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The Studies of Economic Systems and Institutions: Some Views on Future Directions[1]

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Abstract: This paper discusses the future directions of the studies on economic systems and institutions. It suggests that research on economic systems should focus on the various forms of coordination mechanism within a market economy. The evolution and performance of different coordination mechaisms as well as cross-country and cross-institutional comparisons are some examples. In addition, institutional economics is viewed as an important avenue for expanding the field of economic systems. The suggested themes include the roles of transaction costs and culture in institutions as well as institutional embeddedness and complementarities.

Keywords: economic systems, institutions, coordination mechanism, capitalism, socialism

JEL Classification Numbers: P11, P21, P36, P51

1. Introduction

Where should the profession of economic systems go? What are the future directions of research in the field of economic systems? These questions have been raised frequently after the collapse of the former socialist economies in Eastern Europe and the Soviet Union. The disappearance of these socialist economies means that research on these economies became a matter of historical investigation withlittle relevance to contemporary issues. For some time, the transition process of the former socialist economies has provided important research topics that have attracted some economists from other fields into the field of transition economists (See the examples of Olivier Blanchard, Philippe Aghion, and Stanley Fischer, to name a few). However, the transition process is nearly over in most of the East European economies, and research topics on transition policies, such as privatisation and liberalisation, appear less frequently in academic publications after the completion of these policies.

According to the *Journal of Economic Literature (JEL)* Classification Codes, there are eighteen classified fields in economics and two unclassified categories. The category of economic systems is one of the eighteen fields in economics. Within this category, there are five subfields: capitalist and socialist systems, transitional economies, socialist institutions and their transitions, other economic systems, and comparative economic systems. It is also interesting that the political economy is further classified in a subfield within the subfield of capitalist systems. One word—systems—is repeated several times in the above classifications. In addition, five words appear to explain the objects of the study: capitalist, socialist, transitions, institutions, and comparative. Among these words, capitalist, socialist, and transition are the objects of the study, and "comparative" is a research method and thus not unique by itself. Hence, the remaining two words—systems and institutions—appear to be the most important concepts that can differentiate the field from other fields of economics.

This paper attempts to suggest some future directions for the study of economic systems. In doing so, it discusses the main research topics that can be analysed in the literature on economic systems and institutions. In addition, it looks at the relationships between economic systems and institutions. I will discuss the findings of some important papers related to this field. However, this paper is not an exhaustive literature survey but is rather a small paper based on some selected research outcomes. Furthermore, it does not intend to be a scientific enquiry, but contains personal views in order to facilitate discussion on the research directions of the field.

2. Research on economic systems

From the beginning of economics, works on economic systems have been dealing with the question of what mechanisms and institutions lead individual economic behavior to achieve socially desirable outcomes. This was the key question analysed in Adam Smith's *The Wealth of Nations* in 1776, by which modern economics started. In his time, economics was related to philosophy, since Adam Smith himself was not only an economist but also a philosopher. *The Wealth of Nations* consists of six books wherein the topics he dealt with are comprehensive, ranging from the causes of economic growth to debates on economic policy.

Adam Smith called capitalism 'the system of natural order' or 'the system of perfect liberty'. The main concern of scholars in the 17th and 18th centuries was how to reduce conflict between the individual pursuit of their own self-interests and the welfare of society as a whole. Some philosophers warned that the unfettered pursuit of self-interests by individuals would lead to the destruction of society. Hence, they argued that a central body was required to control such pursuit. A prominent scholar following this line of argument was Tomas Hobbes. In his book, *Leviathan*, he claimed that each person should voluntarily delegate his or her right to a strong central authority to avoid a 'war of all against all'. In his poem, entitled the 'Fable of the Bees', Mandeville also maintained that the economy would grow only through immoral behavior of the residents.

