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Economic Systems and Institutions

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ABSTRACT
This paper focuses on a short review on the literature of institutions and economic systems, and the relationship between them. The institutions play a significant role in the economic development of a country. The study also focuses on the role of institutions in determination of financial prices, rate of return and social capital incorporated in a system. Protection of property rights, enforcement of effective law and efficient administration, as well as a variety of norms and civic mores, have all been related to greater economic performance over time. The results of this study can be utilized in the research of institutional economics, as they focus on bringing together different types of coordination systems in market economy.

KEYWORDS: Institutions, Economic Systems, Capitalism, Socialism, Property rights

I. INTRODUCTION

According to cross-country empirical assessments paired with micro-level studies, institutions are enormously significant in anticipating the stage of progress in countries around the world (Daron Acemoglu, Simon Johnson, 2001); (Cavalcanti & Novo, 2005). Property rights protection, effective law enforcement, and efficient administration, as well as a variety of norms and civic mores, have all been related to greater economic performance over time. The goal of this essay is to highlight the importance of institutions in economic development and to support the arguments made. It asserts that institutions support economic development by influencing the price of financial transactions, the appropriability of rate of return, the degree of exploitation and confiscation, and the extent to which the setting is favorable to cooperation and increasing social capital. Literature, country analyses, and micro-level examples provide proof.

What direction should the economic systems profession take? What are the future directions of economic systems research? After the former socialist economies of Eastern Europe and the Soviet Union collapsed, these questions arose frequently. Because these socialist economies have vanished, research into them has become a historical study with little relevance to contemporary issues. For some time, the former socialist economies' transition processes have provided important research topics, attracting some economists from other fields to the field of transition economists such as (Zilibotti et al., 1999); (Aghion et al., 2020). However, most East European economies are nearing the end of the transition process, and research topics on transition policies, such as privatization and liberalization, appear less frequently in academic publications after these policies have been implemented.

It's also worth noting that political economy is subdivided into a subfield within capitalist systems. In the preceding classifications, one word appears several times: systems. Furthermore, five words appear to explain the study's objects: capitalist, socialist, transitions, institutions, and comparative. The objects of the study are capitalist, socialist, and transition, and "comparative" is a research method and thus not unique in and of itself. As a result, the remaining two words—systems and institutions—appear to be the most important concepts that can distinguish the field from others in economics (Kim, 2012).

II. LITERATURE REVIEW

In the following section, we will discuss the theoretical aspects of the economic systems and the institutions, the role of institutions in the economic systems and the relationship between the two. The thorough literature for this paper is gathered from past literature, published papers and books.

Economic Systems

Economic systems, according to (Stuart et al., 2003), are described as a set of methods and organizations for making and implementing decisions concerning production, income, and consumption within a specific geographical area.

Work on economic systems has been addressing the question of what mechanisms and institutions lead individual economic behavior to achieve socially desirable outcomes since the beginning of economics. This was the central question addressed in Adam Smith's 1776 book, The Wealth of Nations, which marked the beginning of modern economics. Because Adam Smith was both an economist and a philosopher at the time, economics and philosophy were closely linked. The Wealth of Nations is made up of six books in which he covers a wide range of topics, from the causes of economic growth to economic policy debates (Kim, 2012).

Capitalism was dubbed "the system of natural order" or "the system of perfect liberty" by Adam Smith. The main concern of scholars in the 17th and 18th centuries was how to reduce conflict between the pursuit of one's own self-interest and the welfare of society as a whole. Some philosophers warned that individuals' unrestrained pursuit of self-interest would lead to the destruction of society (Bradley, 2010). As a result, they contended that such a pursuit required the control of a central body. Tomas Hobbes was a well-known scholar who followed this line of thought. In his book Leviathan, he claimed that in order to avoid a "war of all against all," each person should voluntarily delegate his or her right to a strong central authority.

The claims made above were rejected by Adam Smith. According to Adam Smith, the welfare of society is increased not by personal vices, but by individual self-interest. Self-interest, according to Adam Smith, is the love of oneself without harming others, whereas selfishness is self-love that undermines the interests of others. For example, a butcher's pursuit of profit by selling meat has no effect on other people's property or bodies, and thus can be considered self-interest. Through the invisible hands of self-interest, economic growth is generated. Although the term "invisible hands" appears to be a more theological term in his books, he uses concrete examples of the price mechanism and wage determination to illustrate this invisible hand (Mikkelson, 2021).

