

Emergence of Capitalism

In this lecture, we will attempt to address the following two fundamental questions:

1. What is capitalism?
2. Why does it only work in a few places?

What is capitalism?

*A **political economic** system in which individuals decide how, what and for whom to produce - private decisions are used to allocate limited resources.*

It uniquely *blends* market and command economy approaches to address the economic problem (wants > have) and produce efficient resource allocation.



It is important to realize Adam Smith's ***laissez-faire*** economic policy and the workings of its *invisible hand* in the market require the ***rule of law***.

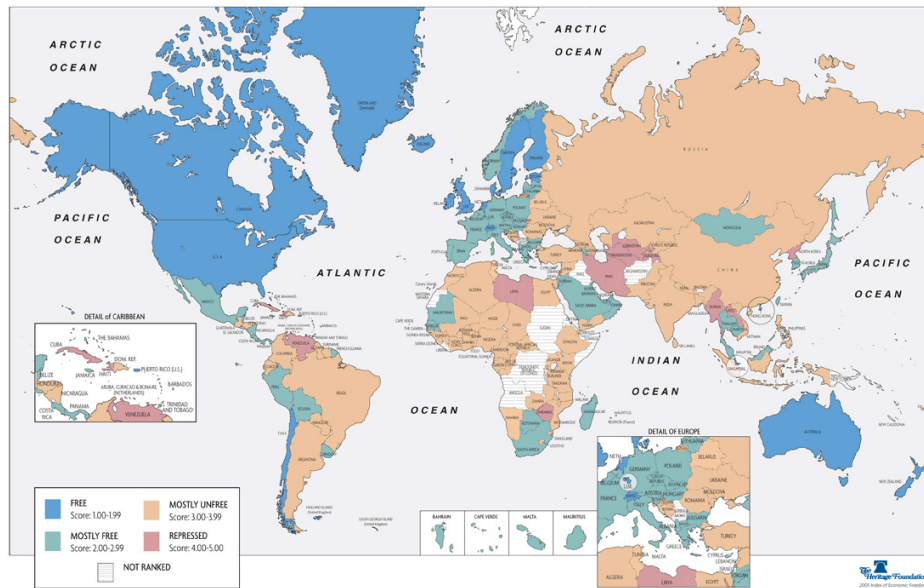
Which nations or economies practice capitalism (as we defined it)?

Since the collapse of the Berlin Wall in 1988, many assumed that capitalism has triumphed and it is poised to dominate the world. And now, it is clear that this assumption is incorrect.

According to the Heritage Institute, there are only a few selected economies that practice capitalism (or individuals making key decisions in regard to managing limited resources.).

Which are they?

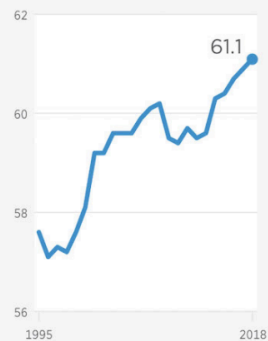
DISTRIBUTION OF ECONOMIC FREEDOM



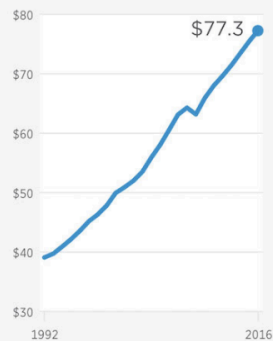
The data continues to show that more economic freedom leads to greater material wealth and higher standards of living..

