Explain the economic system of capitalism economics essay

Economics

Historians, economists and political economists have taken various perspectives on the analysis of capitalism. Economists usually emphasize the degree that government does not have control over markets (laissez faire), and on property rights. Most political economists call attention to private property, power relations, wage labor and class. There is general agreement that capitalism enhances economic growth. The extent to which different markets are free, as well as the rules defining private property, is a matter of politics and policy. This economic system where government allows a free hand to all the firms and entreprenuers is on the basis of some 'behavioural assumptions'. The two basic assumptions; that all the producers and consumers are rational in their behaviour and that they have complete information, has gone wrong and been violated numerous times! So, one has to be very clear about the reality that when the assumptions or the structure of a building is weak then how can it hold the burden and functioning of the entire economy. Here comes the need for Government Intervention and the system of 'laisaz-faire' is taken over by a 'mixed economy'! Economic role of the Government has four main components: what is to be produced? how is it to be produced? for whom to be produced? how are these decisions made? Now, lets see how an incentive structure can influence different markets. Institutional structure shapes the economic framework of a country. They build the basic structure of an economy which influences the level, pattern, and sustainability of growth. As an evidence, same macroeconomic models when applied to different countries produce different outcomes altogether! Institutions are a set of formal rules and informal norms that together with enforcement mechanism structure human interaction. They are to contain both incentives and disincentives which constraint human behaviour. The fundamental determinant of types of organizations emerging in a country is the institutions in place. Organizations are the players of the game and institutional framework are the rules of the game. Organizations therefore try to play the game within the rules provided by the institutions. Institutions provide incentives for the organizations by reducing uncertainty and risk . institution help in minimizing the transaction cost and the transformation cost. Countries all over the world are experiencing patterns of growth because of their institutional framework. Inefficient institutions provide high transaction cost and as a result the country struggle to grow. Incentives such as working hard are missing in inefficient institutions. Efficient institutions create an institutional matrix which strives for growth by reducing transaction cost and changing informal constraints through perceptions. Therefore once a country is stuck on a certain path of growth due to its institutions then it is difficult to revert back. The institutions drive organizations into a particular direction depending upon the incentive structure present. Through these incentives and disincentives embodied in rules they induce: efficiency, merit based solutions, hard work, competition and innovation. Hence, productivity increases and so does economic growth. In such an institutional framework organizations like 'Microsoft' emerge. Emergence of Microsoft was not a fluke; it was a direct result of institutions shaping the kind of organization. It has the highest sales in the entire World Industry of software. The reason is extensive research and development. It knows that if it's not at the cutting edge then it is going to get driven out of the market and go bankrupt. This will have backward and forward linkages with universities and lots of other sectors and so these will automatically correct themselves up too. When firms know that they need to be efficient and hire employees on merit basis, it will lead to efficient functioning of universities, training organizations, raw material sectors, etc. there are so many other organizations like Microsoft in the developed countries which shows the ability of their institutions. The success story of the developed countries is due to their institutions. These countries have achieved years of growth because they are locked in a path of sustainable development as a result of their institutions. Companies like Microsoft will continue to emerge in these countries because their intuitional structure promotes such organizations. Whereas, if the rules are not clearly defined by the state: 'what to produce? and 'how much to produce?', or support all kinds of business activity in private sector then economic profits remain the only motive. This can have drastic results! The Financial Crunch of late 2000 is a classic example in this case. Bush Government was very reluctant to regulate the Financial market and Alan Green Span's argument was that free markets are efficient and are able to automatically adjust theirselves. But, unfortunately it went wrong and the whole situation reversed in the US when Bail-outs had to be given to pull the economy out of the crisis it had fell into. Also, private firms will only be producing private goods. The provision of public goods like Defence and physical infrastructure will be under-provided. The consumption of merit goods like education and health will also never be optimal. Let us examine why is this so. It is due to the characteristics of public goods that they are not privately provided; non-excludibility and non-rivalry in consumption. There is always present a ‘ free rider problem’, which will also not let private firms enter into this area. One of the best examples of a