Karl Marx's understanding of capitalism was diametrically opposed to Adam Smith's. He contends that human beings' pursuit of self-interest leads to class struggles, increased income inequality, resource underutilization, and business cycles. As a result, he believes that coordination through central planning and public ownership, rather than the market mechanism and private ownership, should be the essential foundation of a new economic system, namely socialism. High economic growth and social equity would be guaranteed if economic agents followed the instructions provided by this central planning. In this way, following central planning instructions in socialism substitutes for self-interest in capitalism (Fiuza, 2016).

The collapse of socialism indicates that the socialist economic system is not long-term sustainable. It had achieved some success in the early stages of economic development, primarily through the forced mobilization of inputs. However, economic agents did not behave as Karl Marx predicted: they pursued their own self-interests rather than simply following central planners' instructions. As the economy became more complex, the principal-agent problem became more prevalent in the system as a whole. Corruption, a lack of transparency and fairness, and a lack of democracy all contributed to a decline in institutional quality ((ATO) et al., 2012).

Socialism was a large-scale experiment in establishing an alternative economic system based on state ownership and central planning. The failure of this experiment after only eighty years suggests that any economic system that does not take into account human self-interest and lacks proper coordination mechanisms is not long-term sustainable (Chattopadhyay, 2021). As a result, one can conclude that no coordination mechanism can successfully replace market-based coordination based on private property rights.

The preceding discussion points in the direction of future economic system research. To begin, research should focus on a market economy rather than a socialist or other economic system. A sustainable economic system should be based on the human instinct of self-interest, private property rights, and markets. These three elements are so important that a lack of any of them would result in a failure of economic outcomes (Raman & McClelland, 2019). Furthermore, they reinforce each other and should be treated as a package: combining one or two of the three with a different element, such as market socialism, will fail.

Second, the variety of capitalist economies is an exciting research topic. As previously stated, economic systems are primarily concerned with coordinating institutions that link agent behavior to aggregate economic outcomes. In terms of coordinating institutions, capitalism and socialism are diametrically opposed, but there are various versions of coordinating institutions within capitalism and socialism (Bowden & Goldblatt, 1999). In other words, it is entirely possible that there are various capitalist economic systems with primarily market-based but distinct coordinating institutions.

Economic system research will survive and possibly thrive as the economy becomes more specialized and complex. When the economy reaches a higher stage of development, several causes of market failure tend to intensify. Specialization is associated with economic development, which increases asymmetric information. Asymmetric information can stymie market formation and growth (Sloman, 2006). As we saw during the 2008 financial crisis, an information gap between businesses and a government regulator can have serious consequences. Because agents are more interconnected than ever before, externalities can occur more frequently. The tragedy of the commons may be linked to agent specialization and interconnectedness. In other words, when the economy expands, self-interests may diverge from public interests, implying that there would be a greater requirement for understanding economic systems. Of course, an expert in each economic subsystem, such as a financial economist, can deal with unique market failures in financial markets (Kopp et al., 2017). Experts in economic systems, on the other hand, can add to the debates by bringing a broader understanding of the subsystems. Because of the linkages between subsystems, this skill will become more relevant.

Institutions

Institutions are defined by (North, 1991) as "the rules of the game in a society, the consciously constructed limits that influence human interaction." They shape human transaction incentives, whether they be political, societal, or economic." Contracts and collateral requirements are examples of institutions, as are protection of property rights, the legal system, governmental institutions, and financial markets. Educational practices and attitudes, conventions, social cleavages, and traditions are also included (so-called informal institutions) (North, 1991). As social standards in the domains of gender, class, and caste, for instance, ascertain rules of political participation in political, economic exchange methods, and the participation of various groups in society, institutional structures are usually the formation of informal institutions (Thompson et al., 2018).

“The state is the institution of all institutions”, according to (Chang, 2011), highlighting the significance of institutions in structural change and progress. However, this viewpoint differs from that of (Acemoglu & Robinson, 2005) and other formal economic analysts. We demonstrate that "strong" institutions, such as property rights, may only cause structural changes if they are properly implemented, and that this is dependent on the type of economic structure. Even if they are put in place, there is no reason to assume that the new market mechanisms and economic model will be conducive to long-term growth. The effects of structural change on growth are unknown.

