

Outline

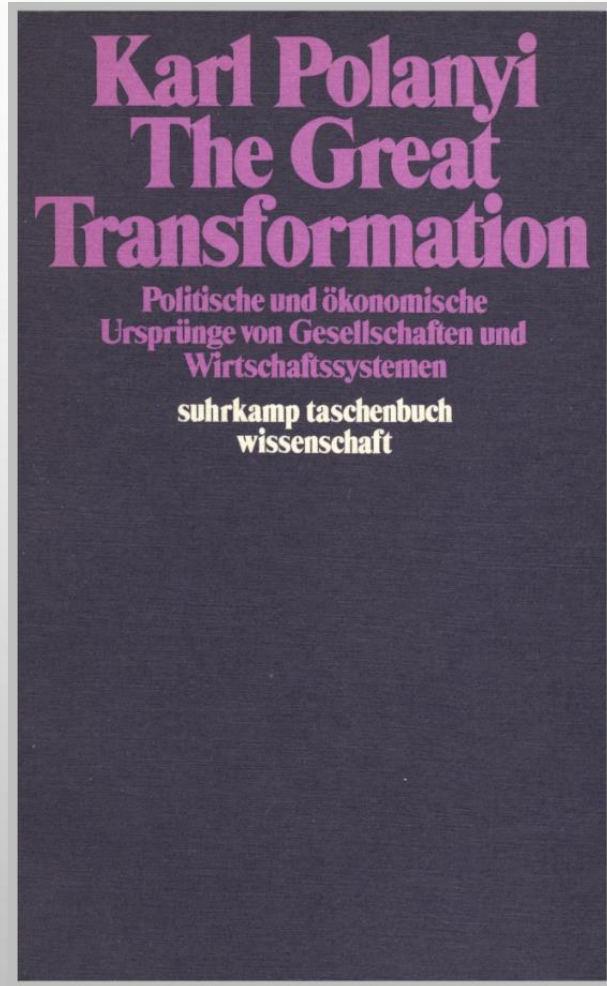
- **What is beyond market? (Polanyi)**
- **New Institutional Economics (North, Williamson)**
- **Case Study (DeSoto)**

KARL POLANYI



- October 25, 1886 - April 23, 1964
- Born in Vienna
- His most famous work, “the Great Transformation”, published in 1944 (wrote during the World War II.)
- Background of Polanyi's thoughts: the puzzles over the chaotic World War and the rise of fascist regimes from the 1930s

THE GREAT TRANSFORMATION



- The end of the 19th century economic system leads to either fascism (merely responds to dissatisfaction with the malfunction of a market system) or a new conception of liberalism
- Polanyi concludes that the intrinsic processes of the 19th century economic system were ***the mechanisms of its own destruction***
- The Utopian dream of the self-regulating market failed, and the future economic order cannot make the mistake of institutionally separating politics from the economy

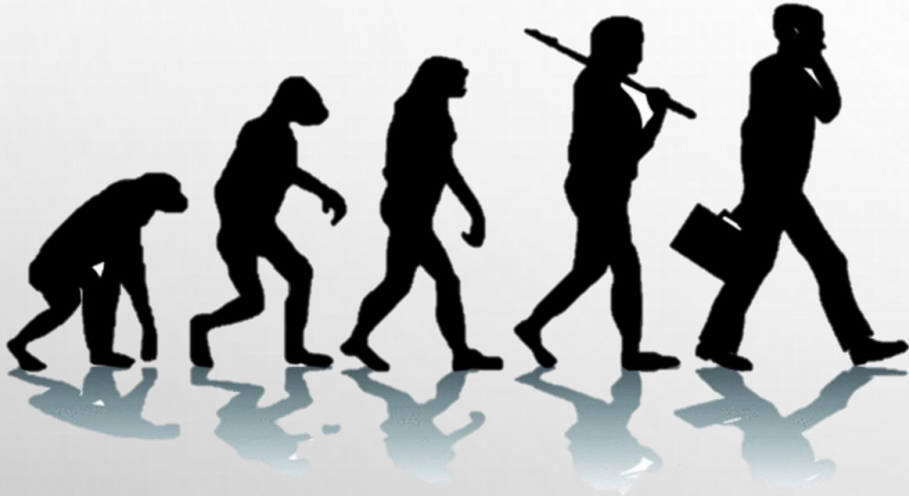
CRITIQUES ON SMITH'S THEORIES



Smith's ideas on the 'Market':

- Market is not only the marketplace; the agora, souq, bazaar
- Market—more concretely, is human's propensity to truck, barter, and exchange one thing for another—facilitates the division of labor
- **Motivations of market exchange:** self-interest
- Some markets are very free/unregulated, some are more regulated but still essentially market-based
- **The result of market exchange:** differentiation and specialization among people

CRITIQUES ON SMITH'S THEORIES



Two core assumptions:

- 1. Market is a uniquely **“natural” form** of economic organization of society
- 2. Human economic behavior is naturally, inevitably motivated by the goal of maximizing profits

CRITIQUES ON SMITH'S THEORIES



Self-regulating market:

- **Market price** is regulated by the quantity brought to market and the effectual demand
 - When supply exceeds effectual demand: the actual price falls below the natural rate
 - When supply falls short of the effectual demand, the market price rises above the natural price
 - When supply is equal to effectual demand, the market and natural price coincide
- **Natural price of a commodity:** based on the cost of land, labor and materials





ADAM SMITH:

- “Economic men”
- Division of labor is based on market
- The separation of land, labor and capital



KARL POLANYI:

- “Social Men”
- Division of Labor is based on social relationship
- The integral relationship between land, labor and capital

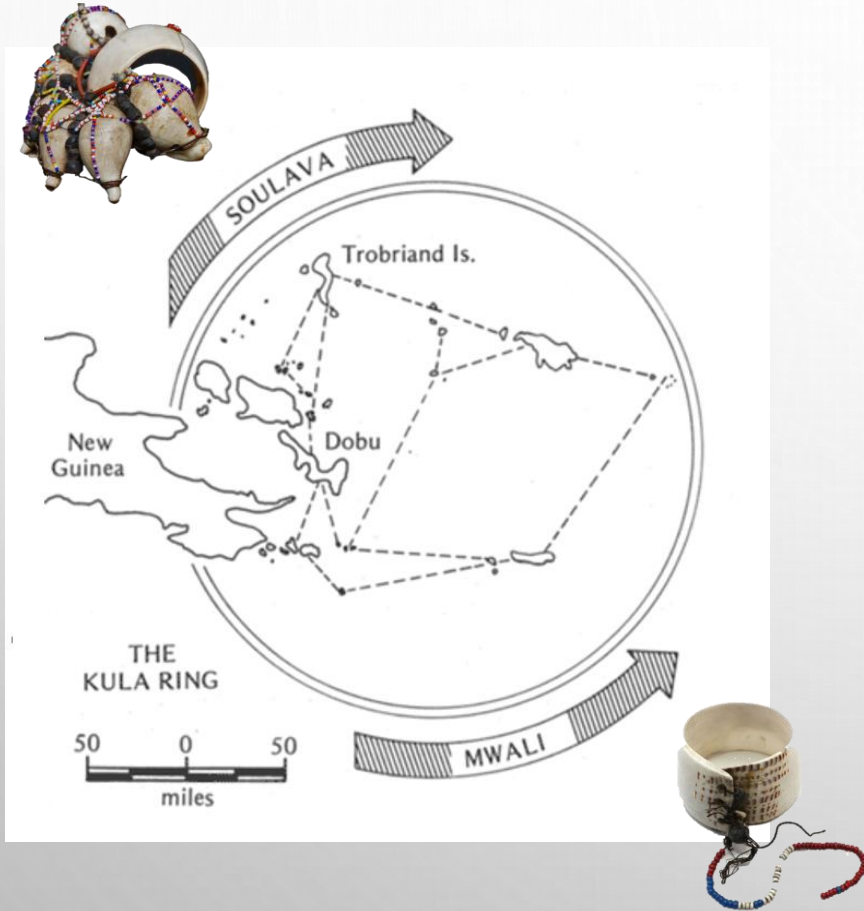
POLANYI'S ARGUMENTS



Bronislaw Malinowski

- If the market economy is so new, what came earlier?
- The self-regulating market in Adam Smith's terms, for Polanyi, was a product of a particular political-economic setting during the late eighteenth and early twentieth centuries.
- Under the influence of anthropologist research, Polanyi believes that the understanding of primitive societies would shed light on our understanding of how livelihood should be.

POLANYI'S ARGUMENTS



- Bronislaw Malinowski's research in the Trobriand islands: the exchange between a shell (soulava) and other armbands (mwali): one item of trade moves clockwise and the other moves counterclockwise.
- "Why would men risk life and limb to travel across huge expanses of dangerous ocean to give away what appear to be worthless trinkets?"
- The purpose of the trade is not to gain material benefits but to reinforce and strengthen relationships between givers and receivers.
- Reciprocity is an implicit part of gifting; no "free gift" is given without expectation of reciprocity

POLANYI'S ARGUMENTS



- Economic systems contain these practices in varying degrees and scales.
- An economic system is defined by the most dominant of the practices.
- Early economies were based on Reciprocity, Redistribution and Householding.
- **It is only within the last 400 years that market patterns have become dominant.**
- **Market patterns create their own institutions – markets!**

POLANYI'S ARGUMENTS

A. The Universal Economic Process



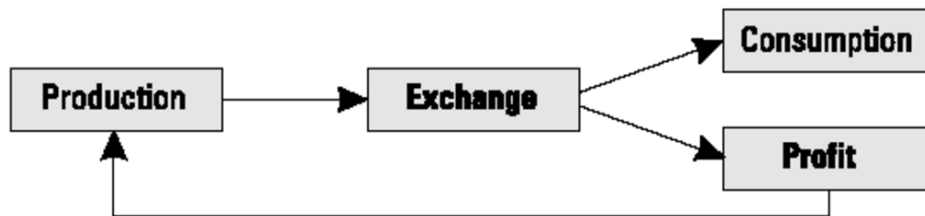
B. The Economic Process where "Redistribution" (Polanyi) is Predominant



C. The Economic Process where "Reciprocity" (Polanyi) is Predominant



D. The Economic Process where "Exchange" (Polanyi) is Predominant



- Economic activities are not only via the market mechanism.
- **1. Householding** (œconomy): Self-production for household consumption
- **2. Reciprocity**: (Exchange between social equals). given-and-take principles (symmetry, regarding two or more axes)
- **3. Redistribution**: (Exchange between social unequals). The allocation of goods is collected in one hand and takes place by virtue of custom, law or ad hoc central decision (centricity, integrating groups at all levels and all degrees of permanence from state itself to units of a transitory character)
- **4. Market Exchange**: Exchange under a price-setting mechanism

POLANYI'S ARGUMENTS



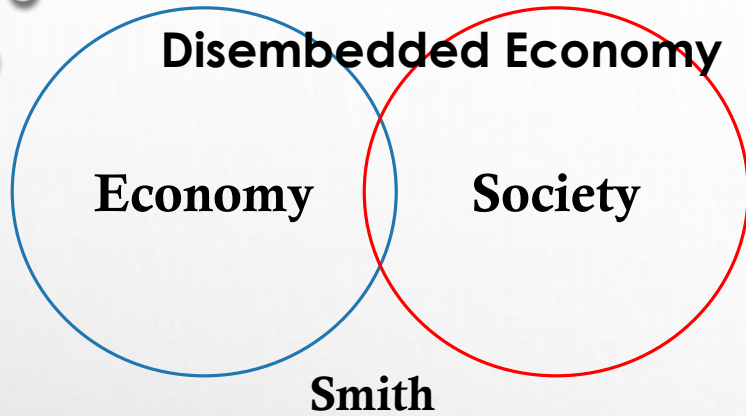
- The **societal effects** of individual behavior depend on the presence of definite institutional conditions, these conditions do not for that reason result from the personal behavior in question
- “Men’s economy is submerged in his social relationships”. These relationships are integrated.
- Material motives (such as hunger and gain) should not dominate the economy.
- Polanyi emphasizes the desire for social status and subsistence vs. the desire for maximum profit & accumulation for accumulation’s sake

POLANYI'S ARGUMENTS



- A **market economy** must comprise all elements of industry, including labor, land, and money.....
- But labor and land are no other than the human beings themselves of which every society consists and the natural surroundings in which it exists.
- To include them in the market mechanism means to subordinate the substance of society itself to the laws of the market
- **Reciprocal and redistributive systems** still feature ritualized exchange, self-interested behavior
- Redistributive power also tends to enmesh the economic system proper in social relationships.
- Can we build an economic system based on reciprocity today?

