaching the contract.

2-2- Existence of the Rules & principles having a Societal Sanction

considering the new institutional Approach (Furubotn,2001,2-8), we may insert the other persons' benefits into the utility function in addition to private benefits, so increasing or decreasing the other persons' benefits could decrease or increase the utility of the individual who is a decision maker. If,meanwhile, the rules and principles accepted by individuals of the society could be in a manner that a loss against the second party may cause a reduction in decision maker's utility, and also, the other persons ' rights could be defined in accordance with a mutual agreement, not based on the decision maker's recognition itself ; then those rules and principles can exert some obligations on maximizing the decision maker's benefits { which, in contrary, involves loss against the second party }.Thus, according to these rules, an individual decision maker seeks his or her maximum utility in commitment to the contract. As a result, the implementation of the contract is guaranteed and therefore the transactional costs will be reduced.

These rules and principles are defined by North as an institution (North, 1998, 19). Robert (1994. 25) says these institutions may be formal or informal. The formal ones may be assumed as the laws enacted by human beings and the informal ones could be those such as conventions and behavioral principles. Thus, such institutions may be enacted, like constitutions, and also may take forms as common laws, which might be evolved calmly and continuously during the time. In fact, as a general rule, the institutions are frameworks through them the maximizing behavior of the individuals could be regulated, and also they may take through history under the process of maximizing the benefit.

Ostrom defines the institution as behavioral obligations as follows:

“The institution are a complex of operational rules being used to determine who can make a decision in several opportunities and what is his or her criterion for decision making, i.e. what is allowed or prohibited, what general rules may be exerted, what procedure may be permitted, what information should or should not be distributed, and what decisions may be made over the individuals due to their behaviors. All the rules imply orders to prohibit, authorize, or make necessary some behaviors and their circumstances. Operational rules are those which the individuals exert whenever they have to make a decision over the act they must do”. (Ostrom, 1990, 5)

In fact a collection of institutions puts an order in society through a framework by which the individuals operate to maximize their benefits.

But the acceptance of these institutions in the society is a kind of interchange of rights itself. i.e. the individuals accept some limitations in their maximizing behavior, hoping that in some similar conditions the other people may accept such kind of limitations in their maximizing behavior, not willing to trespass the benefits (of the second parties). In such a case, the acceptance of rules and principles in the society or in other words, forming the institutions in the society, depends on these acceptations which could be valuable under the conventions, rules, and principle of social behavior ; so a mutual confidence may be fulfilled and resulting in an insignificant transactional costs related to the interchange.

Considering the assumption of opportunistic behavior, we may observe that except the existence of such rules and principles, we need another player to guarantee the performance of contracts, that in case of breaching these principles, the breaches must be punished in a manner that the benefits of the interchanging parties require to perform the contracts. Thus, a third condition is needed and that is the presence of a third party, say government.

2-3- The Existence of the Third Party (An impartial and capable government)

The third party having forcible power, i.e. the government and the punishments exerted by her, is one of the functionaries that in the absence of the second party, retaliation possibilities, can guarantee the enforcement of contracts resulting in making mutual confidence. In other words, when the

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third party can act efficiently it may reduce the transactional costs, hence will prepare the conditions of an effective market.

In fact, to prepare efficient markets and security the rights we need a third party which her presence compels the economic agents to accept these institutions as the obligations against maximizing their benefits. Meanwhile the punishments exerted by the third party must be in a manner that the decision maker individual considers the behavior being done in accordance with this framework of obligations (the rules and principles), as the best one. That is to say the breach of rules and principles could show perceptibly its influence over the utility function of the individual, thus he or she may pay attention to these rules and principles as an obligation against his or her calculation of maximizing the benefits. For achieving this goal, the protections over the contracts, or in fact enforcing these rules and principles, must be exerted equally against all the individuals of the society.

In other words, stabilizing such institutions in the society, and reducing the cost of obedience towards these rules which expands such rules (forming the conditions of efficiency and security the property rights) requires that these rules and principles (the institution) can put in order a compatible arrangement so that the individuals of society encounter an equal chance ; otherwise, these rules may not be accepted by them and the cost of obedience towards the rules will increase, causing an inconstant status; therefore no order will take place through which the individual consider it as a limitations against maximizing the benefits, resulting in preventing the markets be efficient and expanded.

