

A coordination failure occurs when:

- Agents' behavior creates externalities

that

- raise the relative return to those behaviors

so that

- there are multiple equilibria, and some are better for everyone

Early 1970s: Externalities are a “fable,” say Coase’s followers



Cheung (1973)

Contracts between beekeepers and orchard owners resolve the market failure of "unpaid" services

Coase (1974)

British history suggests that market arrangements (once property rights are defined) can efficiently provide for lighthouses.



Old and modern views of externalities and public goods

| | <i>Old view:</i> “Atomistic” | <i>New view:</i> “Ecological” |
|----------------------|---------------------------------|--|
| <i>Externalities</i> | Beekeeper | Systematic, diffuse externalities <ul style="list-style-type: none">• Search costs• Corruption• Spillovers in technology• Social and political interactions• Role model effects |
| <i>Public goods</i> | Lighthouse | Price vector (if there are multiple equilibrium price vectors) Group reputation Knowledge |



“Lawless Capitalism Grips Russian Business”

- The Washington Post
November 7, 2000

Transition Economies and the Emergence of the Rule of Law

There is a debate about two alternative strategies in the transition process:

- regulation followed by privatization

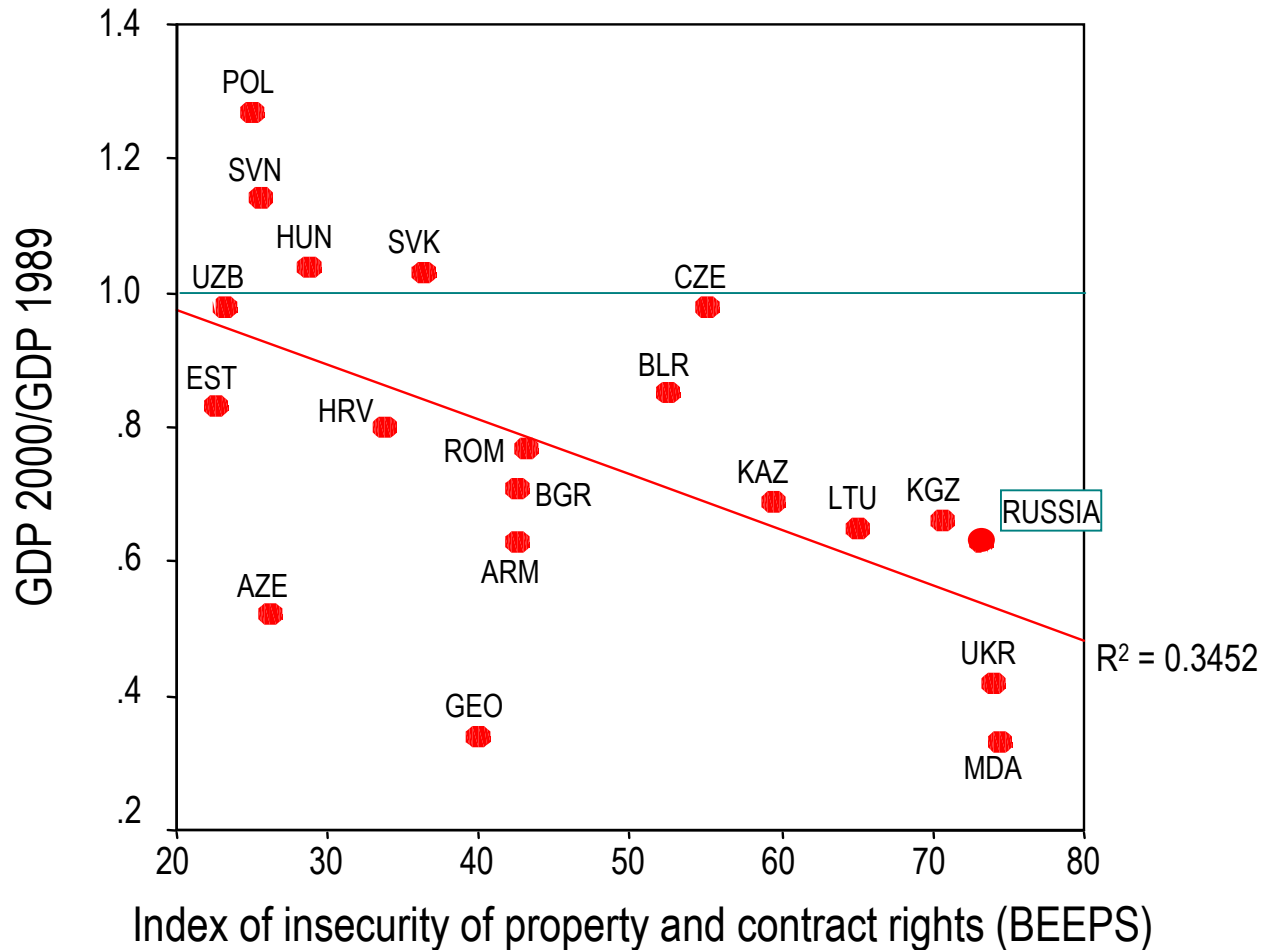
versus

- privatization without prior regulation

Two Views

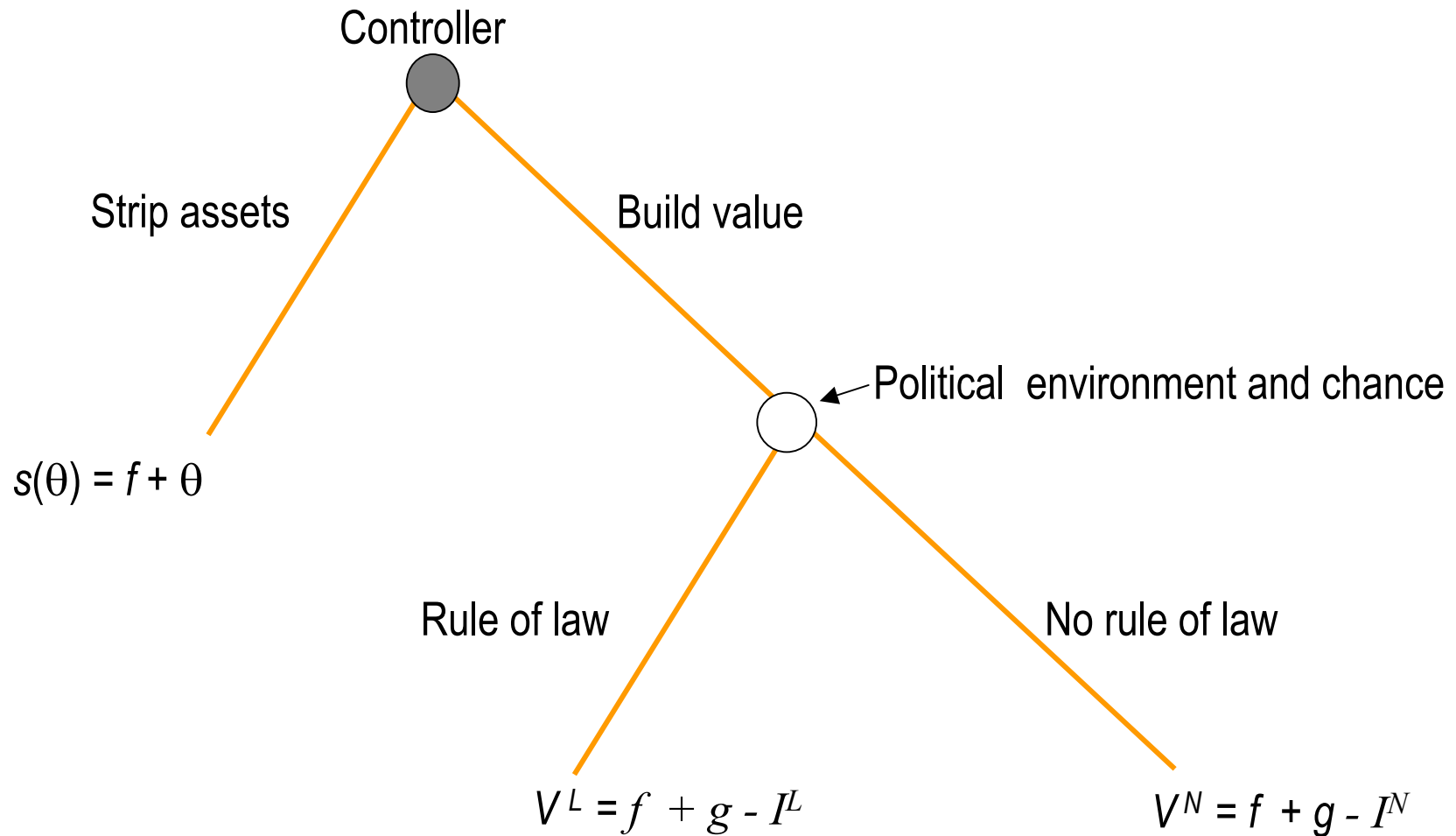
- *“Privatization offers an enormous political benefit for the creation of institutions supporting private property because it creates the very private owners who then begin lobbying the government...for institutions that support property rights.”*
Murphy-Shleifer-Vishny 1998
- *“[The owner typically] doesn’t pay wages to the employees, doesn’t pay taxes, is not interested in the enterprise’s development, establishes subsidiaries in order to ‘pump out’ the assets while leaving only the legal shell of the company, etc.”* Radygin 1999

