

## *Economic Growth and Human Development with Capabilities Expansion*

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Abstract:

The underestimation of social effects of sustainable development arises from the neglect of crucial variables in analyzing development. The role of economic growth and institutions in development is neglected in Sen's influential alternative concept of development, quality of life and other versions in terms of expansion of capabilities. During the growth process there is economic transformation which is multidimensional. Growth and development could go together or one without the other. During this process, public policies play a vital role (within an appropriate institutional framework). But the institutions are usually taken for granted, just as growth is taken for granted in discussing development and the quality of well being in terms of capabilities expansion. People with institutions promote and generate growth and development within a socio-politic-economic system, which people build and may also change with the process. The paper shows why poverty and other ills may persist during growth and suggests the inclusion of the missing variables in the analysis of (human) development with capabilities expansion.

### **1) Introduction:**

The concept of development has evolved from simply regarding quantitative changes in GDP or GNP or per capita income through UNDP human development with other versions to broader concept of development. Human development concept regards the people as the goal of development. According to UNDP, development is the enlargement of the people's choices to lead valuable lives as they choose to (HDR 2002). Yet basic to expanding human choices is developing individual's capabilities for what s/he can do or be. All these different concepts are concerned with the improvement of well-being of individual or people with growth as a key factor. Technological change is central to economic growth just as growth is crucial to development. All these depend on institutions.

The neoclassical economics provides a friction free environment as well as easy flow and movement of resources with efficiency as the main objective. Development as expansion of capabilities is also built on such environment. The institutional features are missing. Or there is a fundamental assumption that institutions are well developed and function very well, and therefore capabilities expansion could take place easily. In this paper we bring out and stress the importance of institutions in the development process, which includes growth and capability expansion. The paper's main argument is that institutions make a great difference in development which includes capabilities expansion.

Institutions create also the environment for the proper functioning of the socio-political-economic life of societies and economies.

Without proper institutions, societies would not develop in terms of capabilities expansion. This has been the difference between developed and developing countries where institutional differences have been very significant. In the rest of the paper, we discuss growth and development in section two. In section three, Sen's concept of development in terms of capability expansion is examined. Section four focuses on institutions, and brings out transaction and transformation costs which are discussed in section five. Lastly, we conclude in section six, with emphasis on the role of institutions on technology, growth and development.

## **2) Development and Growth:**

Economic development is a process of quantitative expansion as well as qualitative changes in factors such as institutions, organisation, culture etc in an economy or society. Economic development involves the distribution of income or wealth towards equality, sectoral distribution of income, and employment changes with increase in employment opportunities, positive changes in environment and production techniques or production methods accompanying economic growth as well as expansion of capabilities according to Sen's. Economic development leads to improvement in the quality of lives of the people.

The main objectives of development are to i) improve the living standards of the people including raising incomes, creating jobs, providing better health and providing more and better education ii) increase not only the availability but also the improvement as well as distribution of food, shelter, health, education, protection etc. iii) expand the range of socio-econ choices available to the society and individuals. People are ends and means of development, hence development should be seen as quality improvement in people's lives such that it is equitable intra and inter generations, and consistent with human freedom – human freedom as defined by the people within a society.

A component of development is Economic growth which refers to quantitative expansion of economic aggregates such as gross domestic product (GDP) or income per capita or aggregate society endowments. Economic growth is an important part of economic development as well as a basis for development. Sustained output expansion or economic growth is central to economic development. Economic growth is based on the appropriate human capital formation shaped by institutions.

The neoclassical growth model assumption of diminishing returns in physical capital implies that as capital accumulation increases the marginal product of capital ( $a_K = MP_K$ ) tends to zero. In the long run as the  $MP_K$  is zero, the total factor productivity or technical progress and the growth rate of labour (as well as human capital) determine the rate of growth. Yet in the short run a high rate of capital accumulation generates a higher output; while technical progress and human capital can sustain high growth rate in the long run. Capital accumulation is therefore important mainly in the short run. Hence human capital and technological progress are the basis of growth and development.