POLANYI'S ARGUMENTS

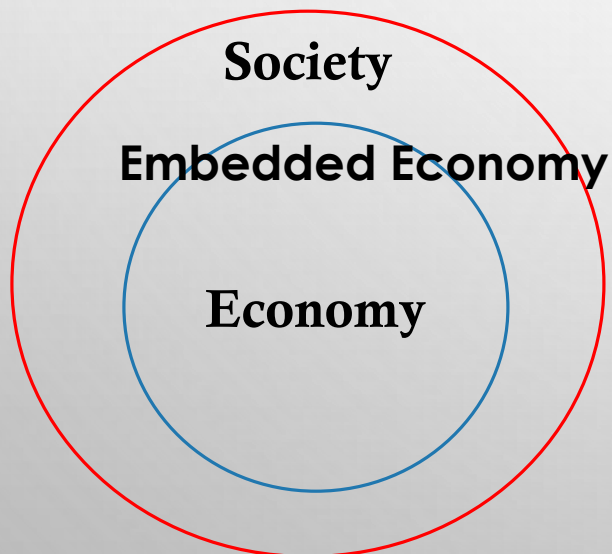


Disembodied Economy

Economy

Society

Smith



Society

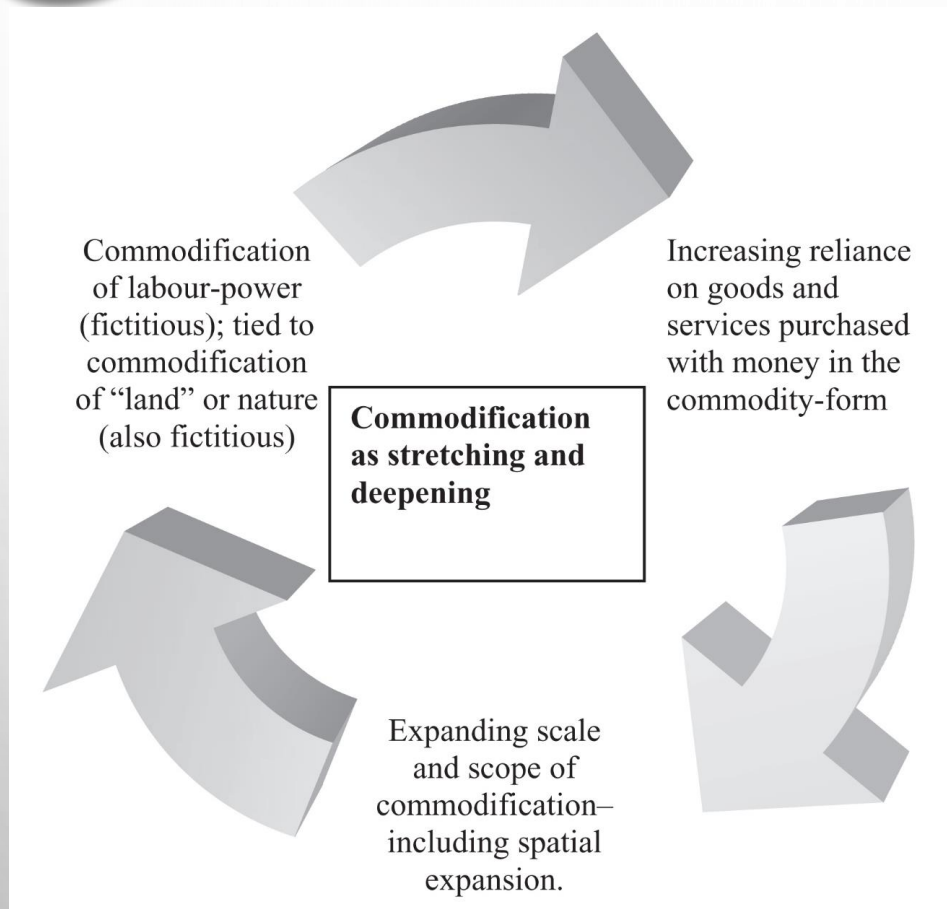
Embedded Economy

Economy

Polanyi

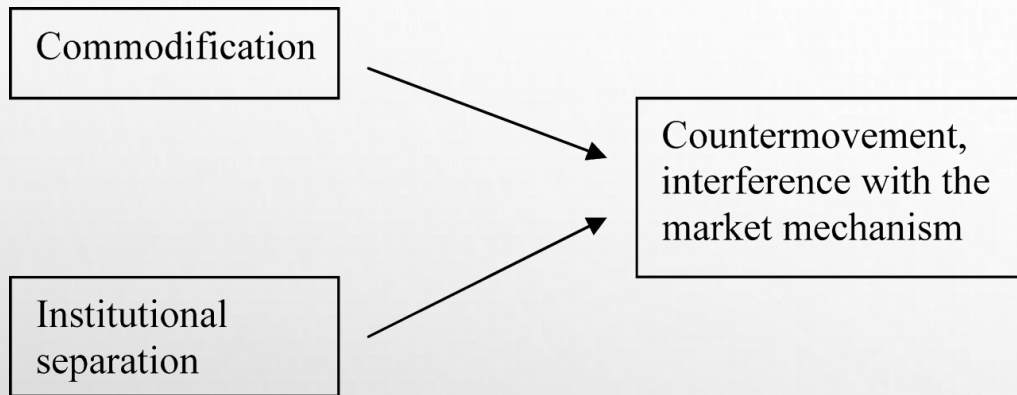
- Market Economy - based on self-interest – is therefore an unnatural foundation for a society
- “A **self-regulating market** demands nothing less than the institutional separation of society into an economic and political sphere.
- Such an institutional pattern could not function unless society was somehow subordinated to its requirements.
- **A market economy can exist only in a market society. ...**
- In market societies, markets control social relations.
- Instead of the economy being embedded in social relations, social relations are embedded in the economic system.

COMMODIFICATION



- As labours mobilized, it increasingly sought through politics the social protection that the economic order could not provide, but in so doing undermined the market system itself
- This transformation paves the way for the commodification of land, labor, and money: the three “**fictitious commodities**”
- A truly self-regulating market will never again be the core of the international order because ***labour, land, and money have been pulled out of the market***

DOUBLE MOVEMENT



- The **laissez-faire** reformers' idea to seek to "**disembed**" the economy is a utopian project, as economies are always embedded in societies
- To the degree the liberal market expanded in industrial Europe, it created **counterpressure** among the social groups most vulnerable to its excesses, especially **labours**
- The dialectical process of marketization will push for social protection against that marketization
- A reactionary "**countermovement**" arises whereby society attempts to re-embed the economy through the creation of social protections such as labor laws and tariffs

LAND COMMODIFICATION



- **Land Enclosures** - the Western European trend of economic progress which aimed at eliminating an artificially maintained uniformity of agricultural technique, intermixed strips, and the primitive institution of the common."
- Enclosures increased the value of land, BUT: left the common laborer utterly dependent on employment

Double movement

- Also, conversion of formerly common land to pasturage reduced employment, damaged the land through erosion

MONEY COMMODIFICATION



International Gold Standard

- Money = another name for a commodity used in exchange more often than another!
- 1844 the Bank Charter Act: A gold standard is a monetary system in which the standard economic unit of account is based on a fixed quantity of gold
- Global Market Place Without Global Government!
- “Gold standard and constitutionalism were the instruments which made the voice of the City of London heard in many smaller countries which had adopted these symbols of adherence to the new international order”

DOUBLE MOVEMENT

- Recession, Business Cycle, Keynes
- Most nations abandoned the gold standard as the basis of their monetary systems at some point in the 20th century, although many hold substantial gold reserves.
- **A gold standard** means that **the money supply** would be **determined by the gold supply** and hence monetary policy could no longer be used to stabilize the economy
- After the World War II, a system similar to a gold standard and sometimes described as a "**gold exchange standard**" was established by the Bretton Woods Agreements.
- All currencies pegged to the dollar thereby had a fixed value in terms of gold
- Why did the supposedly self-adjusting mechanism of the gold standard fail?
- "Central banking and the management of the monetary system were needed to keep manufactures and other productive enterprises safe from the harm involved in the commodity fiction as applied to money."

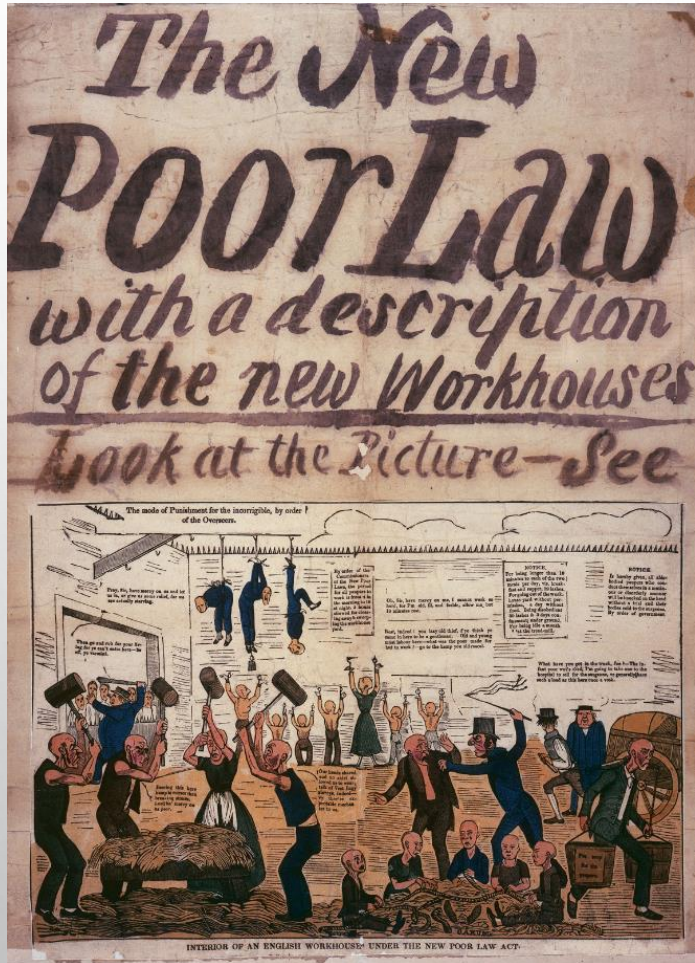
LABOR COMMODIFICATION



-BRACERO PROGRAM, 1960S, MEXICO

- The mechanization of labor changes the context in which policymakers and laypeople make choices for greater productivity
- The full commodification of labor came after land and money
- The commodification of land, labor, and money cause severe hardships for large groups of people
- Polanyi argues that extreme degrees of deregulation & privatization will always threaten society, provoke social protest

POOR LAWS



- The **Speenhamland** system was a form of outdoor relief intended to mitigate rural poverty in England at the end of the 18th century and during the early 19th century.
- The law in 1975 was an amendment to the Elizabethan Poor Law.
- The authorities at Speenhamland approved
 - A means-tested sliding-scale of wage supplements in order to mitigate the worst effects of rural poverty
 - Families were paid extra to top up wages to a set level according to a table.
 - This level varied according to the number of children and the price of bread.