AS ECONOMIC FREEDOM RISES, THE GLOBAL ECONOMY EXPANDS AND POVERTY FALLS

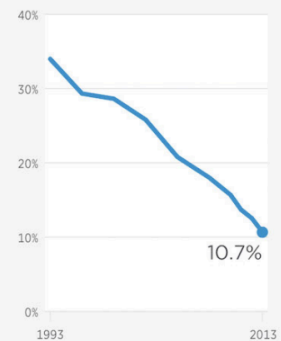
Average Score in the *Index of Economic Freedom*



Global GDP, in Trillions of 2010 U.S. Dollars



Percentage of Global Population in Poverty



SOURCES: Terry Miller, Anthony B. Kim, and James M. Roberts, *2018 Index of Economic Freedom* (Washington: The Heritage Foundation, 2018), <http://www.heritage.org/index.org/index>; The World Bank, *World Development Indicators*, <http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators> (accessed November 16, 2017); and The World Bank, PovcalNet, <http://iresearch.worldbank.org/PovcalNet/povDuplicateWB.aspx> (accessed November 16, 2017). Some figures have been interpolated.

Chart 3 heritage.org

If this is the case, why not import or download capitalism so that every nation can get wealthier (and solve the current poverty problem!)



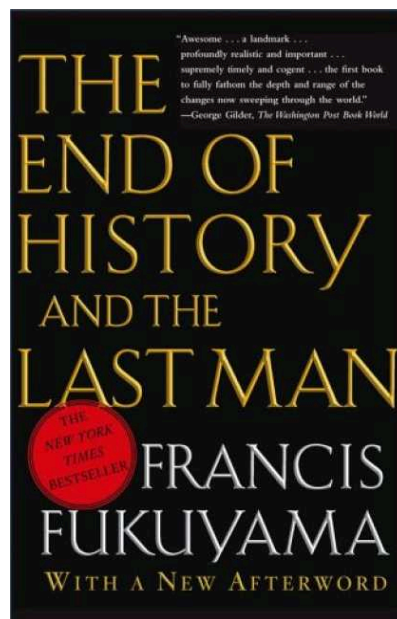
The World Bank reports that:

26.2% of global population lives on less than \$1 per day

56.0% of global population lives on less than \$2 per day

In fact, the collapse of communism (defined below) - an alternative economic system - suggests that capitalism is the only viable system left today.

a political theory derived from Karl Marx, advocating class war and leading to a society in which all property is publicly owned and each person works and is paid according to their abilities and needs



Enigmatically, the implementation and wide practice of capitalism has been tarried.

Why? An important question (for anyone who studies international economies) is why don't we see the use of capitalism everywhere?



Perhaps, if we can understand how it emerged in the first place then we may be able to answer the question. (You need to play the role of an economic private investigator)

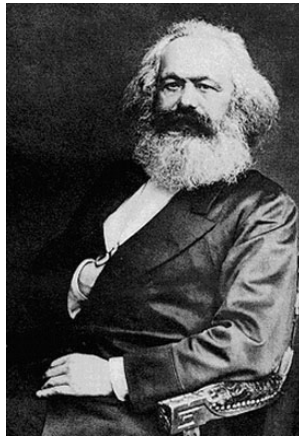


To answer this question, we turn to the work of five well known thinkers/observers to synthesize a potential explanation or "story." The five thinkers/observers are:

Adam Smith - *The Wealth of Nations* (1776) – Many consider Smith to be the father of economics. He advocated specialization and trade (to create greater wealth).



Karl Marx (& Friedrich Engels) – *The Communist Manifesto* (1848) – They explained the development of capitalism (e.g. exploitation) so that he can oppose it.



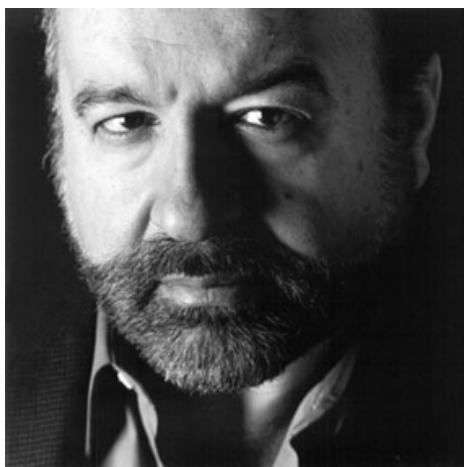
Karl Polanyi – *The Great Transformation* (1944) – Outlined the stark utopia of capitalism (e.g. destruction of social organizations) but suggests that there is no other option.