Property rights, the law and order, and money are administrative institutions that facilitate exchange within a certain economic framework. Despite the fact that property rights have a considerable effect on output, (Goldin & Reinert, 2007) notes that they are largely used to facilitate arbitrage. According to (Haustein et al., 2008), the background of invention is mostly determined by governmental support and chance rather than the application of patent rules (property rights). Trade policies (tariffs, subsidies, and so on) are production institutions that promote structural changes while fostering growth.

Douglass North's seminal publications emphasized the relevance of institutions in economic development (North, 1991). Two reasons have contributed to the revival of interest in institutional economics. First, the transition process of Eastern Europe's former socialist economy led to the conclusion that institutions played critical roles in transition performance (Djankov et al., 2003). Second, empirical studies have shown that institutions are a key predictor of long-run growth. (Daron Acemoglu, Simon Johnson, 2001) is one of the most commonly mentioned studies among these.

The transition of former socialist countries to a market economy, which began in the late 1980s and early 1990s, was supposed to boost economic efficiency. It was even predicted that economic conditions would improve practically immediately when the changeover began. However, such an anticipation was not met because, at least in the early stages of the transitions, all of the transition economies witnessed a sharp drop in output. Despite the fact that a recovery process began following a transition recession, significant variations in output patterns were seen across economies. Why was there an unexpectedly sharp drop in output during the changeover period? Why were there such large disparities in economic performance among transition economies?

A variety of factors were proposed and empirically examined, and two things became obvious as a result. For starters, establishing a functional economic system takes time, especially because the market economy necessitates the establishment of supporting institutions. Institutions, on the other hand, such as property rights, contract enforcement, and a coordination mechanism, emerge in an evolutionary fashion. Second, changes in institutional quality appear to account for at least some of the variation in economic performance observed in transition economies. Of course, prior to the fall of the communist economies, structural reforms, political restraints, and economic development all had an impact on output trends, but these elements were influenced by institutional quality.

Economic development organizations reduce the costs of economic activities. Among the costs are transaction costs such as research and information costs, settlement and resolution costs, and monitoring and enforcement charges (Coase, 1995); (Dahlman, 1980). They lower transaction costs by identifying mutual legal frameworks (for example, contracts and contract enforcement, corporate conventions and rules), and they build confidence by building policing and judicial systems to fully comply with common laws and regulations. Communities in LDCs sometimes rely on personal or ethnic and religious relations systems to ensure conformity with common rules and regulations when it comes to trade. Communities in LDCs frequently rely on familial, ethnic, and religious ties for trading.

However, cultural relationships are inadequate to capitalize on economic prospects with different groups and expand the scope of business interactions. More information on trading partners is needed, as well as institutions which assure agreement on exchange terms and conformity with agreed-upon criteria. Contracts, behavioral guidelines, standardized scales and measures, transparency agreements, and enforcement by courts and authorities are examples. Private contract compliance may still be preferred where transaction costs are low. However, as commercial transactions become more impersonal, the role of a third party in enforcing prudence becomes increasingly vital (Shirley & Padgett, 2006).

Such institutions increase the possibility that the cost of participation in a financial transaction will be offset by total appropriation of the transaction's future benefits. This includes individual private property rights. Individuals are more willing to invest and suffer sunk costs if their property is secure. (Pande & Udry, 2009) show that when individual views of land tenure security are poor, investment in land falls precipitously, and productivity suffers as a result. In actuality, there is no change in levels of funding because security of tenure is assured in the few cases where land is acquired through contractual relationships (as opposed to the old informal system of land redistribution). This increases output and, as a consequence, economic development.

Relationship between Economic Systems and Institutions

The economic systems and the Institutions comprise of property rights, coordination and information mechanisms, decision-making framework, and incentives. The key parts are property rights and mechanisms of coordination and information, because the other two can be derived from these two. We highlighted the significance of the coordinating mechanism as the most important research topic in the field of economic systems since the degree of reliance on market mechanisms varies significantly, even between market economies. This contrasts with property rights, which do not vary greatly between market economies.

