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The Application of Institutional Economics Theory in Solving Developing Countries Market Problems - Taking Ethiopia Grain Market and China Tomato Market as Examples

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Abstract: Since the 1990s, when the new institutional economics was first introduced, many economists have been looking for a way to incorporate its ideas into the field of development economics. In this paper, we investigate the prospects of using development economics theory, which is grounded in institutional economics, to address the economic challenges faced by developing nations. In this paper, we conclude that institutional economics theory can be successfully applied to the problem of economic development in low-income countries. Developing nations shouldn't discount the harm caused by irrational trading decisions. When people act irrationally in the market, it can have a negative impact on the economy as a whole. As such, developing countries could benefit from implementing brokerage institutions to lessen the blow of irrational behavior on economic growth.

Keywords: instutional economis, development economis, developing countries, Ethopia, market

1. Introduction

In 1990, with the release of Douglass C. North's Institutions, Institutional Change, and Economic Performance, the neoclassical economics assumption began to shift. Prior to 1990, the vast majority of economists held the view that all economic models could benefit from applying the same three foundational assumptions of economics (methodological individualism, methodological instrumentalism, and methodological equilibration) [1-3]. But as Douglass and other non-neoclassical economists argue, that's only half the story [4].

Ethnicity and racism, Marcel Fafchamps and other economists find, can be a serious problem or a tremendous hindrance when attempting to solve economic problems in developing countries like Ethiopia and Kenya [4]. However, neoclassical economic theory rarely distinguished between the economic models of developing countries and developed countries. The assumptions made for individual behavior in developing countries and developed countries are actually the same in conventional economic theory and case studies. In fact, according to neoclassical economists, consumers in all economies follow the same basic rules. However, Fafchamps and Gabre-Madhin argue that, contrary to popular belief, it is not a reasonable economic assumption to hold that all individuals act identically [2]. People in developing countries behave differently from people in developed countries because of issues like racism and asymmetric information, which are much more

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severe in developing countries than in developed countries [2]. Then, without a doubt, it is time to reconsider the paper's initial introductory assumptions.

Using current research data on the economies of Kenya, Zimbabwe, and Ethiopia, the author discusses how the new institutional economic assumption helps us to understand the problems of ethnicity and gender discrimination there, and suggests ways forward. The ultimate aim of development economics is to stimulate the economy in developing countries, and this goal will be made more achievable if more options for addressing development issues in these countries are made available. When developing nations' economic situations improve, so too do their citizens' living conditions.

2. Introduction and Comparison of Neo-classical Economics and New Institutional Economics Behavior Assumptions

Douglass C. North has previously done this reevaluation of development in his book, Institutions, Institutional Change, and Economic Performance. The neo-classical economics behavior assumption that Douglass modified in Chapter 3 is depicted below, along with the new institutional economics behavior assumption that he coined to describe it.

2.1. Neo-classical Economics Behavior Assumption

To begin, it seems fair to say that global economic conditions are stable. The second is that people who participate in the economy are constantly put through the same, or very similar, series of decision-making scenarios. Third, the actors' preferences are consistent, so they use consistent standards to assess the results of individuals' decisions. Fourth, businesses would be forced to take advantage of any opportunity to improve their outcomes if they were exposed to it often enough, or risk being driven out of business. Fifth, this means that there is no possible equilibrium in which all players' preferences are not maximized. Sixth, because the world is roughly in equilibrium, the patterns used by the maximizing actors are roughly visible. And finally, seventh, the specifics of the adaptive process are likely to vary depending on the actor and the circumstances. The regularities associated with optimization equilibrium, on the other hand, are relatively simple; therefore, considerations of parsimony dictate that the way to advance in economic understanding is to explore these regularities theoretically and compare the results with other observations [3].

2.2. New Institutional Economics Behavior Assumption

First, the concept of equilibrium is a useful tool of analysis for some purposes, but there is not a single equilibrium for most of the issues that we care about. Second, although individuals face many recurring situations and can act rationally in these cases, they also face many nonrecurring choices where information is limited and outcomes are uncertain. Third, the stability issue is not so easily dismissed, even though Becker and Stigler have made an impressive case for relative price changes accounting for many apparent changes in preferences. Anomalies manifest themselves at the disaggregated level at which psychological research has been done, and there is no doubt that preferences change over time, as evidenced by historical records. The author has been unable to come up with an explanation for slavery's decline in the nineteenth century that does not involve a shift in public opinion about whether or not it is moral to own another person. And finally, fourth, actors want to do well, but they may not know how to do so because the information they receive is inadequate. When competition is low and signals are muddled, adaptation can be sluggish or misguided, and typical evolutionary outcomes may not hold true for very long epochs of time. Sixth, there is abundant proof of much more than simple rational noncooperative behavior in the state of the world throughout history. Seventh, economists' assumptions about human nature can be applied to

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practical problems. They are the primary roadblock to understanding the genesis, development, and persistence of institutions [3], and they are woefully inadequate to address many of the challenges faced by social scientists.