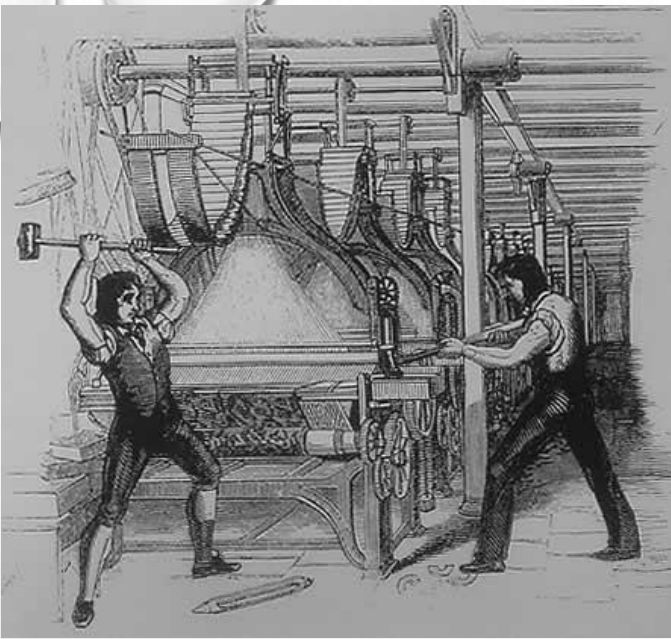
POOR LAWS



- Poor Law reform in decade following 1834 brings about **transition to market society** (or closest example we've ever had).
- Act abolishes the "right to live." People could **move into workhouses**, but these were so degrading/full of destitute people that many poor families refused, became homeless and starved.



"If Speenhamland had overworked the values of neighborhood, family, and rural surroundings, now man was detached from home and in, torn from his roots and all meaningful environment"



DOUBLE MOVEMENT

- Industrial Revolution and Luddites
- Luddites were 19th-century English textile workers (or self-employed weavers who feared the end of their trade) who protested against newly developed labour-economizing technologies
- The British Army clashed with the Luddites on several occasions.
- Parliament subsequently made "machine breaking" (i.e. industrial sabotage) a capital crime with the Frame Breaking Act



DOUBLE MOVEMENT



by Danielle White

- “**New Deal** started to build a moat around labor and land, wider than any ever known in Europe.”
- As long as [man] is true to his task of creating more abundant **freedom** for all, he need not fear that **either power or planning will turn against him and destroy the freedom he is building by their instrumentality**. This is the meaning of freedom in a complex society; it gives us all **the certainty** that we need” -- Polanyi

DOUBLE MOVEMENT



“Trading classes had no organ to sense the dangers involved in

- the exploitation of the physical strength of the worker*
- the destruction of family life*
- the devastation of neighborhoods*
- the denudation of forest*
- the pollution of rivers*
- the deterioration of craft standards*
- the disruption of folkways,*
- and the general degradation of existence including house and arts,*
- as well as the innumerable forms of private and public life that do not affect profits”*



MODERN DOUBLE MOVEMENT



Outline

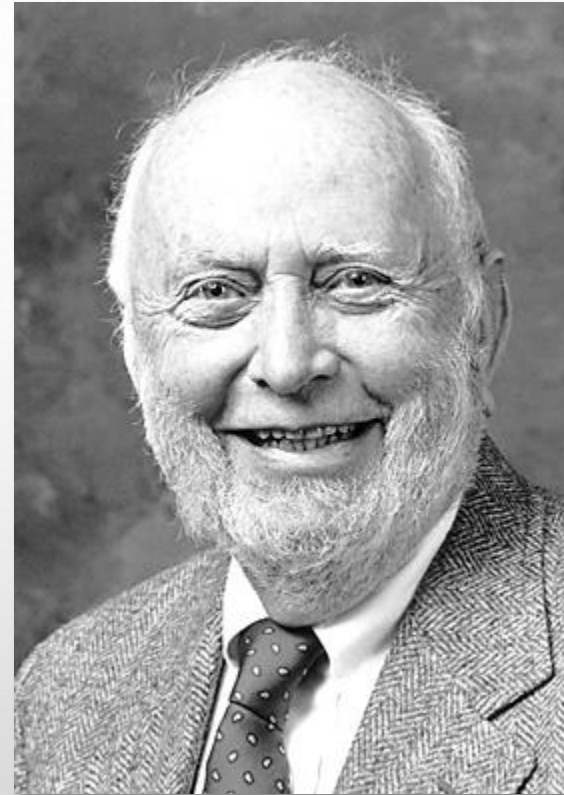
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INSTITUTIONAL ECONOMICS

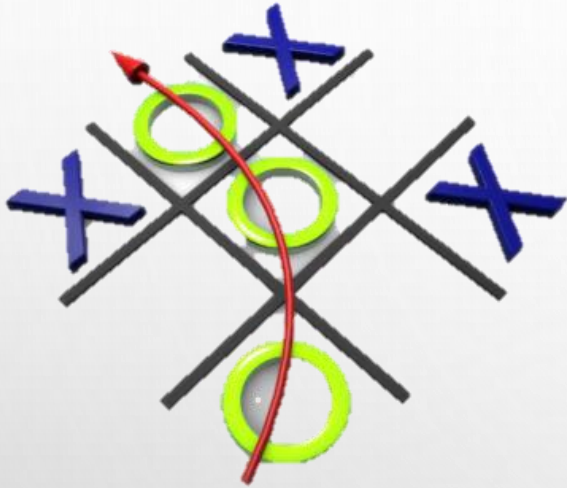
Douglass North

Nobel Memorial Prize in Economic Sciences (1993)

"for having renewed research in **economic history** by applying economic theory and quantitative methods in order to explain **economic and institutional change.**"

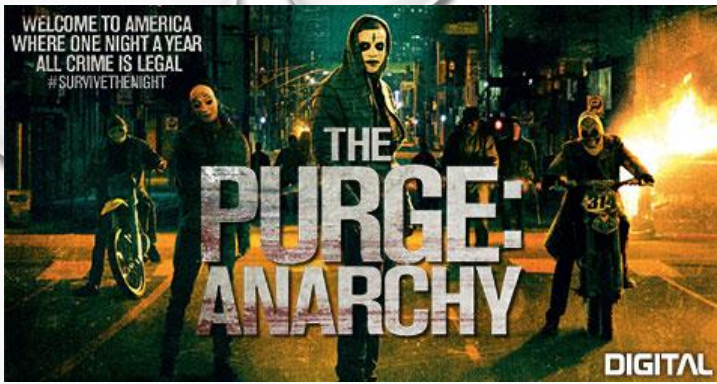


WHAT IS INSTITUTION?



- Institutions are **the rules of the game**
- They structure incentives in human exchange, whether political, social, or economic.
- **Institutional constraints** include both what individuals are **prohibited** from doing and, sometimes, under what conditions some individuals are **permitted** to undertake certain activities





WHAT IS INSTITUTION?

- Institutions **reduce uncertainty** by providing a structure to everyday life by establishing **a stable (but not necessarily efficient) structure to human interaction**
- Societies create **informal rules** that deliberately **restrict people's freedom of choice** so that they don't have to make fresh choices constantly.
 - Ex. a convention for queuing so that people do not have to constantly calculate and recalculate their positions at a crowded bus stop in order to ensure that they get on the next bus



WHAT IS INSTITUTION?



Two components of institutions:

1) **Rules:** the purpose of the rules is to define the way the game is played

- **Formal constraints:** Formal written rules - such as rules that human beings devise
- **Informal constraints:** Unwritten codes of conduct that underlie and supplement formal rules - such as conventions and codes of behavior

2) **Enforcement:** The functioning of institutions is the costliness of ascertaining violations and the severity of punishment



Types of institutions (Ellickson 1991)

	Rules	Enforcement mechanism	Example
Informal constraints	1. Convention	Self enforcement	Language
	2. Ethics	Imperative self binding	Being a veterinarian
	3. Norms	Social enforcement	Social codes of conduct
Formal constraints	4. Formal private rules	Organized private enforcement	Self imposed rules inside organisations
	5. Law	Organized state enforcement	Business Law

- Some basic facts about institutions :
 - Institutions change over time
 - Institutions may be created, or they may simply *evolve* over time.
 - Institutions differ across societies and cultures
 - *Institutions differ* if we were to try to make the same transactions in a different country

Formal Institutions

Examples for formal institutions:

- Constitutions of the country and other “basic” laws
- Inheritance laws of a country
- Voting rights
- Health care system
- Institutions for regulating common pool resources
- System of rules for getting a Ph.D. or, in general, a doctorate
- Institution of the market
- No gum is allowed to be bought or sold inside Singapore and there is a \$700 fine for spitting out gum on the streets
- Grown children in China must visit their parents or potentially face fines or jail