Protection of property rights implies a greater role for state power. Groups and individuals give up some of their liberty in exchange for state protection; they pay charges and taxes to cover security costs, and the government has a monopoly over the use of force for public safety (Horritt & Bates, 2001). However, there is a risk that states with the capacity to enforce property rights will also expropriate property. This elevates the risk of business interactions rather than diminishing them. As a result, property rights are inadequate to drive economic growth and must be regulated by institutions that limit the extractive ability of state power. These are typically characterized by autonomous assemblies and judiciaries. Democratic institutions with political clout play an important part in this (Rodrik, 2001).

As a result, institutions dictate the degree to which participants in positions of authority can privatize the economy's assets for their own gain. Unequal institutions hinder development by limiting people's capacity to access resources, increase production, and increase their incomes. A review of country development paths demonstrates that institutions that enrich elites and allow them to take resources and products have exacerbated underdevelopment.

Countries that have had colonial control are more likely to be affected by such extractive institutions. They have outlived the independence of these countries, and their power has been completely taken over by local leaders. There are various examples of societal repercussions that may be followed back to decades-old institutional frameworks.

Political Power in Economic Structure

Economic structure determines wealth distribution, which serves as the foundation for legal state and autonomous state political authority. By maintaining institutions that promote the production structure, the obtained political power is used to perpetuate income distribution. Finally, the economic structure determines the rate of economic growth. This is the essential process for the reproduction of organizations, political power, and economic institutions.

Throughout structural transitions, the distribution of wealth, direct rule, and enforced political authority vary, permitting the establishment of new institutions to regulate the new economic structure. When the state effectively enforces production institutions, systemic changes that promote growth are noticed (Zubiaurre et al., 2016). This has the potential to catalyze democratic revolutions or stabilization, as well as accelerate the transfer of technology all across the economy. In contrast, many regions of the world are facing financial slowdowns, accelerations, and crises, and these economies are often embedded in democratic democracies. Their inability to establish democracies and provide a solid platform for economic advancement is a result of their falling returns economic structure.

Role of Institutions in Economic Structure

There is strong proof that institutions play an important role in affecting a country's level of economic growth. Cross-country studies show that metrics such as the amount to which property rights are protected, the law system, and civil liberties are strongly related to economic performance. This essay has described why institutions are so important for economic advancement and has provided facts to support its claims. It has discovered four broad paths that could explain the relationship. Displayed the costs of economic transactions: they support growth by promoting contracts and contract enforcement, standard industry rules, and improved information availability, all of which reduce transaction costs, risk, and uncertainty.

Developmental institutions support expanded self-expression, the free information flow, and the formation of unions and clubs. These establish profitable social ties, which in turn promote increased economic contact by increasing confidence and making information more freely available (Putnam, 1994). They allow for better resource distribution through democratic institutions and the use of the state to reduce the risk related to economic activities (Bardhan & Mookherjee, 2006). The social welfare system is an important component of an institution that has pooled resources to minimize the negative effect of business cycles on incomes and unemployment. They are the ones who will most likely shape the outcomes.

Institutions assess the extent of expropriation in terms of return on investment: property rights protection and the judicial framework encourage investment, which raises income. The propensity for elite persecution and resource expropriation is also influenced by systems: unequal institutions that enable ruling elites to dominate economic trade severely impede development, as seen in many former countries. Finally, institutions have an impact on how conducive the climate is to collaboration and increased social capital; open and interconnected institutions promote flow of information and the degree to which assets can be pooled to reduce risk and ensure protracted levels of income (Johnson & Lybecker, 2011). This correlates to historical studies' results that high-quality institutions in ancient history are now grounded in more justice, political competition, and collaborative norms. Institutions have a huge effect on a country's economic growth because they define the contexts within which socioeconomic interaction occurs at all levels of society. They determine the quantity of available encounters, the benefits of economic transactions, and the structure they can take.

III. CONCLUSION

This brief article presents perspectives on research directions in the field of economic systems and institutions. Despite the fact that the old subject dealing with the communist economic system has passed into history, the subject will survive and possibly thrive. This research proposes two explanations for this prediction. For starters, there will be a greater demand for a clearer idea of economic processes. Economic systems are organizations that connect individual economic conduct to aggregate societal effects. Although markets are the primary organizing institutions in a capitalist economy, they can fail in a variety of ways. Economic system research is supposed to improve our knowledge of why markets collapse and what treatments are available to correct or alleviate the problems. Economic system researchers will have competence in coordinating institutions across diverse sectors of the economy, allowing them to contribute to a better knowledge of the capitalist system as a whole.

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