Chapter 11

- Introduces key ideas in chapter 11 and provides examples.
- Chapters 12 (Land), Chapter 13 (Credit) are among longest chapters in *DE*, Chapter 15 (Insurance) not as long.
- Repeated application of ideas in chapter 11.
“Forensic” Studies

- Till now standard diet of perfect competition model.
- Model of perfect competition useful to highlight impact of imperfections.
- Competitive Model is the benchmark.
  - Example: cost of monopoly?
  - Answer: misallocation of resources from competitive equilibrium.
Key Departures

- Importance of information (who knows what? [when do they know it?])
- Incentives.
- There are limits to contracts.[2em]

These limitations in an environment of *uncertainty*.
Contagion and Market failure

- Ray: Imperfect markets are contagious: market failure in some sector can lead to problems in other sectors. (p. 408)
- Imperfect markets sometimes called “missing markets”. Used this terminology, in Chapter 9 as fertility a response to missing (asset) markets.
- Market imperfect is neither a necessary or sufficient condition for government intervention.
- Must also have some evidence that government intervention will not suffer from same problems that cause some markets to be missing.
- Informal institutions reactions to market imperfections due to legal informational or incentive restrictions.
Examples: Information
Hidden action; moral hazard

- We observe output \((q)\) not effort \((e)\). \(q = g(e) + \epsilon\). To elicit the right amount of effort pay piece. Many jobs \(q\) also no observable. Pay on salary. Must find other incentives to elicit effort.

- Once covered by insurance, may not make the same effort to avoid accident.

- Translate insurance into more salient terms. Purchase insurance against low grade in (this) course.

- General setting: principal and agent.
Basic idea: agents (people, firms, etc.) are heterogenous.

- Labor market: (a) people who live to work; versus (b) people who work to live.
- Credit market: some people will do all in their power to repay loan. Another subgroup, not so much.
- Health Insurance: different lifestyles.
- Risk preferences: risk averse, risk loving.
The moral hazard examples illustrate the need of incentives to elicit the proper amount of effort.

One possible solution to imperfect monitoring of employee effort is to offer a high wage. If caught shirking (loafing, goldbricking) fired.

Some times output low because of bad luck. Bad luck out of worker’s control. (cheap talk example)

Risk and absence of insurance creates an inefficiency.

Problems can be difficult. Second Best
Enforcement: Limited Liability

- Limited liability: a borrower is poor and has no assets to use as collateral for a loan.

- Lender can be paid back if project succeeds. Lender paid nothing if lender fails. Lender bears downsize risk, not borrower.

- Implication: credit rationing. Borrower can not borrow as much as want at going market interest rate.

- Some (the poorest) may have no access to credit.
- Charging higher rate of interest will attract the more risky borrowers.
Enforcement: Breaking Agreements

- Insurance scheme in which several people in village put funds into pot to insure one--another against fluctuations in output.
- If person A has a good harvest, and person B does not, then mutual insurance a will send money to B.
- How to enforce the contract between A and B? What sanctions can be used to force B to pay A?
- At a minimum A and B must be able to observe enough to detect another’s “misbehavior.”
- How to enforce contract when courts do not exist or if they are incapable of verification.
Ray lists four puzzling questions of transactions which would not occur within perfect market setting:

- Why do landowners ask for a share of the tenant’s crop instead of a fixed payment, which would save the landowners the cost of verifying and measuring output.
- Why might an indebted tenant not be forced to give up his land to a landlord to whom he might owe money?
- Why do some moneylenders advance loans at low, even zero rates of interest?
- Why are similar laborers given different contractual packages with different values?
Several examples listed in Section 11.3 to highlight the role of informal institutions attempting to compensate for missing or imperfect market.

Basic Idea: the more flexible markets will attempt to adjust for the failings of the less flexible markets, bringing the “flexible” inputs into line with the “inflexible” ones.

For example, in situation of restricted credit, land and labor markets are both likely to funnel inputs in the direction of those who have access to capital equipment or bullocks.
Animal power (bullocks) functions poorly if it functions at all (market failure).

1. Animals may be overworked.
2. Animals used in time-bound activities: everyone needs to harvest crops at same time.

To compensate market failure: the operational distribution of land may follow the ownership distribution of bullocks (i.e., land rented to farmers with bullocks).

So owners of bullock may be able to lease land and hire labor.
Markets connected

Easy to miss critical insight: land, labor, capital, credit, insurance markets are connected: to understand operation in one must consider some or all of the others.

Imperfection (or nonexistence, e.g., insurance) in one spills over into the others.

Consider setting where all five (land, labor, capital, credit, insurance) markets exist and function well.

Then can consider (analyze) operation of one independently of the others.

Agents need operate in only one market. Large land owner would hire labor, but with CRS would not also rent additional land.