Ludwig von Mises – *Human Action* (1949) - He argued that the free-market economy not only outdistances any government-planned system, but ultimately serves as the foundation of civilization itself.



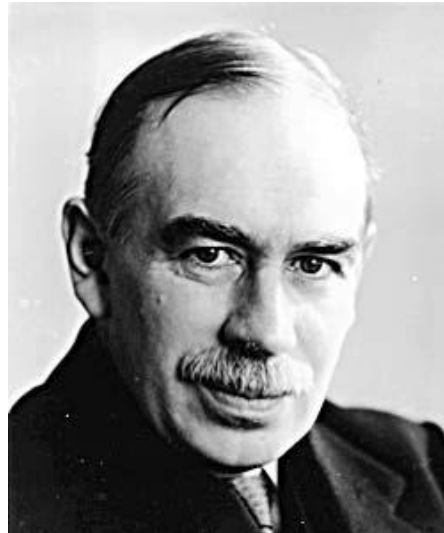
Hernando de Soto – *The Mystery of Capital* (2000) – He explained why capitalism requires hard work (political & legal structure) to implement it.



Note that these ideas do shape the world. John Maynard Keynes once wrote:

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood.

Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.



And our **synthesized story** goes this way....

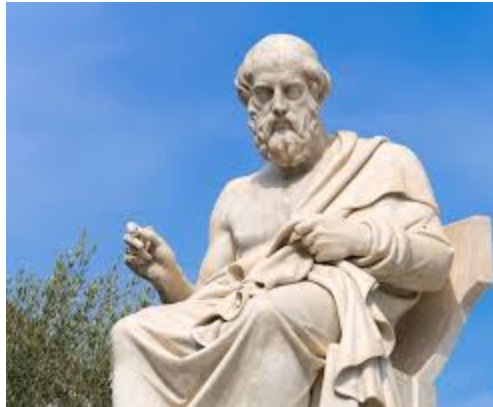
Pre-Market System Period

Before dominant market (commercial exchange of goods and services) institutions appeared, cultural and traditional systems addressed economic issues in a community.



Everyone had a place in the tribe or feudal community. Tradition and norms strictly maintained social order.

Small tribes and cities (e.g. Greek cities) were established but their growth was limited (social bond). In fact, Plato's Republic suggests that an enlightened ruler should rightly rule.



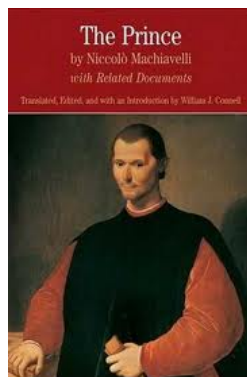
Which economies are at this stage of development?

Nation States

We have a natural desire for order and to control the environment. (It is a power thing)

Strong tribes and cities emerged into organized states and eventually nation states to establish order and control their surroundings (e.g. within the area).

Niccolo Machiavelli – *The Prince* represents the emergence of state power over the individuals and communities.



Pursuit of national wealth (and power) – accumulation of gold and silver – became the primary goal. States believed that when gold is accumulated then nations are better off.

To get gold, nations had to export and minimize imports (still working with the win-lose framework.) Trade guilds and government sanctioned monopolies prospered.

Mercantilism evolved (**government determines who, what and for whom**) was to support the state.

This process created conflicts – everyone wanted to export – engaged in a zero sum game and subsequently fueled colonialism, imperial trades (e.g. slavery) and commercial wars.



Extralegal Community

Ongoing conflicts and trades encouraged the development of markets, transportation (roads, ships, trains and etc) and the flow of information.

Migration of masses (for the first time...) resulted in the erosion of traditional communities. Migration provided cheap labor for capitalists to generate production surplus and accumulate capital. (This is happening in western China provinces now.)