According to Mantzavinos's (2001,102) : "The markets can act through a framework of rules "; recalling that the rules and principles may be formal (sanctioned laws) or informal (the explicit values arising from social culture) thus the governments, in addition to their roles of guaranteeing the enforcement of these rules should proceed with a relevant definition and sanctioning the rules, and also play a role to change the existing rules, i.e. "offering a protection over the individual assets through laws and sanctioned regulations" (Mantzavinos, 2001, 197)

Therefore, the governments can affect on the efficiency and expansion of the markets by proceeding two directions, first defending the laws and second, guarantee in their enforcement. Now the questions are; what general rules may be emphasized in the culture and what structure may be related to

the government compelling the people to regard the rules, and also make her capable to establish these rules?

Now we proceed with the inspection of these rules; the informal ones being explicit in the culture, and also the formals, and also the theory of the government will be analyzed through the framework of the analysis (the assumption of maximizing behavior and the probability of opportunistic one).

3- The Culture and Theory of the Government

3-1- The culture and limitations Against Maximizing the Private Benefits.

Government is the most powerful influence on our culture today because government spends about \$2.5 trillion a year, and every dollar carries the power to affect our culture and behavior through laws, regulations, grants, entitlements, and tax credits. More influential than all the laws and judicial decisions, and even the media, in directing our culture is the arm of government known as the public schools (Schlafly, 2008:1).

It means, the behavior rules and principles consisting in social cultures should define clearly and specify these benefits and the boundary of the individuals' rights. So, each person during the process of decision making and regarding a reliance towards such rights, will consider the boundary as the limitations against his or her tendency towards maximizing the benefits (second – party retaliation), and the second condition of guaranteeing the enforcement of the contracts and also forming the equivalent chances for the individuals will be actualized in that society. (Monsef, 2005)

However, if boundary mentioned was not defined in the culture of the society, it would depend on the decrement of the individuals during the process of their decision making. Thus, even if the trespassing on the other's rights are not permitted in the social culture, and being no clear definition of the rights (by being the case of existing limited rationality and imperfect information during decision making), the others' benefits, because of not being defined, cannot be regarded as the limitations on maximizing the benefits. Therefore, the decision maker will proceed with the contracts as far as they can be compatible with his or her maximum benefits (not regarding the others rights). Meanwhile, the cost of obedience towards laws in such a society will seriously increase and encounter the society with great difficulty.

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Another question is what general rules can clearly define these rules to make the limitations operate against decision maker individual's

(Or collective's) maximum benefits?

We may consider that if the general rule might be accepted in the society culture, emphasizing that all human beings are equal in their humanity, and they themselves better known than others what can increase or decrease their utility (accepting the principle that measuring and comparing the individuals utility is not possible), and also the equivalent participation of the individuals in their mutual rights might be accepted; then the agreements in such a society would have been considered as valuable. That is to say the boundary of rights can be defined in accordance with the agreements, therefore the second condition of actualizing the efficiency is guaranteed. (The contracts are considered as a boundary for the rights believed).

Thus it seems that, under the above condition, the freedom to choose and maximizing the private benefits would be coordinated with the maximum benefit of the society so the balance between rights and chances would be guaranteed. Also the cost of obedience towards the rules would decrease, and by having a liable government as the third condition of actualizing the efficiency, the order in the society would be actualized and, as a result, the transactional costs would decrease and the security of property rights would be secured.

Any note to this general rule (equivalency of human beings) will result in entrusting the power of distinguishing the boundary of other's rights to the decrement of a decision maker individual, so the limitations on maximizing the private benefits depend on the decision maker individual's definition of these limitations. Therefore considering the assumption that all people seek their maximum benefits, the principle of maximizing the private benefit will be considered as a limitation to maximize the person benefits. As a conclusion, the enforcement of contract will depend on decision maker's maximum benefit. In this case, opportunity cost for performing the contract is very important. In such a case, the order in the society vanishes since the cost of obeying the rules will strongly increase, so following these rules will depend on decision maker's discernments and decision.

Accepting these general rules (equivalency of human beings, and so on) in a certain cultural environment will result in that even public agents could not be able to define social rights without the public confidence, since they

are similar as the others. As a result, their power should be limited to the protection over these agreements.

3-2- Government and the Security Property right

For researching the government behavior (in the framework of new institution, analysis) we proceed with it to research the general public agents' behavior (Furubotn, 2001, 413-422). Based on the primary assumption of this analysis, i.e. methodological individualism, we commence with the analysis of government behavior by researching the individual behavior; but because of the assumption that the individuals seek their maximum benefits in accordance with the definition and restriction exerted by social institutions against these benefits, then the analysis goes to its final status as researching the evolutions of these institutions.

North (1981, 21-28) tries to describe the relation between the property right's structure and the government in the framework of the government theory. At first step, he propounds two existing explanations of the government as: one, the contract theory, and two, the exploitation theory (plundering theory). According to contract theory, the government has taken action to develop the property rights. In exploitation theory, the government operates as an agent of a class or group to exploit (to plunder) the others.