Formal Institutions



WORK EMAIL BAN

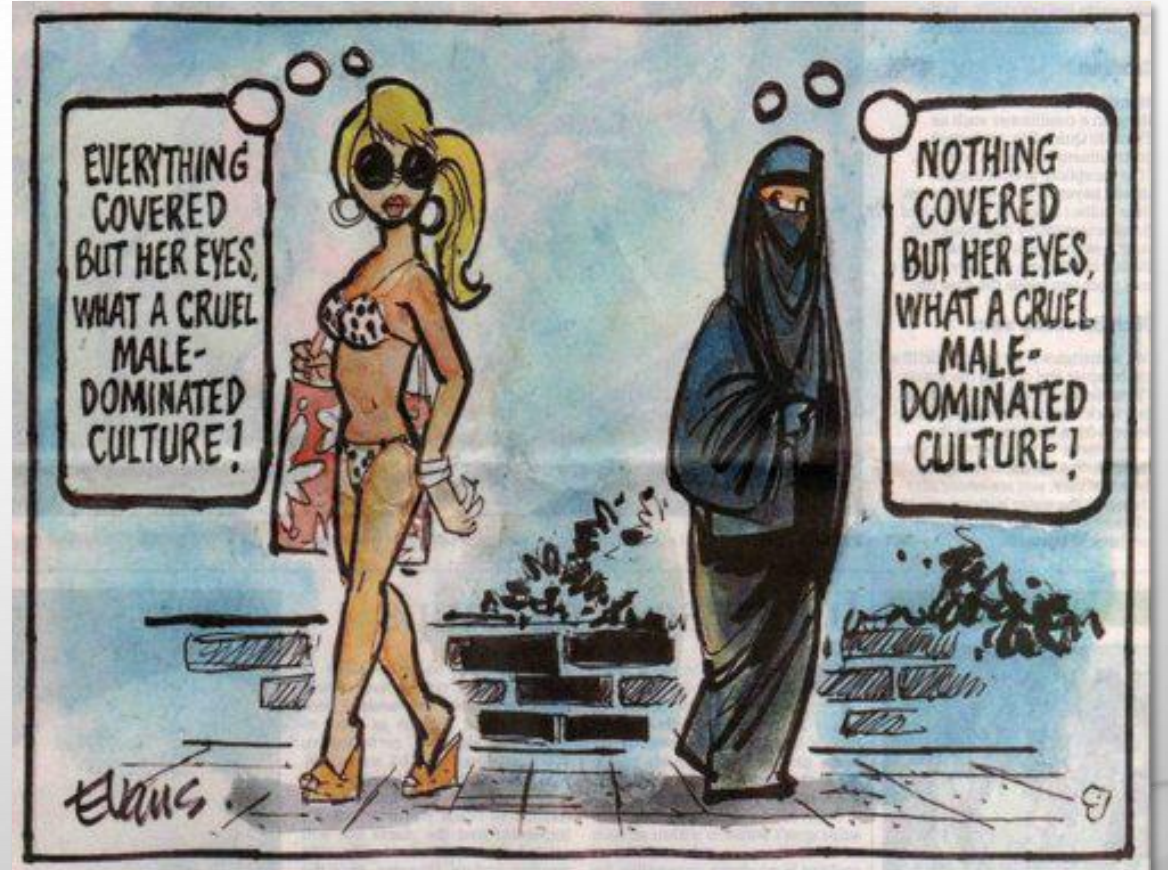
- ▶ COMPANIES WITH 50 OR MORE EMPLOYEES
- ▶ NO EMAILS ON WEEKENDS OR HOLIDAYS

SOURCE: HUFFINGTON POST



Informal Institutions

Culture and Norms



Informal Institutions

Culture and Norms



- 'Dowry' or bride price culture in Thailand

Institutions vs. Organizations

Institution or Organization?

- Both the formal and the informal institutional constraints result in particular exchange **organizations** that have come into existence.
- **Organizations** are created to take advantage of those opportunities, and, as the organizations evolve, they alter the institutions

- นักศึกษาวชิชาณี
- ศาสนาพุทธ
- พรรคพลังประชารัฐ
- คณะก้าวหน้า
- รัฐธรรมนูญ 2560
- ร่าง รธน. ฉบับมีชัย
- สภาหอการค้า
- FTA ไทย-ญี่ปุ่น
- กฎจราจร
- ประชญาเศรษฐกิจพอเพียง
- คณะกรรมการการเลือกตั้ง
- พ.ร.บ. การประกอบธุรกิจของคนต่างด้าว พ.ศ. 2542
- ความกตัญญู
- คสช.
- ม. 44
- ระเบียบหอพัก

Institutions & Performance

Institutions may have **effects on**:

Micro-view

- **Behavior:** Conformity to or violation of the norm
- **Preferences or attitudes** (e.g. Toward the regulated behavior or toward the norm makers);
- **Cognitive beliefs** (e.g. Expectations about the regularity of the demanded or prohibited behavior);
- **Other norms/institutions** (path dependence – see Constitution);
- **Change of the respective norm itself at a later time** (feedback effects – e.g. If a norm does not work it may be changed).

Macro-view

- Institutions, together with the standard constraints of economic theory, determine the opportunities in a society
- Institutions affect the **performance of the economy** by their effect on **the costs of exchange and production**

Institutions & Performance

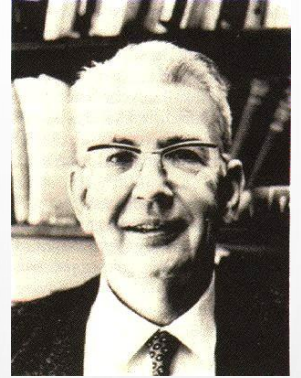


First Dilemma: “Price mechanism”

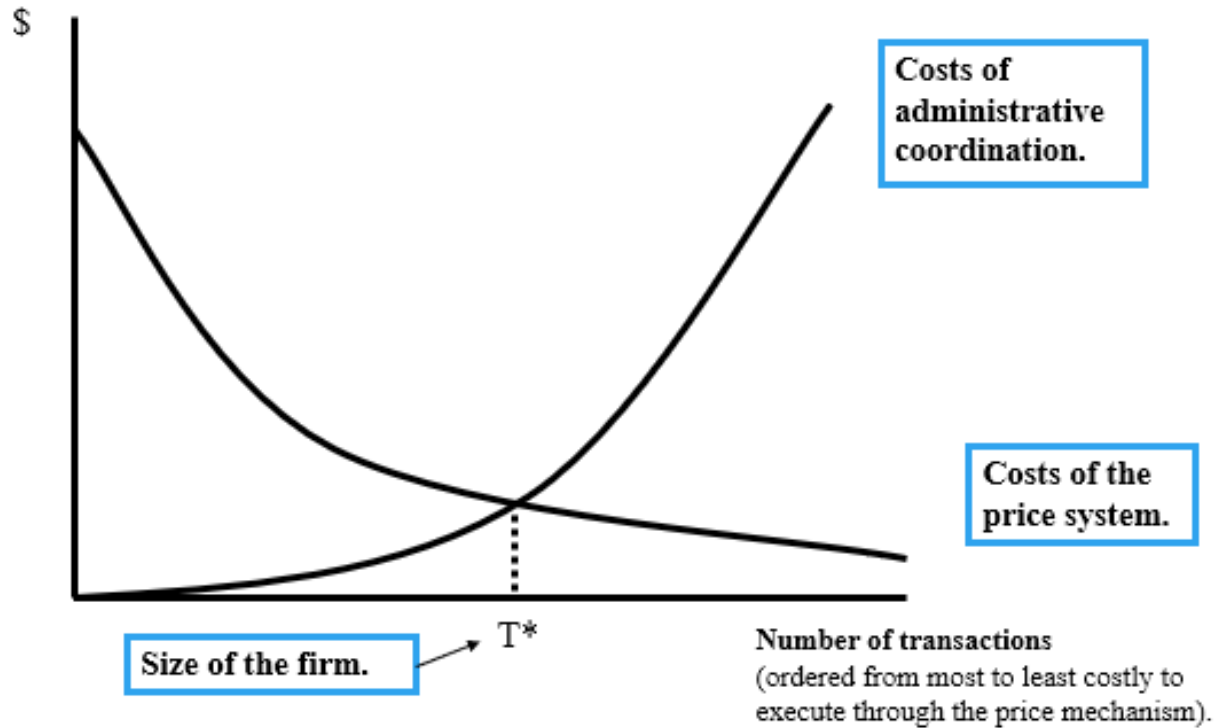
- Indeed what you have is a world in which you must integrate at low cost specialized knowledge by building **connections**.
- Exchange of products or outputs is coordinated spontaneously, in the sense that relative prices rather than fiat direct resources.
- **Relative prices** create incentives to construct efficient institutions. The **incentives** embodied in the framework and therefore **agents** depend on it for the **profitability of the activities** that they undertake.



TRANSACTION COSTS



Ronald H. Coase



“The main reason why it is profitable to establish a firm would seem to be that there is **a cost of using the price mechanism.**” → “**Transaction Costs**”

“A firm will tend to expand until the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on **the open market** or the **costs of organizing in another firm.**” (Coase 1937, p. 395.)

The firm as a **nexus of contracts.**

TRANSACTION COSTS



- Why not pay for office services by the piece?
 - \$1 per letter typed, etc.
- Manager unlikely to know in advance which services needed.
- Manager pays for the secretary's time, and decides tasks later.
- The size of the firm not its output (Q) but **the number of transactions or activities within its boundaries.**
- If the telephone reduces the costs of using the price mechanism more than it reduces the costs of organizing, then it will have the effect of reducing the size of the firm."

TRANSACTION COSTS



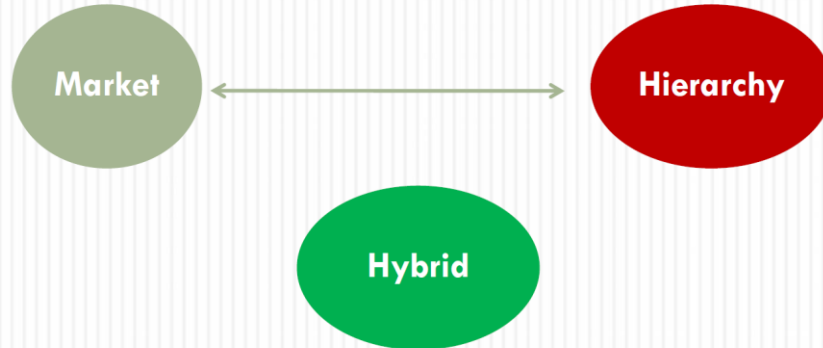
- Types of transaction costs
 - **Information cost:** Cost of discovering the relevant prices.
 - The actors frequently must act on **incomplete information** and **process the information** that they do receive through mental constructs that can result in persistently inefficient paths.
 - More info → More efficient market coordination
 - But seeking information is costly.
 - **Negotiation cost:** Costs of negotiating and concluding a separate contract for each exchange.
 - Employment contract vs. Spot contract.
 - **Enforcement cost:** Costs of coordinating when tasks are uncertain.

TRANSACTION COSTS: MARKET GOVERNANCE



Oliver Williamson

- Two polar forms



Hierarchy

- Many economic activities take place within firms
- “economies of scales”/ “comparative advantage”: ‘to make’ instead of ‘to buy’
- Employers & Employees contract

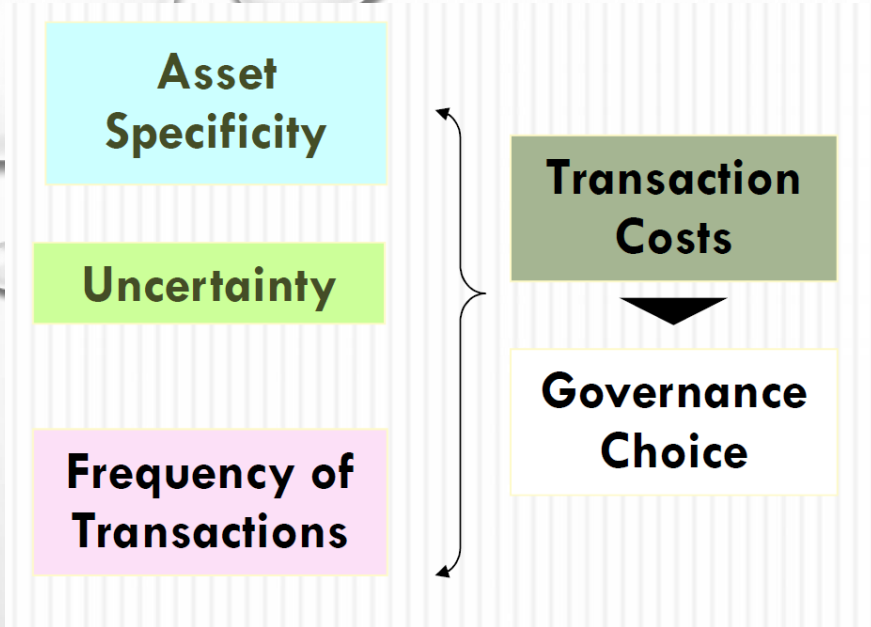
Hybrid

- Pooling Resources
- Reciprocal Returns
- Contracting (to regulate the relationship among partners)
- Cooperatives/ Franchising/ Sub-contracting/ Contract farming/ Sharecropping