This paper has shown that unlike neo-classical economics, the assumption of individual behavior in new institutional economics theory now accepts more diversity of people's behavior and would take into account different individual action. Some economists apply the new theory of institutional economics to the question of how the actions of people in developing countries differ from those of people in developed countries and what effect those differences have on the markets and economies of those countries. Fafchamps and Gabre-Madhin have conducted studies like "Ethnicity and Credit in African Manufacturing" and "Market Intuitions, Transaction Costs, and Social Capital in the Ethiopian Grain Market" to determine how well the current new institutional economics theory explains economic issues in developing countries. For instance, Fafchamps claims that when he applies case study data on manufacturing firms in Kenya and Zimbabwe, he discovers that an ethnic and gender bias is noticeable in the attribution of supplier credit, which, in other words, will drastically alter the market situation in both countries [4]. People in Zimbabwe and Kenya are more likely to act irrationally than those who are not affected by ethnic and gender bias [3]. While this summary satisfactorily addresses the posed question of how new institutional economics assumptions improve our understanding of the market situation in developing countries, the central issue of how to solve the economic problems of developing countries remains unresolved. Most studies addressing this issue have focused on the causes and consequences of people's increased conformity to the new institutional economists' working assumptions, rather than on how to mitigate the problem it presents. According to Fafchamps, "the bulk of the evidence indicates that network effects play an important role in explaining this bias [4]," but he offers no way to exclude the possibility of discrimination in the market.

3. Situations in Kenya, Zimbabwe and Ethiopia

3.1. Kenya and Zimbabwe

In Kenya, men of Asian descent make up the majority of the country's business elite. Particularly in Kenya's food markets, males of Asian descent are the go-to traders. Male Luos, for example, predominate in the fish trade, while male Kenyan-Asians do particularly well in the textile industry [4]. Bart Minten asserts that the most crucial element of business success for traders and suppliers in Kenya and other African countries is the quality of their personal relationships [5]. Given the current climate, it is safe to assume that the majority of Kenyans will look to males of Asian descent as the only potential source of supply. Most economists probably see this as a recipe for the other, equally reliable suppliers to leave the market and go elsewhere. Therefore, market buyers are restricted to conducting business with male Kenyan-Asians, even though some of these vendors are unreliable. Choosing a business partner solely on the basis of their ethics rather than the maximization of the buyers' own utility is not, in any sense, a rational action.

As in Kenya, many merchants identify with a specific race. In Zimbabwe, however, they are overwhelmingly white males, in contrast to Kenya. Despite the fact that they may provide a perfect food supply or high-quality production, traders who are not male Kenyan-Asians or whites have a very low chance of establishing trade credit in either country.

Irrational actions may have disastrous consequences for market efficiency. The new institutional economics differs from neo-classical economics in its belief that the consequences of ignoring the harm done by irrational actions will be dire. The market is failing when most participants don't choose the option that maximizes their profit or utility. If the market's optimal quantity or price does not correspond to the actual quantity or price, then the market is inefficient even if there is a generally

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accepted price. A strong adjustment policy is necessary for such a market, which means that the government must step in to either fix the problem or at least mitigate its negative effects.

3.2. Ethiopia

The Ethiopian grain market illustrates the failure of a market unfettered by government intervention due to discrimination based on gender and ethnicity. Prior to 2003, the bulk of the trade between sellers and buyers in Ethiopia's grain market was conducted through personal connections, which raised concerns about the potential for severe information asymmetry and ethnic tensions. The government imposed strict regulations as well, but that all changed in 2003. The less government intervention policy is used, the more self-sufficient the market will be, so says neoclassical economics. For this reason, in March of 2003, the government of Ethiopia lifted all grain market restrictions in an effort to boost the market's economic performance [6]. Unfortunately, the market economy's performance gets even worse [6]. The elimination of government restrictions on the grain market has little effect on price and quantity because of the heavy reliance on personal relationship during trading. Even though the price restriction has been lifted, there is still not enough grain on the market to sustain Ethiopia's population [6].

Based on current events in Ethiopia's grain market, it's fair to assume that decreased government intervention isn't the only factor contributing to the market's undersupply. New insights from the field of institutional economics suggest that irrational decisions may be to blame for developing countries' poor economic performance. In this paper, the author does not claim that there is no other explanation for the poor economic performance in some developing countries; however, the irrational behavior that the author will go on to discuss could be a very attractive answer for how we are going to improve the economic performance in developing countries.