$$Y = Af(L,K)$$

And in growth rates the equation becomes

$$g_Y = g_A + a_L g_L + a_K g_K$$

as  $K \Rightarrow \infty$ ,  $a_K = 0$  and then  $g_Y$  is influenced only by  $g_A + a_L g_L$

That is growth becomes a function of technology and human capital. This also invalidates the constant return assumption. More so introducing institutional variables would affect output due to human and physical capital in both equations. In general there is, therefore, a strong focus on technological development and human capital accumulation. Technological progress arises from human capital accumulation. It is promoted by deliberately increasing resource utilisation and investing in people. Increase in human capital accumulation increases the stock of technical knowledge and in turn raises the productivity of productive units. Technological progress also generates increases in productive resources. Technology increases economic resources and consequently

increases in productivity and output. Higher productivity increases depend on a flexible labour force with ability to change. The incentive structures determine the level or size of investing in the inputs or factors that promote growth and development.

It is now generally agreed that a well trained, skilled labour force or work force is necessary for socio-economic development of any society or country. Educational productive value is a function of educational level, the subjects studied, and the training relevant to the occupations and the economy. This means that the labour force with higher level of educational qualifications may not necessary generate economic growth. This may be because of the content of education may not be relevant to the needs of the society. How do institutions promote the efficient implementation of new technologies? The right institutions would create the appropriate educational system and consequently generate the relevant educational output. The development of the stock of scientific knowledge, within a conducive environment, has been a fundamental source of growth. Socio-politic-economic institutions and organisations have constantly been restructured in order to capture the rewards of technology which is embodiment of scientific knowledge.

There is a general agreement that economic growth is essential and the form of economic growth matters for the improvement of well being. The right kind of economic growth depends on the right policies. The policies that ensure the right types of growth would depend on the socio- politic-economic institutions that formulate and implement the policies. Institutional relationship with growth may mean that there is causality in both directions: good institutions generate growth and good growth produces good institutions.

### **3) Capabilities:**

Sen's concept of development is based on capability with capability being the ability and potentials to do and to be. Development according to Sen is the quality of life in terms of capability expansion. That is the expansion of valuable capabilities – broadening of the set of valuable beings and doings an individual can achieve. Development is the freedom

to achieve valuable doings and beings (functionings). Functionings are ends of human life and they can also be means to human life. Functionings are parts of a person's state of being or doing in leading a good life. Capability gives the combinations of functionings achievable by an individual. It is a set of functioning that reflects the freedom of an individual to make choices of possible livings desired by the individual. Capabilities include endowment, individual capacity and social opportunity which in turn impact on capability and are capable of being developed.

These components are complementary and reinforce each other. Endowments are at individual, household and societal levels, with capability at individual level and social opportunities at societal level. The economic, social, cultural and institutional environment plays a key role in people's lives more so for development of these capabilities. They may impact on personal capabilities and change their opportunities. Sen's capabilities approach explains development as freedom and 'capability to function'. That is "what we can do with what we have". From Sen's approach there are three core values of development, which are sustenance-the ability to keep individual alive, self-esteem and freedom from servitude and poverty.

According to Sen, freedom per se matters but there is implication that the means of having the freedom may not matter. Sen's notion of development as capability expansion has been criticised Diziilbash (1996), for example, argues that capability expansion may include impoverishment of some lives and can be achieved through vicious means. The ways in which expansion of capabilities are achieved may be objected to partly because the means may be anti-social. That is, the means of achieving objectives are important and should be considered, just as well as the ends. Sen does not seem to take this into consideration. Sen neglects incorporating negative freedom into his analysis.

Also the relevant list of functionings and capabilities is ill defined. Some items included as valuable functionings could be ability to steal, ability to destroy self or others which should not be included. So how to achieve a good life is not well explained. Enlarging the

number of capabilities may not be what the concept of development should be. More capabilities may not mean a better quality of well being.

An individual may try to expand his/her capabilities in order to attain a given quality and combination of good education and health which promote well being. That is certain quality and combination of functionings are needed to achieve a given level of well being. Hence some specification of the type of life an individual lives is needed. Nussbaum (1988) brings out the issue of negative freedom and distinguish between internal and external capabilities. She shows that external capabilities influence the exercise of internal capabilities. But she rules out vicious capabilities and stresses on virtuous capabilities for correcting functionings, since certain capabilities are needed to function correctly and live virtuously.