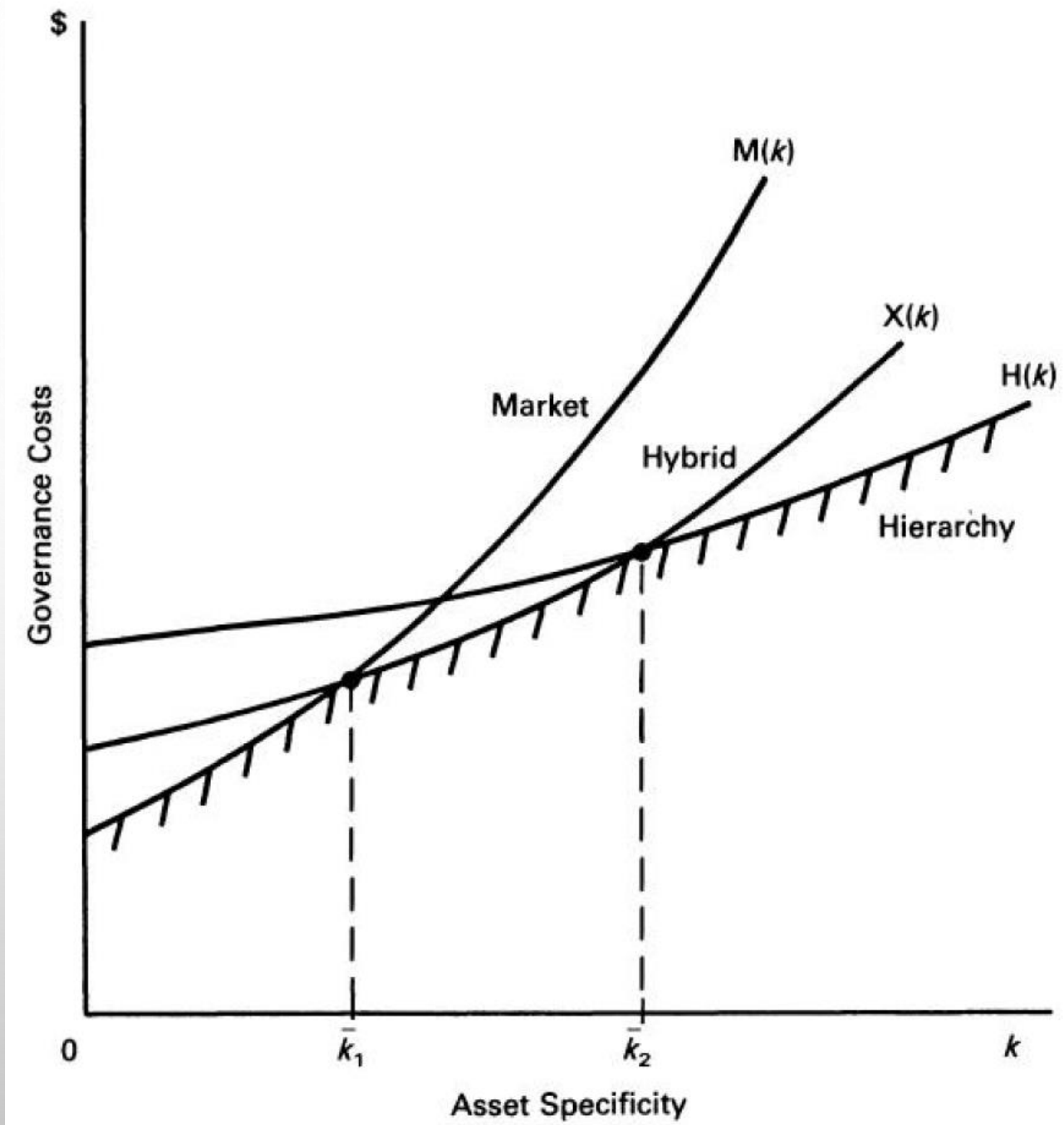
Distinguishing Attributes of Market, Hybrid, and Hierarchy Governance Structures*

Attributes	Governance structure		
	Market	Hybrid	Hierarchy
Instruments			
Incentive intensity	++	+	0
Administrative controls	0	+	++

* ++ = strong; + = semi-strong; 0 = weak.



- Three “critical dimensions” of transactions:
 - Uncertainty;
 - Frequency;
 - Asset specificity.
- “The most critical dimension for describing transactions is **asset specificity.**”



Institutions & Performance

- **Second Dilemma: “Transaction Cost”**

- Those connections requires institutions and organizations that deliberately lower the **“transaction costs” of integrating knowledge in a society.**
- Effective price system gets you part way, but beyond that, then you need to develop **a variety of organizations and institutions that will bridge at low cost, and integrate at low cost**
- **Transaction costs** in political and economic markets make for inefficient property rights
- In the developed countries we have evolved all different kinds of specializations on various dimensions. → **Low transaction cost!**
- But supposing you are a third world country and are trying to compete with already developed countries. You face a big disadvantage



If you are a good chemist you do much better staying in the United States, in Switzerland or in Germany than you would in Bangladesh.

Institutions & Performance

- **Third Dilemma: “Rules of the Game”**

- Institutions (+technologies) determine the **transaction and transformation (production) costs** that make up total costs

- Any market that works well, whether it is a product market or a factor market, does so because it is structured in such a way that the players compete at those margins, and those margins alone, that ensure that people pursuing their self-interest also improve the well-being of society.

- If **political and economic markets** were efficient (i.e., There were zero transaction costs) then the choices made would always be efficient.

- **But in reality:** almost any market that is structured that way is going to have a mixture of **property rights** and **formal rules** underlying it.



INSTITUTIONAL CHANGES



- We made institutions the determinant of economic performance and **relative price changes** the source of institutional change
- Incremental change comes from the perceptions of the entrepreneurs in **political and economic organizations** that they could do better by altering the existing institutional framework at some margin
- Institutional change affects the choice set at a moment of time
- Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change

INSTITUTIONAL CHANGES



Continuous changes

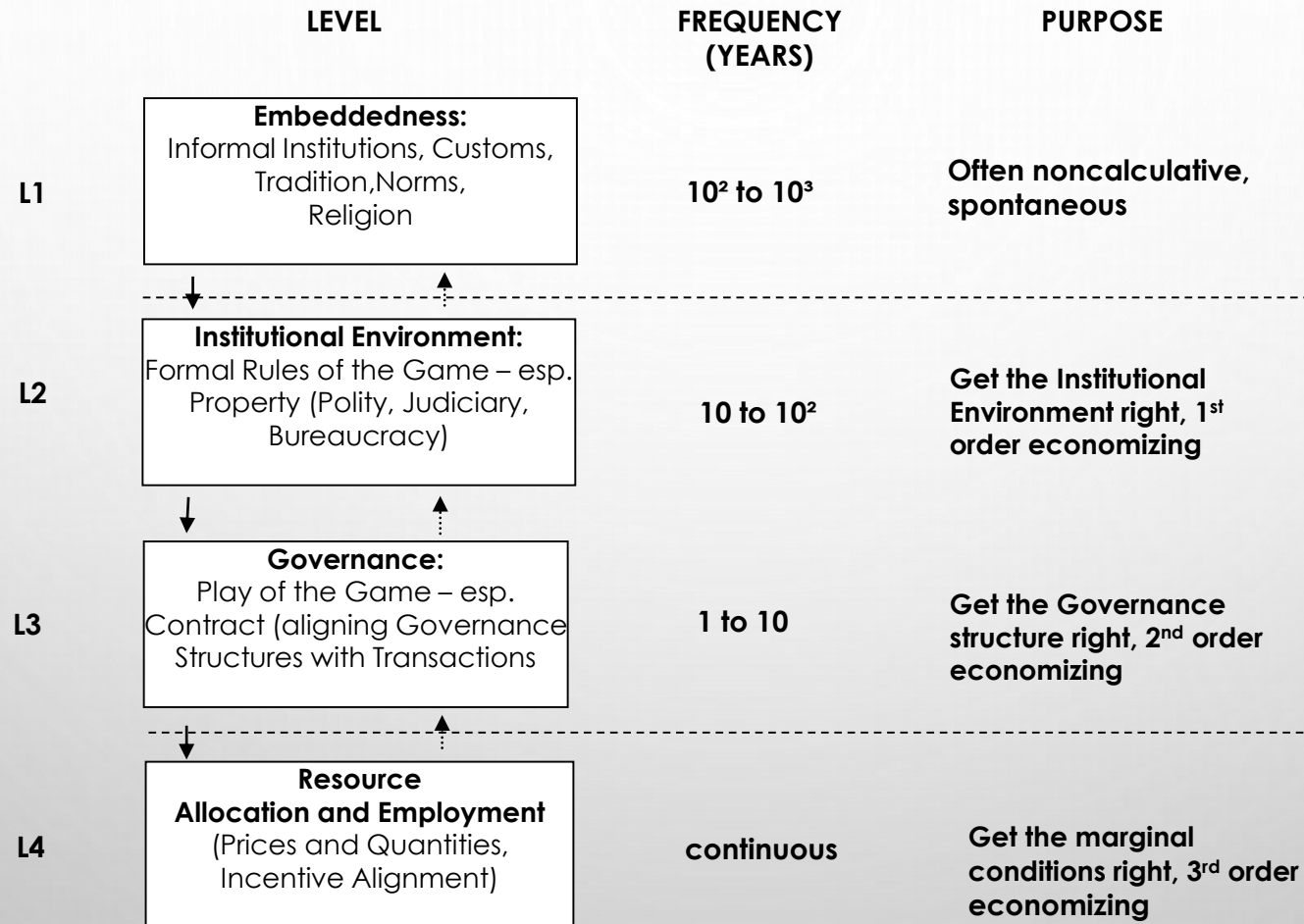
- The changes at the margin may be so slow and glacial in character that we have to stand back as historians to perceive them

Discontinuous changes

- Formal rules may change overnight as the result of political or judicial decisions
- However, informal constraints embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies.