public good is national Defense. To the extent one person in a geographic area is defended from foreign attack or invasion, other people in that same area are likely defended also. This makes it hard to charge people for defense, which means that defense faces the classic free-rider problem. Indeed, almost all economists are convinced that the only way to provide a sufficient level of defense is to have government do it and fund defense with taxes. Another reason for market failure is the presence of negative externalities. This has also been tried to solve to a larger extent with the help of ‘ property rights’. Well-defined property rights can solve obvious public-goods problems in environmental sectors as well, such as land use and species preservation. The buffalo neared extinction and the cow did not because cows could be privately owned and husbanded for profit. It is difficult to imagine conveniently applied and enforced private property rights in schools of fish. For this reason we see a combination of government regulation and privately decided quotas in that area. The depletion of fish stocks nonetheless looms as a problem, as does the more loss of biodiversity. The state can also use the basic incentive factors to reverse the situation to create consistent and successful markets. For instance, if the state does not regulate monopolies for some time and allows them to work then they can earn 'good rents' and are always useful for the development of that entire industry, hence efficient functioning of markets. IBM, Google, Microsoft, etc are all classic examples in the case where these firms were not regulated for a long period of time and this helped them in earning huge profits. It had backward and forward linkages in the economy and 'knowledge leakes' enabled other firms to enter the market and ultimately benefits of competition are now reaped! Governments all over the world have played an imoportant role of reducing ‘ transaction costs’. When transaction costs are reduced then economic actors find the environment less uncertain and thus impersonal exchange takes place. This altogether increases the number of transactions in an economy and it benefits from 'increased productivity' and 'specialization'. Different types of specialization effects on any economy are: i) Static economies of scale: The growth of any firm is a function of its productivity. This includes division of labor, learning by doing, etc. ii) Dynamic internal economies of scale: Here, the productivity of any firm is a function of its growth! Countries that exported manufactured goods were able to enjoy dynamic economies of scale. When a firm gets new orders and wants to expand business then it will invest in new machines, machine body becomes younger and more productive due to improved technology. iii) Dynamic external economies of scale: When steam power was first introduced in textiles it was soon also started to be used by other industries like spinning, weaving, ships, etc. iv) Automation and Innovation: Computer designed production is so far the most sophisticated one, for instance the 'spark eroded machine' is used to make holes of 1/millionth mm where a hot spark is used to make up a hole of that size. The precision and quality of that product wants new technology and machinery. Similarly, by increasing mechanization labor reduces in short run but eventually it provides employment to large people. v) Gains from trade: We gain from trade when advantage lies in exchange of goods and services across the borders. For instance, India has absolute advantage in both cars and textiles but its comparatively efficient in cars than textiles then India will still trade and export cars, while Pakistan focuses on textiles. This will give them 'gains from trade'. People were aware of this concept even before Industrial Revolution and in Harappa they had fixed up a gate where they collected toll from traders! When European countries were growing and industrializing they needed more markets and resources for their industries. They began to colonize economies like India where they destroyed their manufacturing sector and through whole set of administrative measures they made them specialize in those agricultural products which were being exported to Europe for the industry there. There are even countries who are earning or gaining through competitive advantage in subsectors of the same industry, e: g, one country could produce tyres while others could specialize in other components. Another role of the State in case markets fail, is to 'reallocate' the resources or provide the ‘ initial endowments’ and then allow the private sector to function! It is in the favour of the state that these big firms keep operating. They are a source of employment to a large population and earn most of the foreign exchange reserves for the economy. So, it is the duty of the state to help them get out of any financial trap that they ge into. This is perhaps one of the most important jusrtifications given for the bail-out packages given to General Motors and other firms after the financial crisis in the US. Over time these organizations become so strong that they start influencing the decions of the government. Policy makers have to take consent and require full support of these organizations before making any ammendments or announcing any new policies. Government knows that if it wants a sustained functiong of the markets then the big-share firms are to be considered as the most vital steakholders in any decisions. For instance, some automobile multinational corporations are sobig that they not just effectively take part in deciding for the tariff quotas in their home countries but also in other countries where they operate.