Adam Smith rejected the above claims. According to Adam Smith, the welfare of society increases not through personal vices but through individual self-interest. Adam Smith regarded self-interest as the love of oneself without harming others, whereas selfishness refers to self-love that undermines the interests of others. For example, a butcher's pursuit of gain by selling meat does not affect the property or the body of others, and thus it can be considered as self-interest. This self-interest generates economic growth through invisible hands. Although invisible hands appear to be a more theological term in his books, he illustrates this invisible hand using concrete examples of the price mechanism and wage determination.[2]

Karl Marx's understanding of capitalism was in stark contrast to that of Adam Smith's. He argues that human beings' pursuit of self-interest results in class struggles and increases income inequality, underemployment of resources, and business cycles. Hence, according to him, coordination by central planning and public ownership instead of the market mechanism and private ownership, respectively, should be the essential basis of a new economic system—namely, socialism. If economic agents follow instructions given by this central planning, high economic growth and social fairness would be guaranteed. In this way, following the instructions of central planning in socialism substitute for the pursuit of self-interest in capitalism.

The collapse of socialism suggests that the socialist economic system is not sustainable over the long term. It had achieved some success at the initial stage of economic development mainly by forced mobilization of inputs. However, economic agents did not behave as Karl Marx expected: they pursued their own self-interests and did not just follow instructions given by central planners. The principal-agent problem prevalent in the system as a whole increased substantially as the economy became more complex. Institutional quality deteriorated partially because of corruption, deficit of transparency and fairness, and lack of democracy.

Socialism was a grand-scale experiment of an alternative economic system based on state ownership and central planning. The failure of this experiment after a trial of less than eighty years implies that any economic system without taking account of human beings' self-interests and possessing proper coordination mechansims is not sustainable in the long term. Hence, one can conclude that there is no coordination mechanism that can successfully substitute for market-based coordination based on private property rights.

The discussion above suggests a direction for research on economic systems. First, a market economy, rather than a socialist or other economic system, should be the subject of research. A sustainable economic system should be based on the utilization of the human instinct of self-interest, private property rights, and markets. These three elements are so essential that the lack of any of these would lead to unsuccessful economic outcomes. In addition, they reinforce each other and should be treated as a package: a mixture of one or two elements of the three with a different element, such as market socialism, will fail.

Second, the diversity of capitalist economies is a promising research subject. As we discussed, economic systems primarily deal with coordinating institutions that link the behavior of the agents with aggregate economic outcomes. Capitalism and socialism are extremely different in terms of coordinating institutions, but there are various versions of coordinating institutions within capitalism or socialism. In other words, it is quite possible that there are diverse capitalist economic systems wherein predominantly market-based, but different coordinating institutions operate.

The ‘Varieties of Capitalism’ (VoC) approach, introduced by Hall and Soskice (2001), is one attempt to understand the diversity of a capitalist system. The core of the VoC approach lies in ‘system coordination’ and ‘institutional complementarities’. According to the VoC approach, the subsystems (i.e. financial system, labor market, training system, and inter-firm relations) should be coordinated in such a way that they produce a ‘comparative institutional advantage’. If such an advantage is successfully exploited by firms in their specific production activities, it increases the probability of the survival and prosperity of the system as a whole. On the basis of the comparison of the subsystems, Hall and Soskice (2001) identify two major capitalist systems: the coordinated market economy (CME) and the liberal market economy (LME). The CME and the LME are similar in that the markets are the main coordination mechanism, but they differ in terms of the extent to which they rely on markets. The former refers to the system in which nonmarket relations based on collaboration and long-term commitments are more frequently used than the latter, wherein market principles are more dominant mechanisms of coordination.

The VoC approach has been developed in the areas of sophistication of its hypotheses and its application to various economies. Hall and Gingerich (2004) account for major differences among capitalist systems and provide some empirical tests of its main hypotheses. Using the diversity of linkages between corporate governance and organisational architecture, Aoki and Jackson (2008) identify four models: Anglo-American, German, Japanese, and Sillicon Valley models and trace a change in the Japanese model. Mizobata (2008) applies the concepts of the VoC to explain the diversity of capitalism in former socialist economies.

The VoC approach is useful not only for understanding the diversity of developed economies but also for proposing policies for developing economies. Developing countries often suffer from under-developed market institutions and, as a result, market transactions are limited. In these circumstances, the government can provide some coordination mechanisms to support the creation and expansion of markets. The successes in East Asian economies are good examples of such market-oriented but government-controlled development policies. The following critical question arises in the political economy of these countries: what factors made policymakers’ interests be aligned to economic development not to grab rent for themselves?