ANALYTICAL LEVELS OF INSTITUTIONS



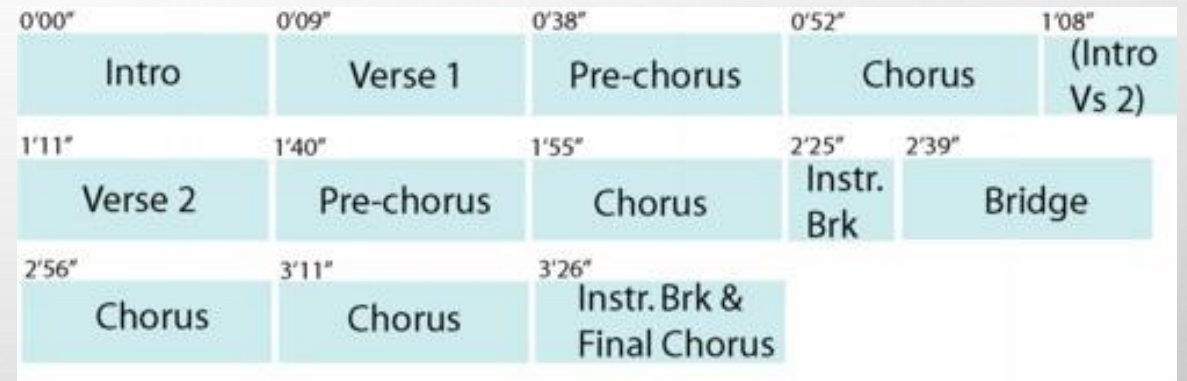
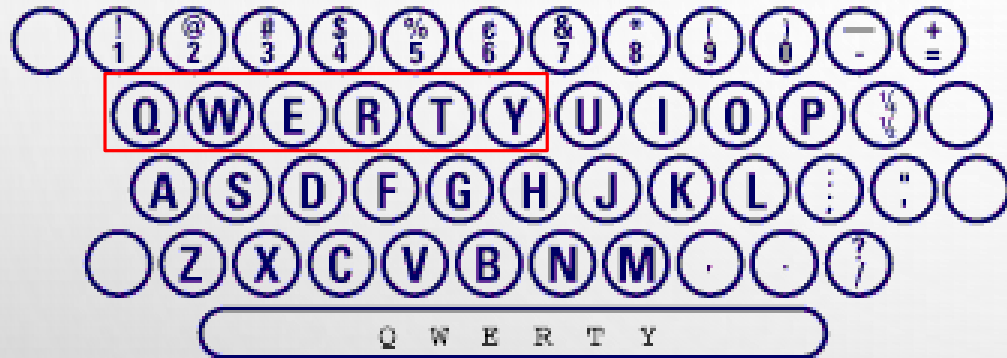
Williamson (1998)

INSTITUTIONAL CHANGES

- The resultant path of institutional change is shaped by
 - (I) The **lock-in** that comes from the symbiotic relationship between **institutions** and the **organizations** that have evolved as a consequence of the incentive structure provided by those institutions
 - (II) The **feedback process** by which human beings perceive and react to changes in the opportunity set.

PATH DEPENDENCE

- History matters for current decision-making situations
- Numerous examples of "inferior" technologies winning in the market



Song writing rule

PATH DEPENDENCE

- **Path dependence** is the idea that
 - Decisions we are faced with depend on past knowledge trajectory and decisions made, and are thus limited by the current competence base.
 - In other words, ***history matters for current decision-making situations*** and has a strong influence on strategic planning.
- People get "**locked-in**" to the inferior standard.



History matters for current decision-making situations?

Cheerleaders
in Thailand



Cheerleaders
in USA



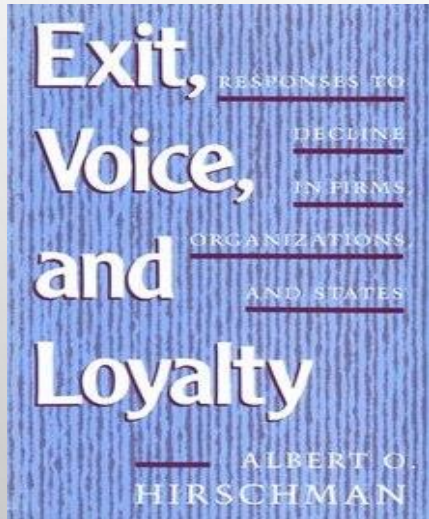
Graduation
Ceremony in
Thailand



Graduation
Ceremony in
Japan



FEEDBACKS PROCESS TO EXISTING INSTITUTIONS



Albert O. Hirschman
(1915–2012).

	Destructive	Constructive
Active	Exit	Voice
Passive	Neglect	Loyalty

lower ← commitment → higher

- Members of an organization, whether a business, a nation or any other form of human grouping, have essentially two possible responses when they perceive that the organization is demonstrating a decrease in quality or benefit to the member:
- They can **exit** (withdraw from the relationship); or, they can **voice** (attempt to repair or improve the relationship through communication of the complaint, grievance or proposal for change).
- However, the interplay of **loyalty** can affect the cost-benefit analysis of whether to use exit or voice. Where there is loyalty to the organization (as evidenced by strong **patriotism** politically, or **brand loyalty** for consumers), exit may be reduced

FEEDBACKS PROCESS TO EXISTING INSTITUTIONS



นิสิตนเรศวรลุกฮือ!ปิดรั้ว ค้าน"นโยบายสีเขียว"

นิสิต ม.นเรศวร นับพันคน รวมตัวบุกล้อมตึกอธิการฯประท้วง พร้อมปิดรั้วมหาวิทยาลัย ค้านนโยบายสีเขียวห้ามใช้รถจักรยานยนต์ทำเต็อดร้อนหนัก แห่ขอให้ยกเลิกโครงการ

Revealed: Thailand's most senior human trafficking investigator to seek political asylum in Australia

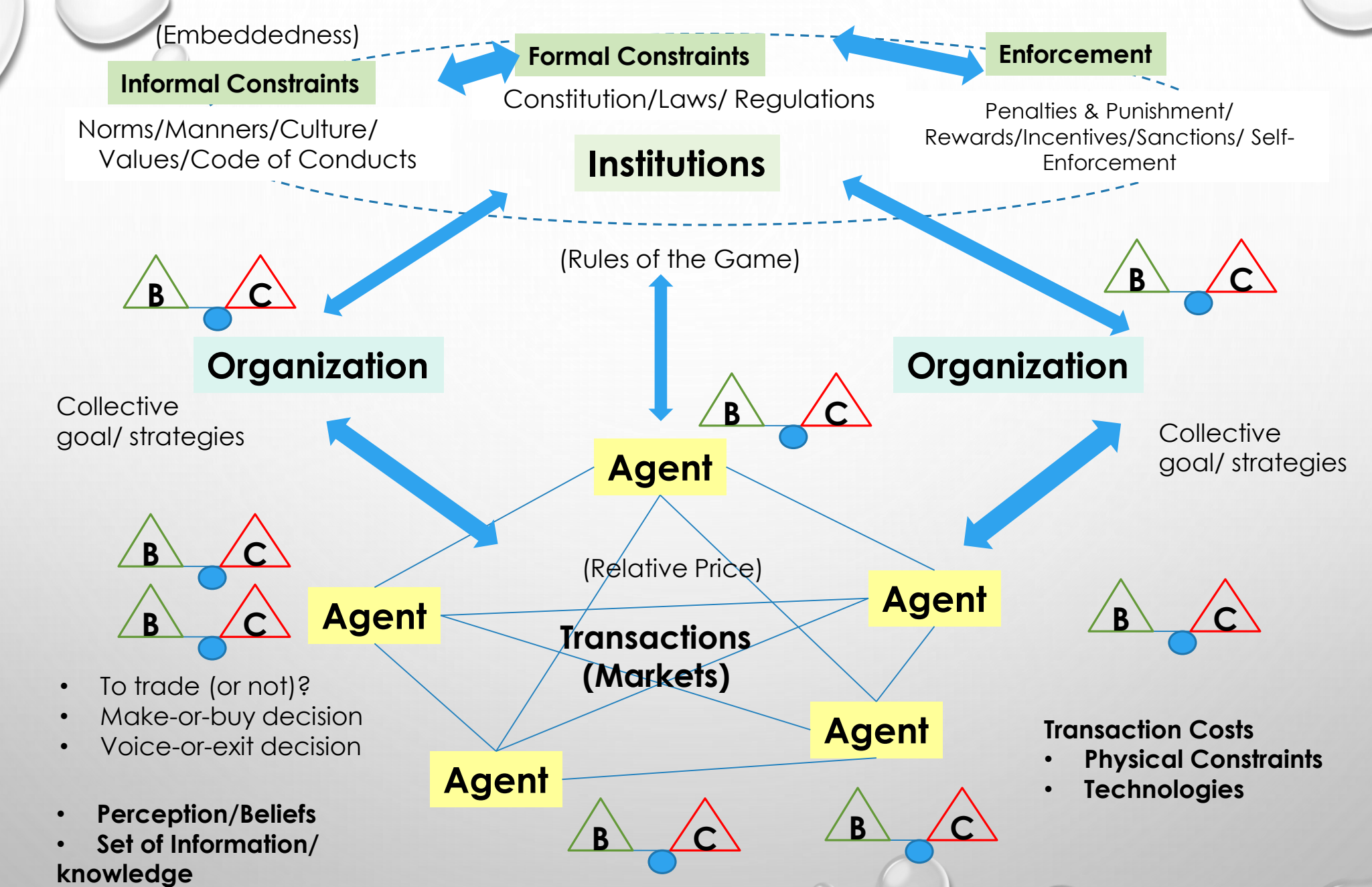
Major General Paween Pongsirin says his investigations into human trafficking implicated senior figures in police and military and he now fears for his life



Major General Paween Pongsirin in Melbourne. He was appointed to lead an investigation into the discovery of more than 30 mass graves that was later stopped by influential people, he says. Photograph: Meredith O'Shea for the Guardian