Which came first - capitalists (owners of physical capital) or laborers?



What is capital? In medieval times, capital denoted a head of cattle or other livestock. It is an important source of production.

Adam Smith suggested that capitalists (Bourgeois) created production surplus via specialization and exchange (e.g. more than what we need to consume now) with excess labor.

The accumulation of capital (production tools and machines) required ever more supply of cheap labor to create more production surplus (and so on).

Production surplus that does not become capitalized needed a market to dispose of. Therefore, nations created markets (e.g. colonies).

With migration, extralegal (outside the legal framework) communities emerged around the major urban cities.

The government or guilds were not able to absorb them into their legal and trade institutions. No government regulations and guild controls stimulated innovations and progress.

More importantly, nation states embraced them so that they can get more gold by exporting surplus production.

Extralegal communities supported individualism and influenced the Physiocrats (doctors of community) in France. They supported the laissez-faire economic policy. This led to the breakdown of mercantilism or state control.



Market Economy

Adam Smith observed what was happening in the extralegal communities and formulated his theory of market – workings of an invisible hand – based on individual actions (specialization) and their interests (win-win exchange).

Specialization and exchange generate production surplus or wealth (not consumed immediately). Surplus requires the development of private property laws.



De Soto suggests that if the private property laws are clear and enforced then more “capital” can be developed.

Accumulated capital (production tools and machines) raises the labor productivity and generates more wealth. Productivity is the key!



Virtuous Cycle:

More Labor \square Specialization + Capital \square Production Surplus + Rule of Law (Private Property) \square More Capital \square More Labor \square ...

Backlash

The accumulation of capital requires more workers. Karl Marx described proletarians as those who have no means of production without capital.

Proletarians become dependent on bourgeois (capitalists). To produce more surplus, bourgeois exploit proletarians by paying natural wages – enough to sustain them.



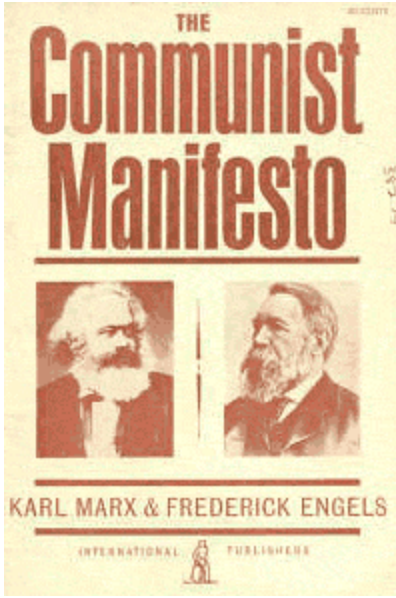
Exploitation of proletarians eventually creates class struggle or fight over limited resources.

The Bourgeois class will eventually get smaller because a smaller number of businesses will dominate the markets.

Therefore, a growing number of Proletarians should unite (workers unite) and overthrow the bourgeois class (revolution).

The revolution requires eliminating private property to stomp out capital formation. If not, it will spread like a disease and tear up the traditional communities.

For more thoughts on Marx, review the Communist [Manifesto](#) (Be careful....)



In the earlier epochs of history, we find almost everywhere a complicated arrangement of society into various orders, a manifold gradation of social rank. In ancient Rome we have patricians, knights, plebeians, slaves; in the Middle Ages, feudal lords, vassals, guild-masters, journeymen, apprentices, serfs; in almost all of these classes, again, subordinate gradations.

The modern bourgeois society that has sprouted from the ruins of feudal society has not done away with class antagonisms. It has but established new classes, new conditions of oppression, new forms of struggle in place of the old ones.

Our epoch, the epoch of the bourgeoisie, possesses, however, this distinct feature: it has simplified class antagonisms. Society as a whole is more and more splitting up into two great hostile camps, into two great classes directly facing each other -- bourgeoisie and proletariat.