He does not believe that the theory of contract and the theory of exploitation sufficiently describe the concept of government all through the history. Since, in the contract theory the governments have merely taken form to develop the property rights; and in the exploitation theory (plundering theory), the governments have (merely) considers and taken form to define the property rights for acquiring the most wealth without paying attention to the results against the society. According to North (2000, 36-37), the former propounds the advantage, and the latter the faults of existence of government.

We may rewrite and develop the North's attitude as follows:

All through the history, the institution of government has taken form to fulfill the people's need of having an institution to security the property rights and fairly protect the contracts. In other words, the individual, of the society, proceeding with their maximum benefits after division of works and performing the interchange, have concluded that they need a third party to guarantee the enforcement of the contracts, and exert the rules being agreed

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by the society to maximize the individuals benefits by forming the equal opportunities.

We may say that the peoples' needs regarding having protection and support concerning the enforcement of the contracts and developing the property rights have caused a market to be taken form. That is to say, all through the history and passing times, the demand for protective and supportive services has been expanded. Meanwhile, similar to other services, whenever a demand took from, some people would be ready to produce these services (general public agents) to earn income in accordance with the maximizing behavior, and then the government will take her form.

In fact, the government takes form regarding two goals, first, the goal of demanders of protective and supportive services i.e. expanding the property rights and forming the equal opportunities, and second, the goal of most income for suppliers.

As you may remark, the first goal requires the definition and enforcement a complex of rights resulting in expansion the property rights and forming equal opportunities, and the second one (maximizing the public agents' benefits) depends on the restrictions on maximizing behavior of the agents. In other words, maintaining of this goal depends on an answer to the question that are the institution(formal and informal rules and principles) in a manner that the public agents(rulers and their representatives) evaluate their maximum benefits by expanding the property rights and forming the equal opportunities or not?

Therefore, according to the framework of the theory, all the individuals in the society are enthusiasts about establishment of the government institution in order to maximize their benefits, they seems to be demanders for such institutions, and some other people in the same society will acquire income by the operations of the established government institution through supplying the needed services.

In a historical perspective, the incompatibility between the goal of demanders and the goal of suppliers has prevented an efficient property rights to be taken form(reducing the transactional costs, forming equal opportunities,and guaranteeing the enforcement of contracts) therefore since, the suppliers of the services(public agents) will be faithful toward their contract on the interchange under the condition that the cost opportunity has not defined and guaranteeing the efficient property rights is more costly than

guaranteeing these right, so they will try to define the rights in accordance with the desire of demanders, and equivalently protect the good enforcement of these rights, and vice versa.

But, according to North's view (2000, 35-36), supplying the commodity of equal protection over the contracts has an economic of scale, so all through history its monopolistic offering by an organization (government has been preferred rather than offering it by several organizations; nongovernmental status). Since the total revenue of the society in the former case will be greater than the latter one. Meanwhile, monopolistically supplying of this commodity by government has carried some defects out, so this characteristic has caused some contradictions between the goal of establishing the government, then, as a result, the government are unable to guarantee the efficiency of market, reducing transactional costs, and security the property rights.

In fact, this characteristic has led to the status that the government acts as a discriminated monopolist corporation(to maximize the benefits of her control)i.e. in the absence of those institutions and rules (the triple conditions of reducing the transactional costs) which could act as the limitations on the maximum benefits of public agents(compelling them to proceed with maximizing their benefits through a definition and guaranty towards an effective structure of property rights) ; the only existing corporation in the market (government) will proceed with maximizing her benefits through a discriminating supplying of the services, thus will prevent an effective order securing efficiency and forming equal opportunities from taking shape which could decrease the transactional costs. In other words, the government herself causes to decrease the efficiency of the market and not to guarantee these rights.

We may ask that in what statuses these principals and rules can act as the limitations on maximizing the benefits of general public agents? The answer is: The decisions and operations of the government is impression by the public agents who have this monopolistic corporation under their control to maximize their benefits and meanwhile they are the main suppliers in the market. At the same time, such a market, during its taking form, has some deficiencies similar to other markets (traditional deficiencies, externality costs and benefits, monopoly, and institution deficiencies)

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Therefore, as Coase (1964) and Demestz (1964) have propounded “the private sectors’ market commence with Pareto best allocation through its failures and unsuccessfulness”, so we may conclude that the market of these services (regarding the similarity of characteristics of human beings who are active in this market, with those of the agents of private sectors’ markets is imperfect too and commences with the failure in Pareto allocation optimality.