In order to be firmly rooted as a field of economics, the VoC approach needs to develop further in a way that deepens our understanding of what mechanisms and institutions are used to reduce potential market failure. Debates on economic systems led to the conclusion that the market as a coordination mechanism can fail, and thus some ways to reduce the possibility of such failure or to mitigate problems arising from it should be developed. Limited competition in the forms of monopolies and oligopolies is traditionally regarded as an important cause of market failure.

Asymmetric information between a potential seller and a potential buyer can lead to market failure. Externalities are also a source of market failure unless they are dealt with through private negotiations or government regulations. In the presence of corruption, competition between agents forms a vicious circle wherein corrupt producers can defeat honest ones in the setting of corruption with theft (Shleifer and Vishny, 1993). The tragedy of the commons leads to a suboptimal outcome of economic games. In what ways does the LME or the CME reduce such market failure? Which one among the different market economies is better to account for specific types of market failure? What factors determine the probability of success in dealing with market failure?

Research on economic systems will survive and can possibly prosper when the economy becomes more specialized and complex. Several causes of market failure tend to intensify when the economy enters a higher stage of development. Economic development is associated with specialisation, which increases asymmetric information. Asymmetric information can hinder the formation and expansion of markets. The information gap between businesses and a government regulator may cause serious consequences, as we have seen in the financial crisis in 2008. Externalities can arise more frequently because agents are more interconnected than before. The tragedy of the commons may be associated with specialisation and interconnectedness of agents. In other words, self-interests can diverge from public interests as the economy develops further, which suggests that the demand for understanding economic systems will increase. Of course, an expert on each subsystem of the economy, such as a financial economist, can deal with specific market failure in financial markets. However, experts on economic systems can contribute to the debates with broader knowledge across subsystems. This expertise will become more important due to the interconnections of subsystems.

3. Research on institutions

The importance of institutions in economic development was highlighted in the seminal works of Douglass North (1981, 1991). Interest in institutional economics has been revived partially due to two factors. First, the transition process of the former socialist economies in Eastern Europe led to the conclusion that institutions played important roles in transition performance (Djankov, 2003). Second, empirical works confirmed that institutions are a main determinant of long-run growth. Among these works, Acemoglu et al. (2001) is one of the most frequently cited studies.

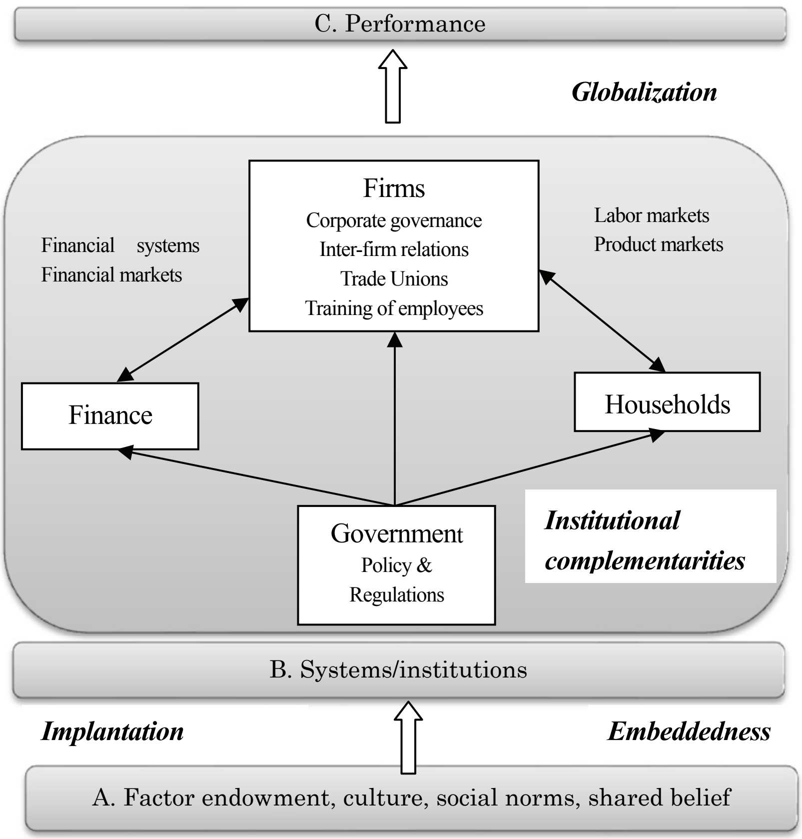
The transition process of former socialist countries toward a market economy, which started in the late 1980s and early 1990s, was expected to increase the efficiency of the economies. It was even anticipated that economic conditions would improve almost instantaneously after the beginning of the transition. However, such an expectation was not fulfilled since all of the transition economies experienced a sharp fall in outputs—at least at the early stage of the transitions. Although a recovery process started following a transition recession, substantial disparities in output trends were observed among economies. Why was there an unexpectedly sharp output decrease during the transition process? Why were there substantial differences in economic performance among transition economies?