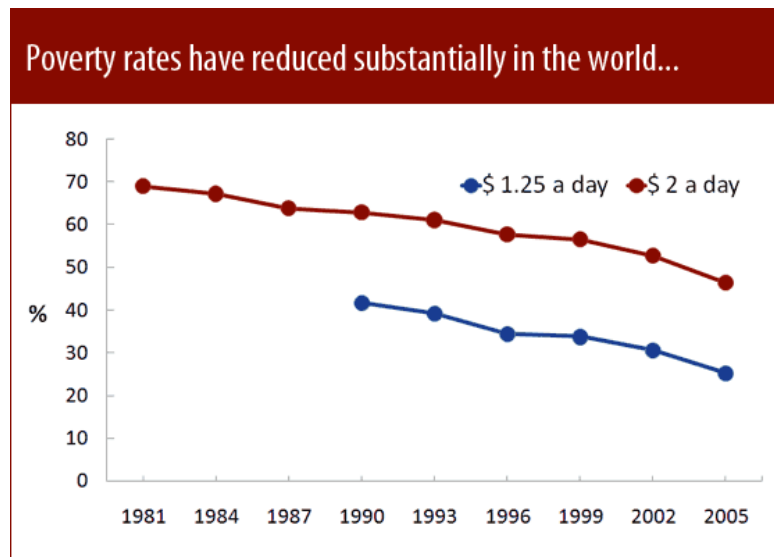
Stark Utopia

Karl Polanyi observed that markets implied a stark utopia and predicted “*it can not exist for any length of time without annihilating the human and natural substance of society.*”

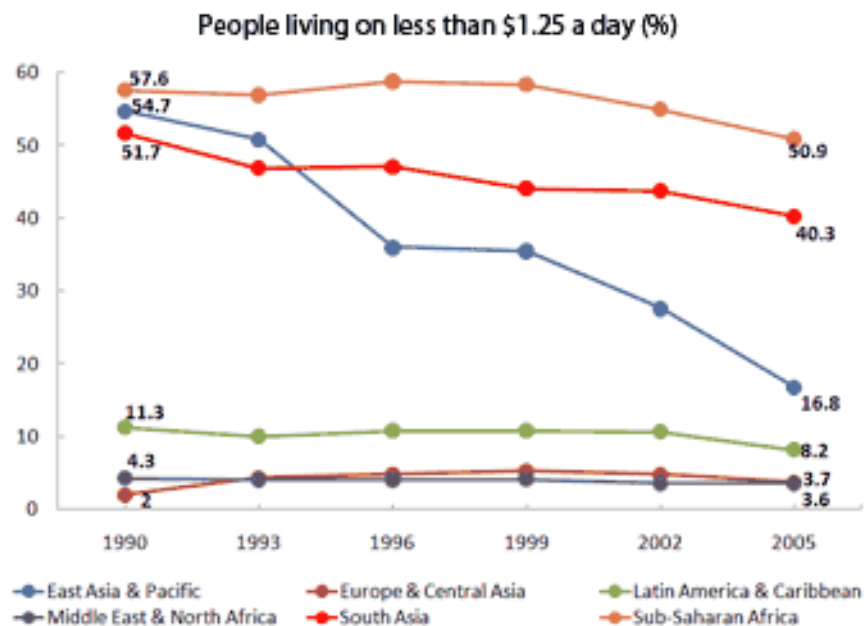
He coined the term, market transformation to describe this dark process. Unfortunately, there is no other economic system that is able to satisfy the material wants and needs of the growing global population.



The World Bank reported that even with the problems that come with capitalism, it has raised the overall level of living standard in the world.



For more detailed information on global poverty, look over:
<http://www.worldbank.org/poverty/index.htm>



Let us go back to our original question. **Why is capitalism not widely practiced?**

De Soto observed, "Mexicans were taking their products to markets long before Columbus reached America."