4. Main Problems and Reason

The economic performance of developing countries, and in particular their irrational choice of trade partners, can be improved by identifying the root causes of this behavior and then working to address those causes. The root of any issue can be pinpointed and addressed more effectively once its cause has been isolated. This paper will concentrate on two particular issues.

4.1. Ethnicity and Racism

It was no secret that entrepreneurs favor working with those of their own gender or ethnicity, given the long-established link between these factors [5]. However, things become more difficult when some people stereotype all people of a different race or gender as being incapable. People in developing nations may feel helpless in the face of discrimination because of a lack of education or other factors.

4.2. Asymmetric Information Caused by Reliance on Personal Relationship

The extreme lack of sophistication in business practice contributes to the importance of relationships [5]. In developing nations, the issue of inadequate business practices is much more pervasive and difficult to rectify. In less developed markets, there may be no reputation mechanisms to punish opportunistic breaches of contract, no checks, no invoices, very little trade credit, and no visual inspection of quality by the trader or a trusted associate at each transaction [5]. Many economists and organizations like the World Bank have acknowledged that the lack of sophistication on the part of developing country governments is not entirely unexpected. However, the government in some of these countries may lack the motivation to adjust these problems because they are still reaping benefits from the personal relationship trading mode.

5. Discussion: Possible Solutions

5.1. Ethnicity and Racism

It is unlikely that discrimination does not exist, as Fafchamps argues in his paper "Ethnicity and Credit in African Manufacturing" [4-5], but we can now try to mitigate its impact through alternative means. First, it is necessary to emphasize that decreasing ethnic tensions and racial prejudice is directly correlated to rising educational attainment. However, in the long run, it will be really changeling for a government to raise the education level if the economic situation of the country is execrable and the market in developing countries keeps in insufficient.

So, how do we stop discrimination from harming people? Possible solutions include having the government formally recognize a brokers' union. An intermediary between an investor and a securities exchange, brokers are either individuals or businesses. They should aid suppliers and buyers in determining the best option for each other, and they should not share the same ethic group or gender as the market's dominant members. Suppliers' gender or ethnicity should never be revealed, and neither sellers nor buyers have any say in which brokers they'll be working with. In order to avoid corrupt practices, the government should pay the brokers directly instead of the supplier or the buyer. In addition, it is important that every local supplier and buyer have access to a comprehensive list of brokers, which includes contact information. Last but not least, if there is still room in the government's budget, the brokers who connect suppliers and buyers should be exempt from taxes.

First, the brokers' solution can lessen the likelihood of irrational choices due to discrimination, as the sellers and buyers might be able to remain completely anonymous to one another. Since they are completely oblivious to one another's gender and cultural background, they are likely to be more concerned with increasing their financial gain. Second, in the long run, people in the trade market might figure out that choosing who to trade with based on gender or ethnic group is not a profitable strategy, and so they might stop using such data.

5.2. Asymmetric Information Caused by Reliance on Personal Relationship

The asymmetric information problems in a trade market can be mitigated by brokers' solution, and the former will benefit from the latter. Existence of brokers will reduce the time that suppliers and buyers spend trying to find each other in the market, as previous research into African markets has found that the brokerage institution minimizes transaction costs and facilitates exchange [1]. Foreseen because the brokerage institution ensures that all sellers and buyers, no matter their size, are aware of the market's full range of pricing, quality, and quantity. In a perfect competition market, all buyers have access to product information, allowing them to quickly and cheaply determine which product will provide them with the greatest net benefit. People are not dependent on a single source, where they have no guarantee of receiving accurate information about the market price and quantity.

Brokers' existence will undoubtedly assist consumers in the market in making more informed decisions, but the government must play a crucial role in preventing corruption and bribery among brokers to ensure the continued success of brokerage instruction. According to the foregoing, brokers should be assigned to each seller and buyer at random, and they should be barred from receiving any form of compensation from any party other than the local government. It is indeed possible that the tax incentives and subsides will get more people to hire brokers.

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6. Conclusion

In this paper, we investigate the prospects of using development economics theory, which is grounded in institutional economics, to address the economic challenges faced by developing nations. In this paper, we conclude that institutional economics theory can be successfully applied to the problem of economic development in low-income countries. Developing nations shouldn't discount the harm caused by irrational trading decisions. When people act irrationally in the market, it can have a negative impact on the economy as a whole. As such, developing countries could benefit from implementing brokerage institutions to lessen the blow of irrational behavior on economic growth.

It is indeed important to note that implementing any of these policies or pursuing any of these potential solutions will take time. Seeing the results of a policy or solution may take longer than three years. When deciding between possible solutions or policies, it's important to factor in the opportunity cost of each.

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