FEEDBACKS PROCESS TO EXISTING INSTITUTIONS



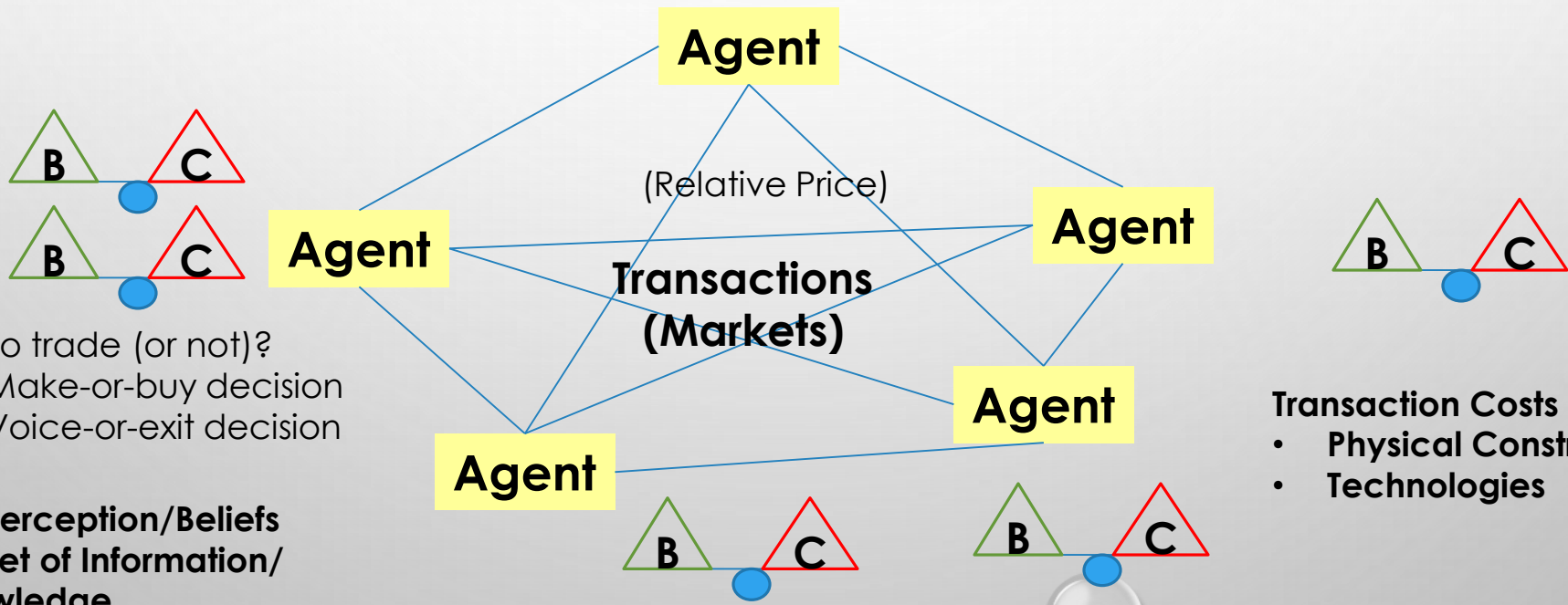


- To trade (or not)?
- Make-or-buy decision
- Voice-or-exit decision

- Perception/Beliefs
- Set of Information/
knowledge

Economic/Political/Social **Structure** → **Conduct** → **Performance**

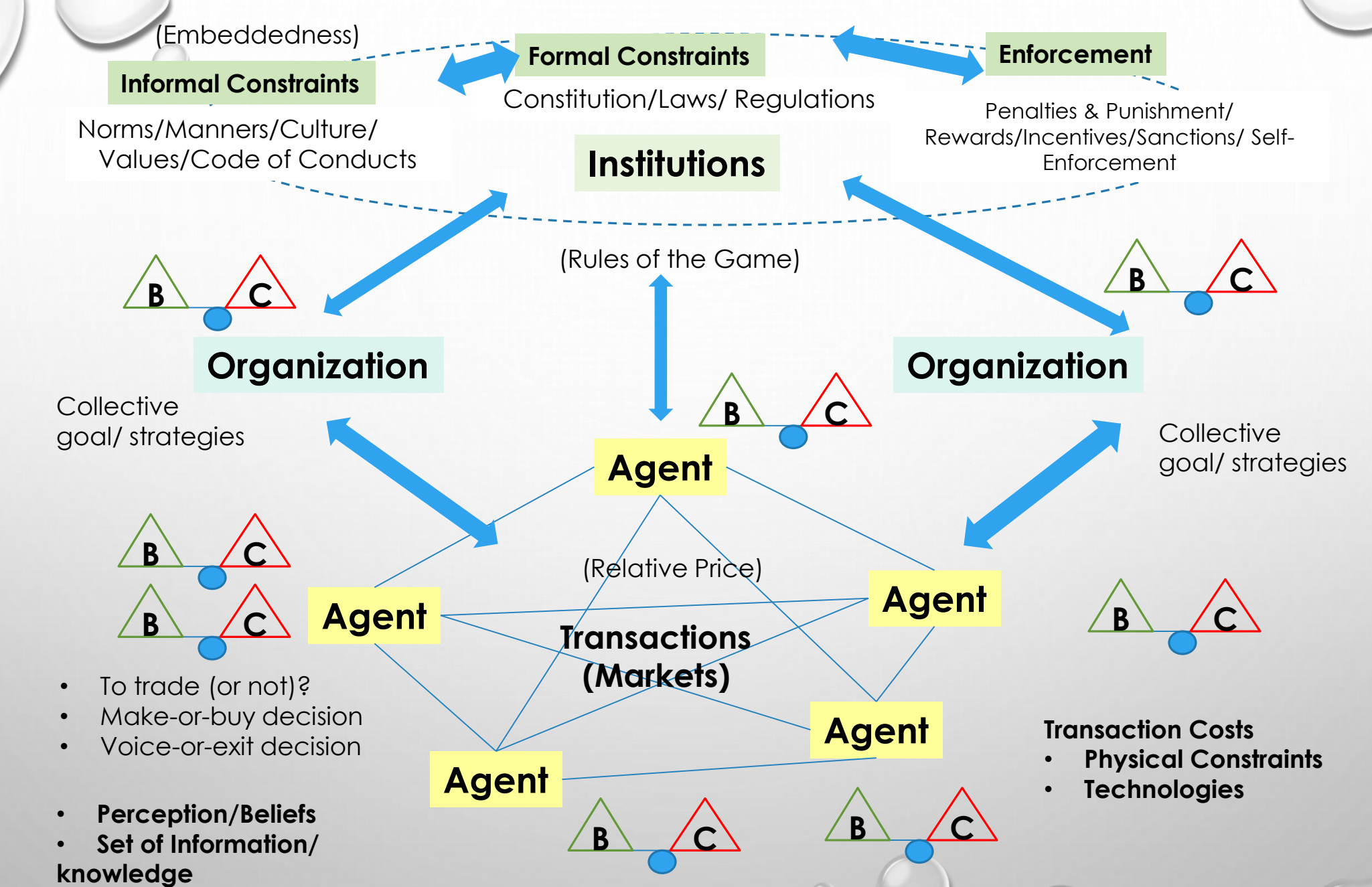




- To trade (or not)?
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- Perception/Beliefs
- Set of Information/knowledge

- Transaction Costs**
- Physical Constraints
 - Technologies



Economic/Political/Social **Structure** → **Conduct** → **Performance**

- **Development** → How to improve the performance of the society? (Growth/ Wellbeing/ Inequality/ etc.)
- **Voice mechanism** → **Liabile organization** → **Change in Institutions** → **New transaction costs** (Change in relative prices) → **Change in agents' behaviors** → **Change in performance**

Making change?

$$D_i = B_{Ni} - B_{Oi}$$

If $D_i > (C1_i + C2_i + C3_i) \rightarrow$ Change occurs!

C1 : Costs of time and efforts spent devising and agreeing upon new rules

C2 : Short-term costs of adopting new appropriation strategies

C3 : Long-term costs of monitoring and maintaining a self-governed system over time

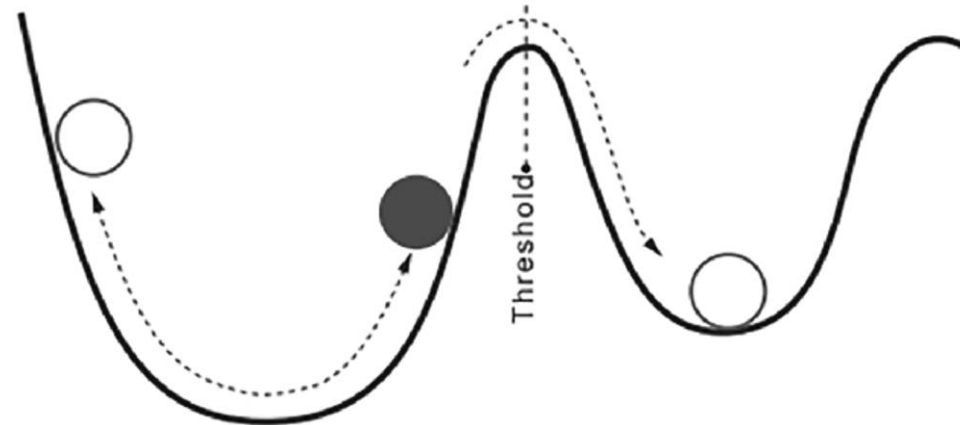
$$D_k > (C1_k + C2_k + C3_k)$$



นิสิตนเรศวรลุกฮือ!ปิดรั้ว ค้าน'นโยบายสีเขียว'

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Ball and Cup Resilience



Institutional Performance

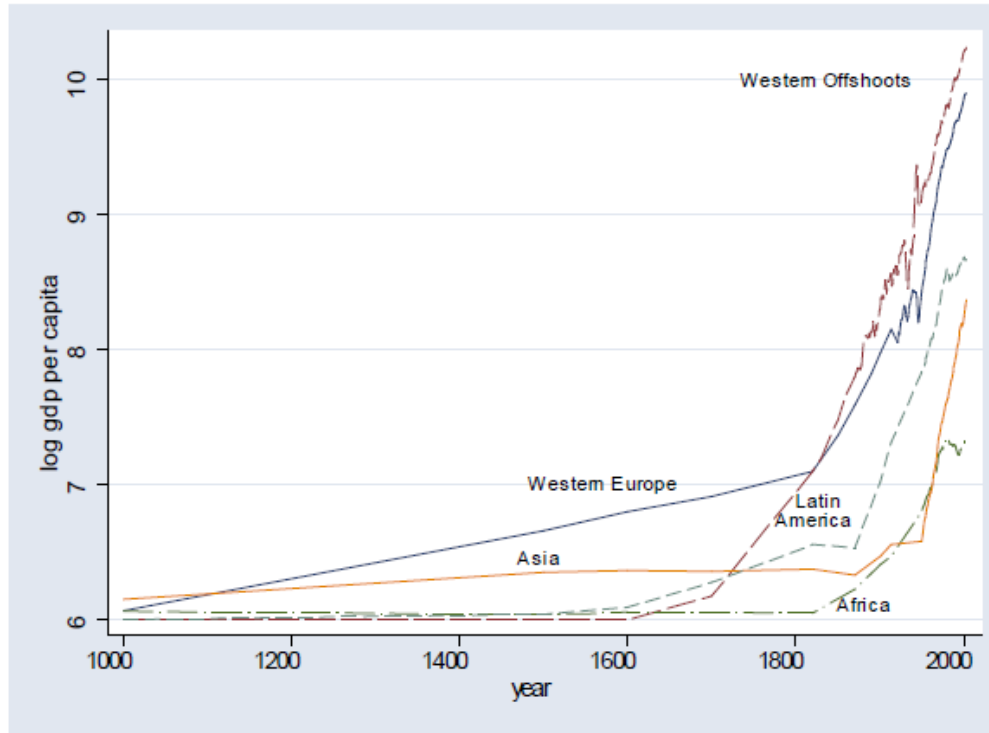
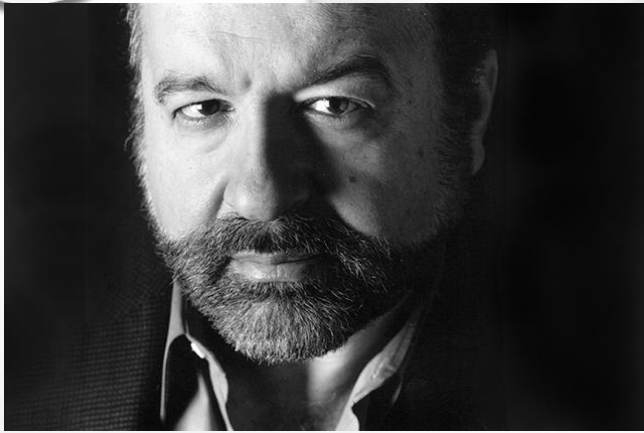


Figure: The evolution of average GDP per capita in Western Offshoots, Western Europe, Latin America, Asia and Africa, 1000-2000.