Growth and property rights insecurity in 20 transition economies



The index of insecurity is the fraction of respondents who disagreed with the statement:
“I am confident that the legal system will uphold my contract and property rights in business disputes.”

The controller's dilemma: Strip asset or build value



Assume: $g - I^L > \theta_{median}$

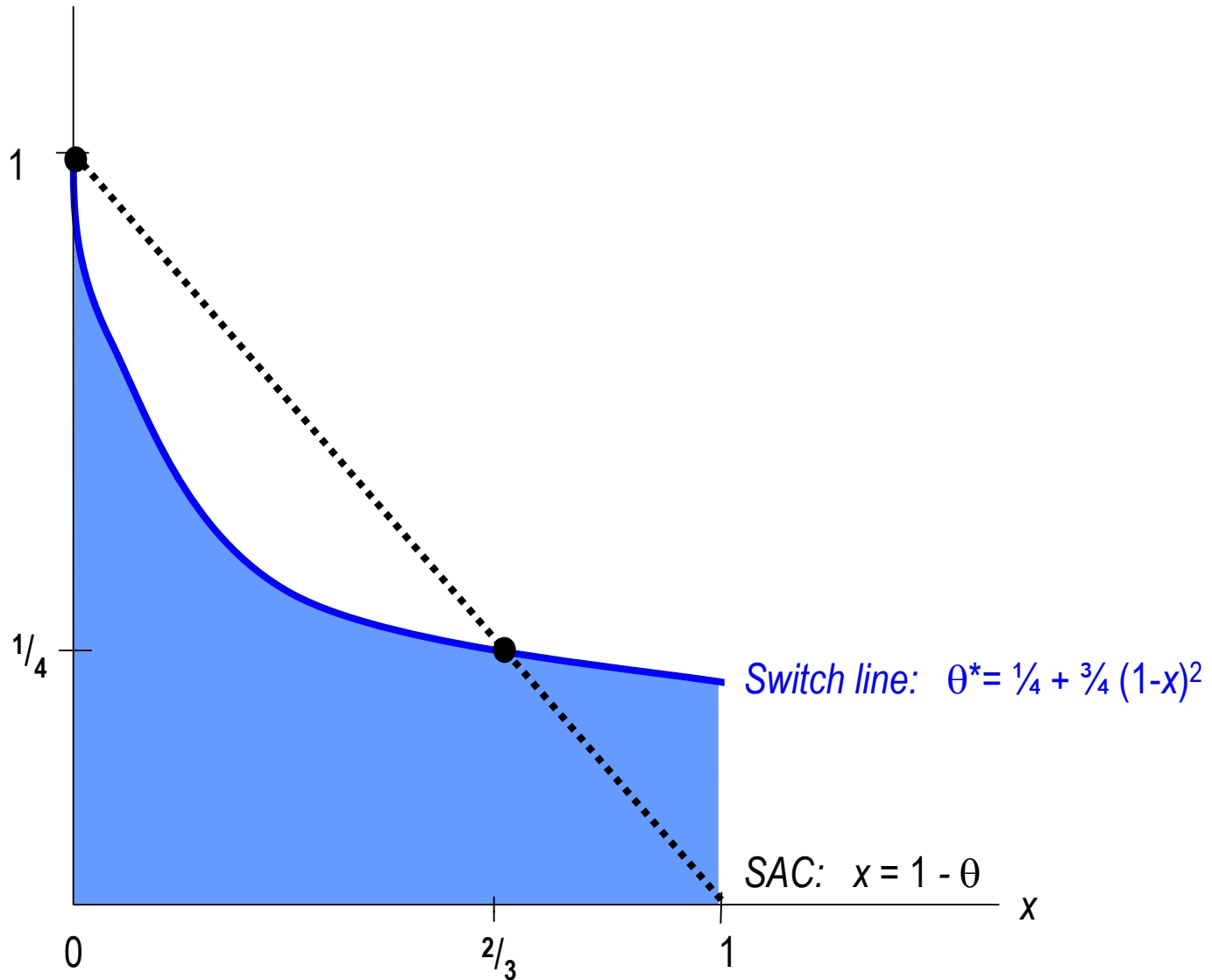
History affects norms

“Vladimir Rushaylo has flatly denied the allegations that 70 per cent of all Russian officials are corrupted ... **‘Only those who have links with the organized criminal gangs can be regarded as corrupted officials. Do not mistake bribe-taking for corruption,’** the Russian Interior Minister stressed.

(BBC, March 13, 2001)