Different cultures within different contexts may provide different conditions for functioning and developing capabilities. What is regarded as correct functioning may not be the same in some cultures; since functioning may differ from culture to culture. Values cannot be measured and so cannot be compared. In discussing development in terms of expansion of capability it is not possible to say anything about development when expansion or contraction in capability occurs in a given situation. This is partly because one's capability cannot be compared with that of another person's. Interpersonal comparison of capability is not possible. We cannot also compare one's loss with that of gain of capability, since capability is not measurable.

But appropriate institutions can define the different parameters for development especially in Sen's sense and also guide against dubious means of achieving objectives or ends. What creates or who develops the conditions or environment for the expansion of capabilities? The institutions and policies are designed by people and people implement policies based on the institutional framework. It is institutions that create the necessary conditions and environment for individual or persons to live flourishing lives.

Well functioning institutions create appropriate environment for the expansion of individuals' capabilities to be and to do. But with weak institutions people's ambition can be damped and thus induced poverty which can make people feel that they cannot fulfil their desires. People may just be contented with their lot or the poor situation. But it seems when people are properly informed and educated they tend to have legitimate expectations, and with more information expectations may change. With proper functioning institutions, these problems would not exist. Institutions would provide good infrastructures, employment, information, education flourishing economic activities. So institutions are necessary to create the appropriate environment for individuals to function properly and attain their expectations and objectives in life.

#### **4) Institutions:**

What are institutions and what are the roles of institutions? Institutions could be socio-politico-economic institutions which are public, private, formal or informal. Institutions provide rules, norms and their enforcement characteristics/mechanisms. Institutions provide and enforce the rules of the game which include incentives and disincentives on behaviour. The institutions also create the incentive structure of a society or economy. They determine also the transaction and transformation costs of the economy. Institutions set the rules of the game with organisations and people being the actors. The institutions and organisations may change with the incentive structure. Institutions create favourable environment for socio-politico-economic activities to be carried out. Such an environment is prerequisite for productive transformation and capability expansion to take place in any economy particularly a developing economy.

The institutions and political processes shape policies. Institutions play a key role in the development process. Country institutional differences and quality of institutions affect technical progress. The rate of technical progress is not constant across countries; it would depend on institutional differences. Quality of institutions would affect production. This would then affect the efficiency of investment particularly in technology, physical and human capital, and development. In countries which are developing, there is a

threshold level of infrastructure, education, property rights etc, which is sensitive to institutions. These are required before a feasible production level and capability expansion could occur.

Institutional framework is integral to cost of transaction, production and transformation in the production process. Institutions that generate high cost of transaction and transformation would tend to affect investment negatively. The quality of institutions has impact on growth particularly through investment effects. Good institutions would define and implement the rules and regulations for the performance of the different activities and provide the necessary incentives for socio-politico-economic activities in the society or economy.

Institutions are a key to development outcomes such as economic growth and human capabilities expansion. Institutions create the environment for the i) efficient functioning of economic markets consequently increase output growth, ii) socio-political freedoms of people and iii) equitable and fair society with well established democratic governance. People may be poor and have restricted capabilities because they may lack the political power. The right political –socio- economic institutions can empower the people with basic will and political freedoms, make them able to fight for their rights and sustain also the institutions. The right institutions create the enabling environment for the expansion of capabilities and promotion of socio-politico-economic progress.

#### **4.1) Institutions and Well Being:**

Differences in well being or living standards among countries and differences in the ability/capacity for people to improve in their well beings tend to strongly depend on the differences in the institutions and policies among countries. Institutions are the major determinant of ability/capacity of people in countries to innovate, adopt, organise and manage their economies and societies. In a given institutional framework, individuals or group of persons formulate and get policies implemented. It is within the institutions that policies are set. This, among other things, creates the enabling environment for

individuals to expand their capabilities. Institutions also create new opportunities and enhance ability to exploit these opportunities. While this seems to be so clear, there tends to be no simple relationship existing between economic performance and political regimes which create the institutions. There is evidence to show that countries having almost the similar political regimes tend to have completely dissimilar outcomes. They may not produce similar institutions. Yet their living standards may be at similar levels. This can be observed from the socio-politico-economic variables of developing countries and developed countries with their respective institutions. Indicators of the performance of countries are reflected in the differences in per capita income, differences in growth rates, and differences in living standards. The growth rates fluctuate or are unstable more in developing than in developed countries. Some rates or levels of per capita income are too low for persons to survive.