Hernando de Soto suggests that people want to be successful and have more (share the same core!). Unfortunately, there are no clear and enforced private property laws in many countries.

Over 80 percent of the global population lives outside the full protection and benefit of private



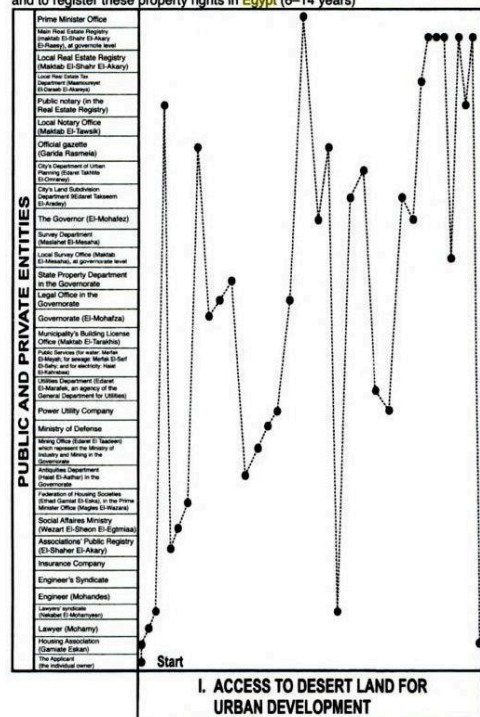
property laws. It is difficult to verify ownership of properties.

If properties are unable to be verified then they cannot be used to generate more capital (no collateral) and more importantly traded or invested.

Who owns that land? Who owns that house?

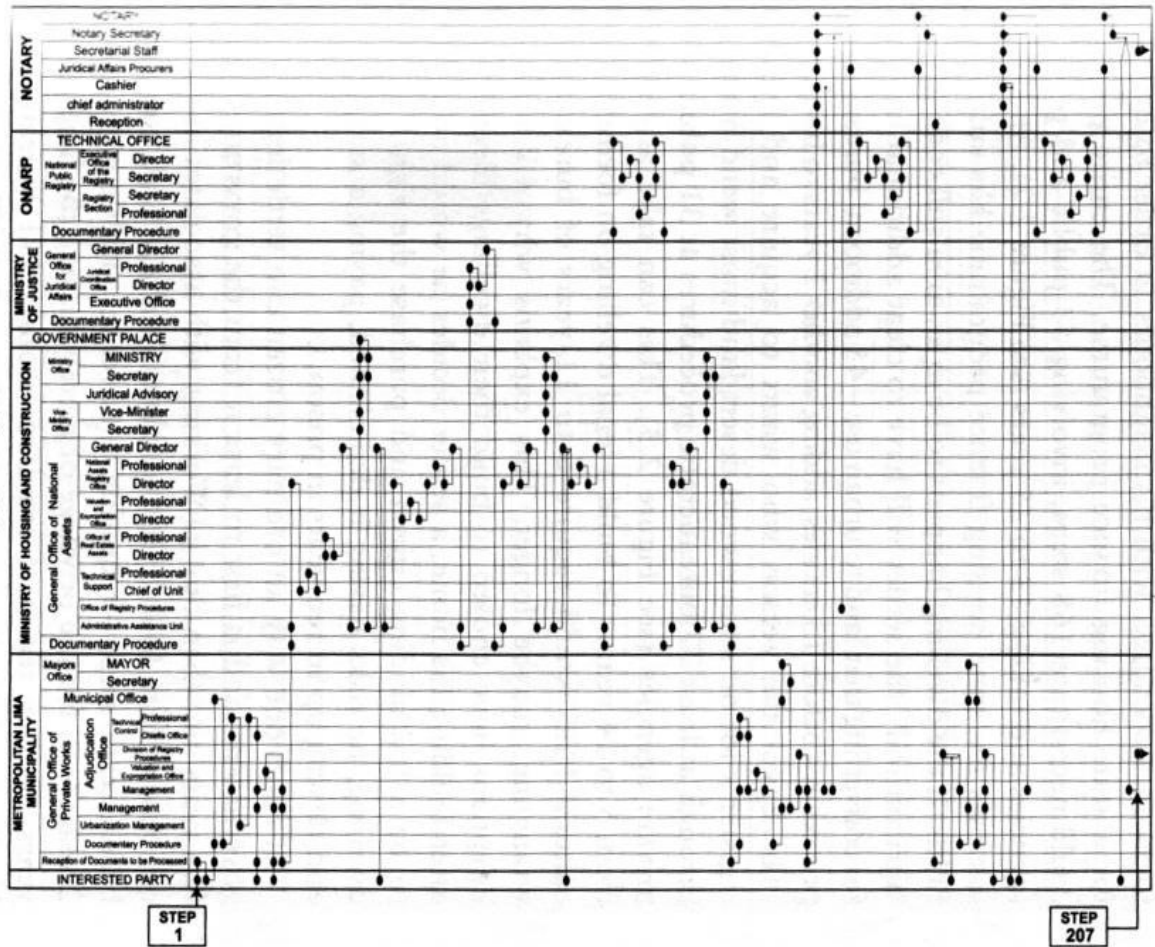
Without verifiable property, it cannot be used to produce more capital (e.g. no loan, investment and etc.) and becomes dead capital – wasted resources.