Payoffs

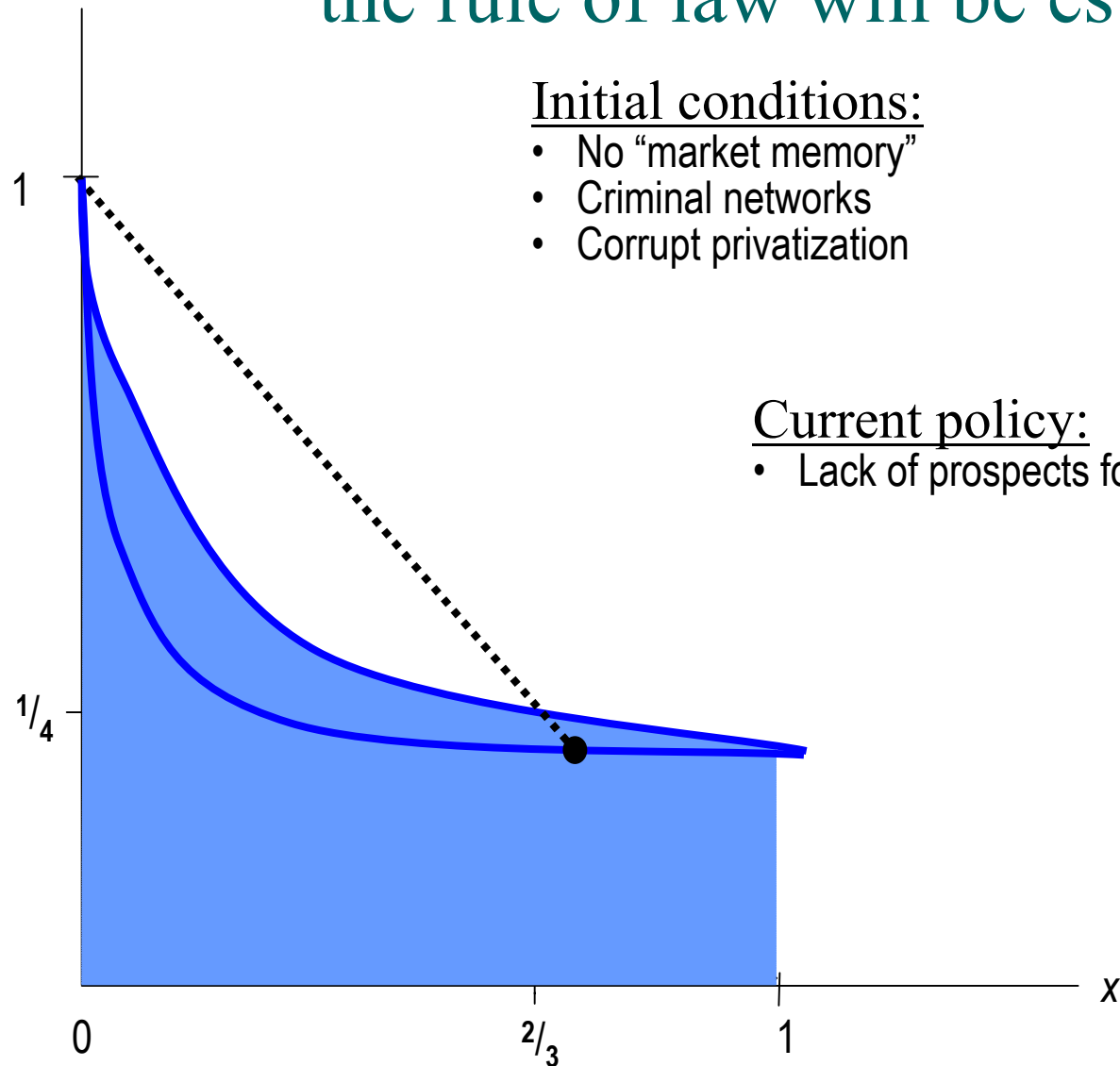
Unique stable equilibrium



← Increasing support for the rule of law

A shift down in expectations that the rule of law will be established

Payoffs



Initial conditions:

- No “market memory”
- Criminal networks
- Corrupt privatization

Current policy:

- Lack of prospects for EU accession

← Increasing support for the rule of law

Summary of the ecological/social interactions perspective

•depend on,
•shape &
ultimately
•may make
traps of

Agents' decisions

the environment

Rely on social networks or markets

search costs

Behave honestly or corruptly

Social reward for honesty

Be punctual or not

Invest in education (by a stigmatized worker)

Lesson of the economics of coordination failures



"The task of ... finding out which combination of activities should be coordinated is not unlike the problem of hundreds of people, scattered in a dense, foggy forest, trying to locate one another. ..even the market mechanism cannot solve it ..." Matsuyama 1995

Culture is a “navigational tool” which influences outcomes.

Results from the laboratory

1. Median treatment:

Investment levels always converged to the *initial* realization of the median. It was usually inefficient.

→ Relation to Russia: History-dependent learning.

2. Minimum treatment:

Investment levels always approached an equilibrium *below* the initial outcome, and quickly approached the lowest possible outcome

→ Relation to Russia: When behavior of a small number of agents has a large effect on outcomes, the lowest risk, but worst Nash equilibrium, is the outcome towards which the system evolves