#### **4.2) Dynamics of institutions :**

Institutions must always adapt themselves to the changing conditions and environment. Institutions have to change or evolve to keep abreast with the technological progress to achieve the best possible results. But the institutions changing are hardly in tandem with technology mainly because of different levels of inertia in their changes. The mismatch has tended to be the greatest hindrance to economic growth and consequently development in many parts of the world – particularly in the developing world. Output growth depends on the types of institutions and organisations in the country or society. In a world with new technological development, institutions and organisations must always be restructuring themselves in order to remain competitive. The world is becoming more and more interdependent and complex because of increased specialisation and division of labour. Potential gains from exchange in such environment would be well secured when an institutional framework permits trade over time and space. Yet this type of institutional matrix is not attained in some societies and so they fail to capture potential gains of exchange or trade. And therefore fail to experience economic growth and development.

### **5) Transaction and Transformation Costs ©:**

Transaction costs include information, coordination, search, measurement, negotiation, transportation and enforcement costs. Costs of physical production are included in transformation costs. These costs became quite important especially with the complexity of the interdependent parts of the economy, but through institutions technology has reduced much of the costs. This occurs in many aspects of the economy and society. Take a few of these examples. Problems of costly principal/agent relationships as well as organisational problems emerging from new technology usage are resolved by the right and well functioning institutions. Because of institutions the principal can monitor the agent's discretionary behaviour across time and space. In this light, institutions have created sophisticated methods in accounting and auditing and more elaborate ways of monitoring agents. Institutional innovations have also transformed uncertainty risks through insurance and portfolio and with much variability reduced through hedging. Countries with good institutional framework and political stability are usually a crucial determinant for a vibrant financial market.

The institutional framework should be such that there is strong property protection and contract enforcement. The rule of law is well respected with the citizens easily using the legal system in enforcing their contracts and mediating their disputes. Institutional development may be based on proper governance, accountability to the people, political stability, government effectiveness, high regulatory quality, respect of the rule of law, good control of corruption etc.

In general productivity improvement has been an outcome of lowered transaction and transformation costs, as well as the application of technology. The institutions that have reduced these costs have improved the technologies. The institutional framework determines the transaction and transformation costs and the extent of success of an economy. This would also give the productivity implications with a given technology. There is much evidence to show that there have been much productivity gains from technologies where property rights have been properly specified and enforced, where

socio-politico-economic decision making has been in place with effective competition. All this has been based on good institutions. Flexible institutions are adaptive to efficiency. Basic institutional framework has promoted the development of socio-economic organisations and encouraged creative entrepreneurial talent.

## **6) Conclusion:**

Institution structure of a country may be the same over time such that one can describe the institutional variables as exogenous to growth. This may be the case of developed countries where the institutional variables may hardly change drastically. In the case of developing countries the quality of institutions changes often and sometimes drastically for the worse. The institution may deteriorate during period of low growth. This may be due to political instability or simply due to policy reversal. Policy formulation and implementation are strongly influenced by institutions, which may be created by political regimes. Institutions, with proper incentive structure determine the economic performance.

Throughout human existence, economic growth (as a basis for development) has been achieved because of institutional and organisational structure that has greatly induced increases in valuable and productive activities. Institutions have also reduced societal friction and conflicts. Economies fail to carry out the appropriate activities with high payoff because of the type of institutions they possess. Institutions resolve frictions and conflicts which economy theory tends assume away. Yet they are crucial for meaningful activities to take place such as individuals expanding their capabilities. People in a society or economy impose institutional structure on human interaction. The institutional structure defines the incentives and constraints which determine the performance of economies across time. The state and people are major players in developing and establishing institutions. Hence development as a function of technology, physical and human capital has to take place within proper functioning of institutions.

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