Thus, we must emphasize that, as Dixit has mentioned, “the governments possessing the absolute authority, infinite knowledge, and benevolence, will put in practice an effective remedy to omit the functionalities of market failure (private sector) But it is clear that all the possible organizational structures, including the governments, are imperfect”. (Dixit, 1996, 8)

Therefore, the necessitation of establishing the governments possessing authority and benevolence is that there must be some limitations in this market similar to other markets in order to compel the agents evaluate maximizing their benefits in accordance with the benevolence towards the society. That is to say following the private benefits by them could be compatible with those of the society.

Regarding that the agents producing such obligations are similar to the private sector’s players, there must be a similarity between the agents’ culture and that culture would have emphasize on the effective rules. On the other side, the constitution as a sanctioned rule related to public agents who act through its framework and attribution must be capable to confirm this culture.

At the same time, since the players in this market possess the characteristics of a limited rationality and a probability of being the opportunists, then there must be another institution to guarantee the enforcement of these rules. Nowadays, this institution is recognized as the competitor parties or the rivals of the present agents. Therefore, three parameters; a culture based on the equality of human beings, a constitution, and competitor parties; are the elements that could guarantee the efficiency of the market to produce and support fairly services. Now the question is: Do constitutions take form based on thoughts and culture, or the culture; thoughts and individuals’ believe are shaping by the constitution? From Ricker’s point of view we may ask: “is the structure of the constitution that is the cause of political conditions and the status of public thoughts, or are

the political conditions and the status of public thoughts the cause of the structure of the constitution? At first look it seems it is similar to the problem of hens and eggs in which there is no causal direction. Anyhow, I suppose there are some causal relations, and the forms of the constitutions are in their kind, extractational. In my point of view it is probable that the people's thoughts are the base or platform of the structure of the constitution, the reverse status has a chance of less probability. As Rousseau says it is finally the law being written in the peoples' hearts". (Ricker, 1976, 73-75)(The rules and laws having a societal sanction (the second condition of reducing the transactional costs).

In fact, regarding this approach, the institutions including the constitutions too, are endogenous, and the individuals and groups will change them or shape them in order to maximize their benefits through passing time.

In such a manner, the economic function of a country all through her history depends on the ability of the government to produce such services; and the ability and disability of the governments themselves depend on the evaluations of these institutions (the culture, rules, and principles having an innate necessitation, the sanctioned laws such as constitutions and the continuation or discontinuation of existence of the competitor parties in the market of these services). (As an example, if we consider the changes being exerted in Iran's constitution of the constitutional government, then we may remark those changes had been taken their form in the direction of maximizing the utility of public agents and neutralizing the rules (as not to be considered the limitation against maximizing their utility)

4- Conclusion

The market encounters with the failure and unsuccessfulness of the optimal allocation; and regarding the three assumptions of maximization behavior, limited rationality, and the probability of opportunism; the transactional costs in the real world are positive, and the enforcement of contracts is encountered with doubtfulness. Therefore the mutual confidence is insignificant, and the markets encounter defeat to guaranty the efficiency and security of property rights, otherwise, the following conditions could be actualized:

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- 1- There should be a possibility of reciprocity, and it will be accessible through repetitive playing accompanying the specific players.
- 2- The existence of rules and principles having innate necessitation which clearly, explicitly, and compatibly defined the rights of the society's individuals in a manner that maximizing the private benefits should be accepted in the framework of regarding the others rights, and this is possible when the formal and informal rules and principles could have their platform of the culture; accepting the equal participation of individuals in defining and guaranteeing the rights.
- 3- The existence of a third party is being capable to equally protect these rules and principles; that party would be a government. The efficiency of the government itself depends on three clauses, first the social culture should explicate the second condition, second the constitution should be based on the same culture, and third, the existence and continuation of the competitor parties should be accepted as a parameter to guarantee the principle of reciprocity.

As a result, inspecting the economic evolutions requires inspecting the foundational evolutions, and considering the changing in foundations

(Formal and informal rules and principles), to find out whether these changes have shaped to bind the maximizing behavior of the agent, (private and public). And also to look forward that whether the existence of competitor parties is accepted and participation in them is considered as a value through the rules and principles of the society or not only the existence of parties is unaccepted but they might be considered as an invaluable subject.

We can summarize very simply what the issue is; if you are going to move to a world of impersonal exchange, you have to change the institutional framework so that it pays to cooperate. That means developing institutions that either through reputation mechanisms or through some other deceives can see it players will cooperate with each other and that they will punish those that do not. And for big market third party should interfere, third party enforcement ultimately means the polity or the state.

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