A multiple number of causes were suggested and tested empirically, following which, two things became clear. First, it takes time to form a working economic system, especially because the market economy requires supporting institutions. However, institutions, which include property rights, contract enforcement, and a coordination mechanism, are formed in a rather evolutionary way. Second, differences in institutional quality appear to account for at least some part of economic performance in transition economies. Of course, structural reforms, political constraints, and economic development before the collapse of the socialist economies affected output trends, but these factors were in turn influenced by institutional quality.

What is the relationship between institutions and economic systems? Is an economic system part of institutions? It partially depends on the definition of institutions and economic systems. North (1991) defines institutions as 'the humanly devised constraints that structure political, economic, and social interaction'.[3] Furthermore, he states that institutions include both formal rules (constitutions, laws, and property rights) and informal constraints (sanctions, taboos, customs, traditions, and codes of conduct). In other words, institutions can be regarded as the rules of the game understood by the agents. In this way, institutions are defined broadly. In contrast, the definition of economic systems is rather narrow. According to Gregory and Stuart (2003), economic systems are defined as a set of mechanisms and institutions for decision making and for the implementation of decisions concerning production, income, and consumption within a given geographical area. The mechanisms and institutions consist of property rights, mechanisms of coordination and information, decision-making structure, and motivation. Among these, property rights and mechanisms of coordination and information are the key elements, because the other two can be derived from these two. We emphasized the role of the coordination mechanism as the most important research topic within the field of economic systems mainly because the degree of reliance on market mechanism can vary substantially, even across market economies. This is different from property rights, which do not differ significantly across market economies.[4]

Research on institutional economics has been developed in three ways. First, the determinants of institutions or the evolution of institutions has been an important research subject (Sokolof and Engerman, 2000; Acemoglu et al., 2001; Williamson, 2000). The suggested determinants include factor endowment, implantation of institutions by European settlers, culture, religion, etc. Second, a number of works have suggested that institutions are a mechanism for reducing

Figure 1 Research Subjects on Economic Systems and Institutions



transaction costs, which are incurred when agents want to make a deal (Coase, 1960; Williamson, 1985). Hence, institutions increase the probability of reaching an agreement. Recently, Aoki (2001) attempted to understand institutions from the equilibrium of the game wherein agents decide on their actions in response to their subjective beliefs of other agents' choice of actions. Hence, institutions can be regarded as a self-sustaining system of shared beliefs. Third, the performance of different sets of institutions has been analyzed (Rigobon and Rodrik, 2005). I expect that these lines of research will continue in the future.

The figure shows possible research areas in the fields of economic systems or institutional economics. Economic systems refer mainly to coordination mechanisms, which are part of institutions. Coordination is needed in all economic spheres, because economic activities conducted by many agents would not lead to desirable outcomes for a community as a whole without proper coordination mechanisms. Markets are predominant coordination mechanisms in a market economy, but formal and informal practices, as well as government regulations, serve as such mechanisms as well. Institutions are the rules of the game, structuring the interactions of agents, which include not only markets but also culture, social norms, and shared beliefs.

Level (A) may be regarded as fundamental institutions that are slow moving and influence other institutions. Culture, social norms, and shared beliefs are some examples. In fact, these fundamentals are embedded in other institutions. Sometimes institutions are implanted from outside. For instance, many colonial countries were forced to adopt institutions implosed by rulers.

In Level (B), subinstitutions should be coherent and should reinforce each other. Otherwise, institutional complementarities would break down, causing deterioration in performance. Institutions affect performance in Level (C). Globalization especially places pressure on institutions that fail to promote efficiency.