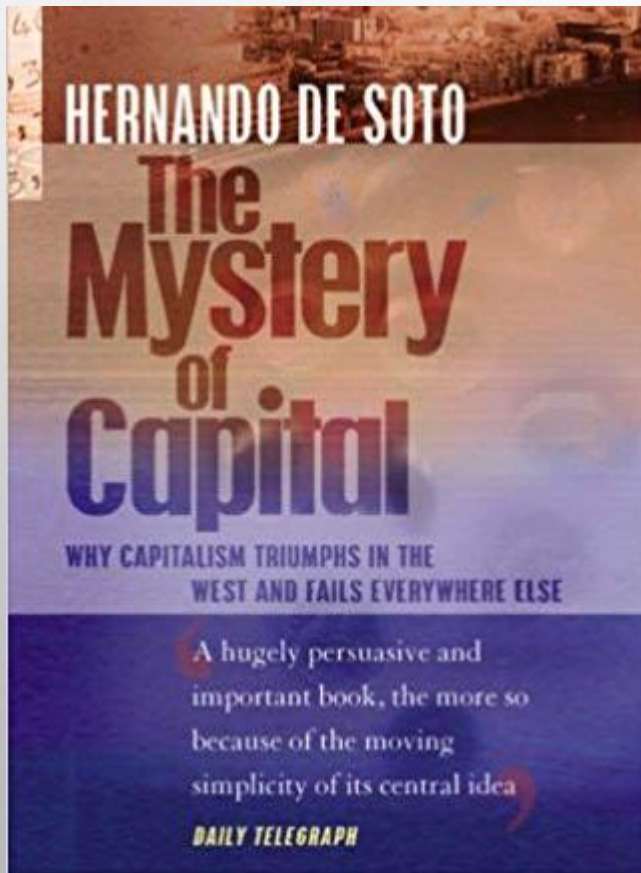
Outline

- **What is beyond market? (Polanyi)**
- **New Institutional Economics (North, Williamson)**
- **Case Study (DeSoto)**



MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE

Hernando De Soto

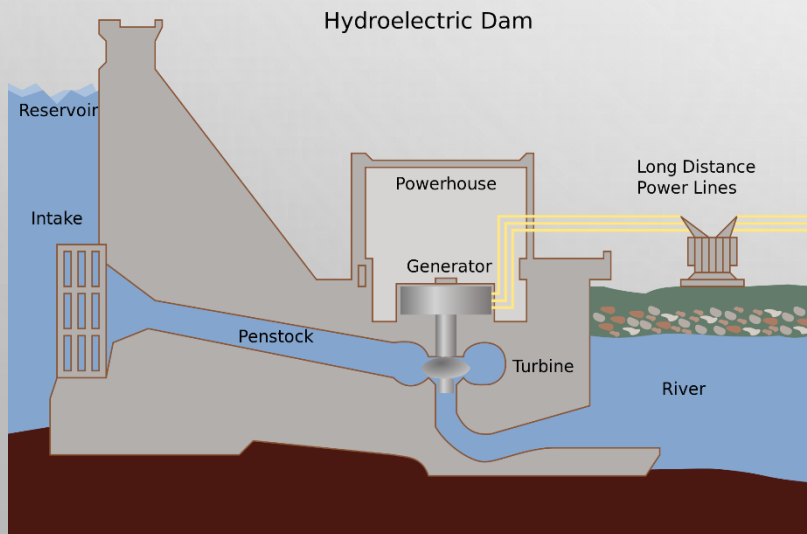


- **The mystery:** why can **assets** be made to produce abundant **capital** in the west but very little in the rest of the world?
- What do we mean by capital?
- What role do formal property systems play?
- Why does this matter?

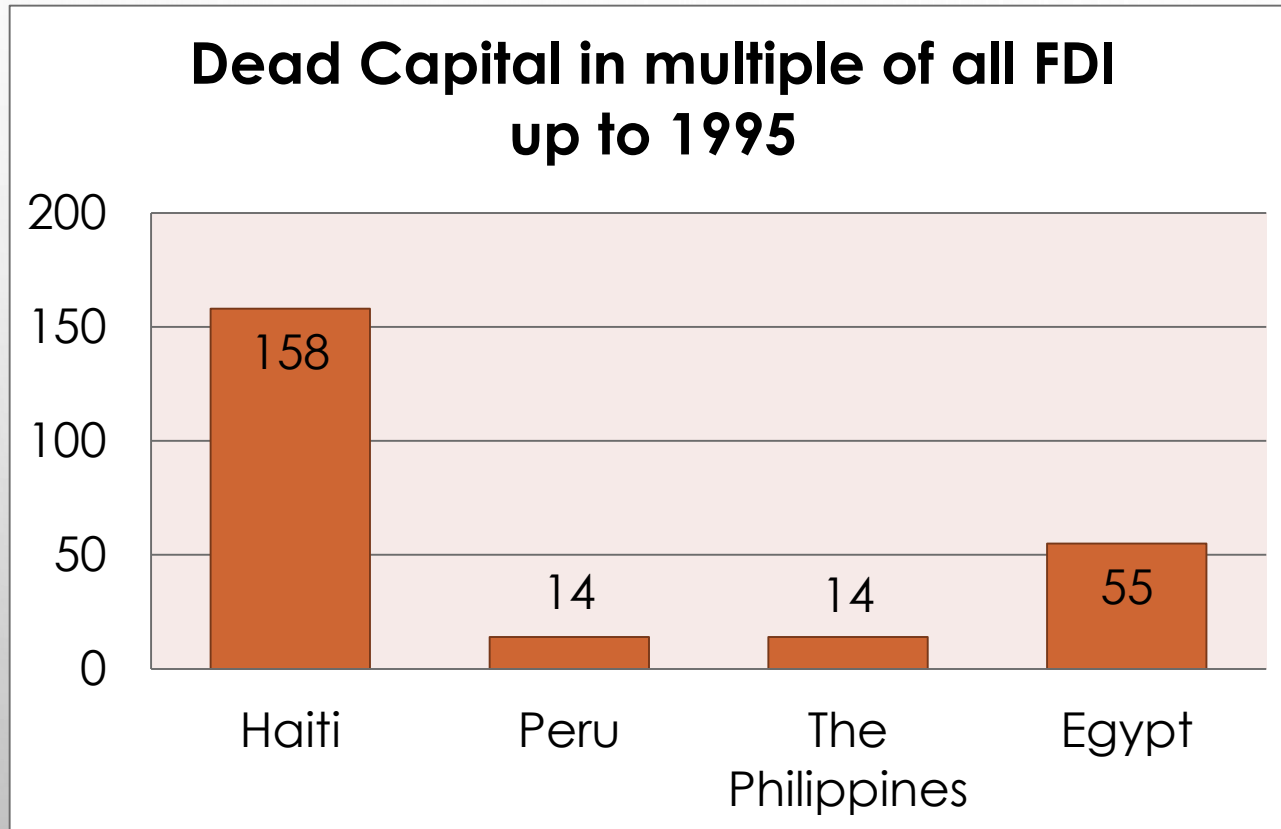
THE MYSTERY OF CAPITAL



- **Capital** is an abstract ability of any **asset** which will result in additional production.
- Historically, capital began to do 2 jobs simultaneously – capturing physical dimension of assets (originally livestock) and their potential to generate surplus value.
- De soto emphasizes that capital is not accumulated stock of assets but the potential that these held assets have to deploy new production.
- Any asset requires the conversion process to become capital. Those assets not converted into capital are called **“dead assets”**
- To be of use, assets must be transformed into tangibles. Dead capital exists because we have forgotten (or never realized) that using a physical asset to generate capital requires a very complex process. Formal property systems are important because they enable capital to be productive.

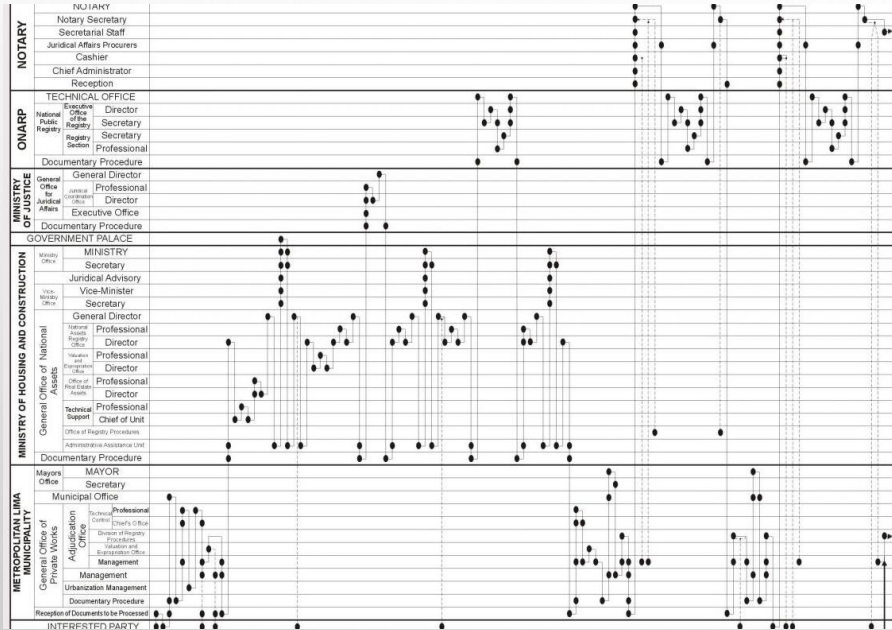


THE MYSTERY OF CAPITAL



- Capital affects a country's ability to initiate surplus and increase productivity.
- That conversion process is somehow unfeasible in developing and former communist countries.
- The challenge in non-western countries is that this is more vague and intangible than in the west.
- **How much dead capital?:** Examples from 5 Third World cities (Cairo, Lima, Manila, Mexico and Port-au-Prince) show that most people's resources are commercially and financially invisible.
- **How much is dead capital worth?:** \$9.3 trillion.

THE MYSTERY OF CAPITAL



PROCEDURES TO FORMALIZE A LEGALLY OBTAINED HOME IN PERU CONSIST OF 5 STAGES; THE FIRST ONE ALONE INVOLVES 207 STEPS

- In order to fix an asset into a form that can be used to initiate additional production, we need **a formal property systems**
- The only way to touch the capital is if the **property system** can record its economic potential on paper and anchor them to a specific location and owner.
- Formal property systems were *not* set up to create capital but for a more mundane purpose of protecting property ownership. Thus, the conversion process has been ignored for a long time.
- **The obstacles to legality:** on the basis of field surveys, in Egypt, Haiti, Peru, Philippines and Mexico, number of years and number of steps for getting approvals related to property have been described.
- In acquiring legal property rights, one might have to go through hundreds of steps and it takes more than ten years.
- It is very nearly as difficulty to stay legal as it is to become legal. There came “extralegals”

THE MYSTERY OF CAPITAL



Extralegal zones are characterized by modest homes cramped together, myriad of illegal workshops and armies of vendors on the streets

Extralegality

- **The undercapitalized sector:**
- Extralegal is when someone quits the system and live and work outside the official law
- Extralegal areas have their own rules which are enforced by their own selected authorities
- These extralegal social contracts have created a vibrant but “undercapitalized sector” (street vendors, apartment building workers, garbage collectors)
- Extralegal settlers, share the desire of civil society to lead peaceful, productive life. However they have no access to credits.

THE MYSTERY OF CAPITAL



Driving factors

- Worldwide industrial revolution-gigantic movement (migration) from isolated communities to participate in wide scale economic exchange
 - Failure of legal order to keep pace/ lack of institutions-forcing migrants to set up extralegal substitutes for established law
 - Fragmentation of property rights arrangements and unavailability of standard norms prevent interaction with the financial and investment markets
-
- **Political blindness**
 - Unaware of the growth of extralegal sector and breakdown of existing legal order
 - Problems are not new

LEGAL VS EXTRALEGAL



Braudel's bell jar

- Governments' attempts to deny the extralegal systems were plentiful, harsh and sometimes, deadly. Only to protect legally established industries.
- More laws were passed to prosecute those extralegals
- More obligations, more extralegality
- "Some investors' assets are integrated, fungible, networked and protected by formal property system. But they are only a minority"
- **"The great majority of people, who cannot benefit from formal property system, live outside the bell jar"**

THE MYSTERY OF CAPITAL



- As the poor flow into the city and create extralegal social contracts, they are forcing a major redistribution of power
- Politicians began to realize that official law will not make sense if the majority of people (extralegal) do not benefit from it
- Law must be adapting to the reality of a massive extralegal push toward widespread property right
- **Making assets fungible** – able to split their assets into shares, owned by different persons, with different rights to carry out different functions