Possible conflict may arise because a change of direction in institutions driven by globalization pressure can be different from the status quo suggested by embedded institutions. Moreover, institutional complementarities may constrain how long a change in one or a small number of subinstitutions can sustain without a change in all subinstitutions. Is the choice always all or nothing, or is it possible to mix changed subinstitutions with existing subinstitutions? Is there an optimal sequencing of changes? The experience so far suggests that globalization is a huge challenge to institutions, but it does not necessarily mean a convergence of all institutions across countries. Successes in German-style capitalism and Nordic capitalism are prime examples.

Transition from one type of capitalism to another type of capitalism is also possible. The features of the South Korean economy transformed substantially following the financial crisis in 1997. Elements from Anglo-Saxon capitalism were introduced forcefully into South Korean traditional capitalism. As a consequence, the power of the government in allocating resources weakened substantially. Long-term employment was replaced by the American-style employer-employee relationship, and job tenure shortened significantly. Wage gaps among employees increased. There were also important changes in corporate governance.

Research on institutions will attract more attention from economists. Significant findings have already been made, but important gaps in knowledge are still present. The role of culture or social norms interacting with other institutions and affecting economic performance is an emerging stage of research. Institutional complementarities need to be better understood, as institutions are not fixed sets and are always evolving. If institutional complementarities are so important, how can they evolve? Do they evolve simultaneously or sequentially? The effects of different sets of institutions on economic performance are important research questions but have not been sufficiently explored. Research on the grand-scale transition from socialism to capitalism will attract less attention, but a small-scale transition from one type of capitalism to a different type of capitalism will take place, which is important not only to academics but also to policymakers.

4. Conclusions

This short paper contains personal views on research directions regarding the field of economic systems and institutions. Although the old subject that dealt with socialist economic systems became a matter of history, the field will sustain and possibly prosper. This paper suggests two reasons for this prediction. First, the demand for a better understanding of economic systems will increase. Economic systems are institutions that link individual economic behavior to aggregate outcomes for society as a whole. Although markets are predominant coordinating institutions in a capitalist economy, there are many cases in which markets can fail. I have argued in this paper that the number of cases of market failure is more likely to increase due to deeper specialisation and interconnectedness of agents' behavior. Research on economic systems is expected to facilitate our understanding of why markets fail and what remedies are available to rectify or mitigate the problems. Countries tackle these cases of market failure in different ways, and thus the comparison of different types of capitalism—notably, as seen in the VoC literature—is interesting. In particular, researchers of economic systems will have expertise on coordinating institutions across different sectors of the economy and thus will be able to contribute to understanding a capitalist system as a whole.

Recent revival in institutional economics will be another important avenue for expanding the field of economic systems. Thus far, various research themes have been suggested: transaction costs, VoC, embeddedness, institutional complementarities, culture, social norms, shared beliefs, and the evolution of institutions. These themes will continue to be important research topics. This paper suggests that theoretical and empirical works that enable us to understand the making and the evolution of institutions are required. Various case studies and historical events related to institutional changes and their effects will be extremely interesting.

Notes

[1] This paper was written during the author's sabbatical leave at Institute of Economic Research, Kyoto University (KIER). The author gratefully acknowledges the excellent research environments provided by the KIER.

[2] According to Adam Smith, there are certain conditions of the working of invisible hands without which individuals' self-interest would not lead to social welfare: social norms that uphold sound consciousness of individuals, fair courts, and competition. However, contemporary economics tend to pay attention largely to competition and thus confine Smith's approach to an economic

system to a mere technical analysis. It is noteworthy that Adam Smith emphasised the importance of social norms and fair courts for a market economy, which can be translated as part of social capital and institutions.

[3] Aoki's (2007) definition of institutions is similar to that of North's. He defines an institution as 'self-sustaining, salient patterns of social interactions, as represented by meaningful rules that every agent knows and incorporated as agents' shared beliefs about the ways [in which] the game is to be played'. I prefer Aoki's (2007) definition to North's (1991) partially becauseit is unclear whether a market economy is the product of human design: Adam Smith believes that human beings possess natural instincts to trade.

[4] Although it is possible that some firms are state-owned in a market economy, property rights are, in general, a binary choice between private and public/state ownership. The reason is that it is difficult to imagine that in a market economy the dominant proportion of firms are owned by the state. Furthermore, the extent to which firms are state or privately owned is not a critical factor in characterizing a market economy if the majority of firms are privately owned.

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