FIGURE 2.3 Procedure to gain access to desert land for construction purposes and to register these property rights in Egypt (6–14 years)



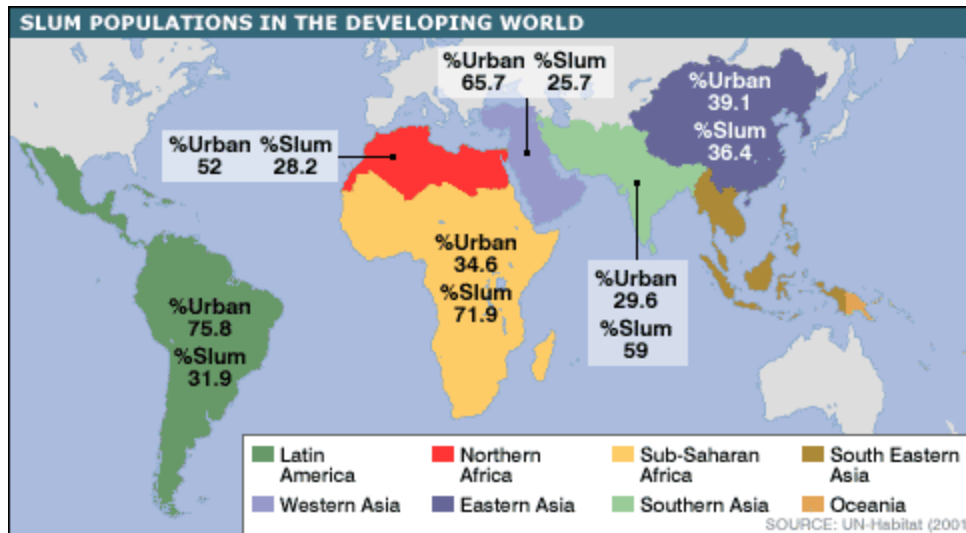
PROCEDURES TO FORMALIZE A LEGALLY OBTAINED HOME IN PERU
CONSIST OF 5 STAGES; THE FIRST ONE ALONE INVOLVES 207 STEPS

Figure 2.1



Dead capital represents waste and lost opportunities. De Soto's dead capital estimates are:

Philippines	\$132.9 billion
Peru	\$74.2 billion
Haiti	\$5.2 billion
Egypt	\$241.2 billion



Why not transform dead capital into living capital?

Barking dogs know who owns the property. Many nations do not have good laws. Even worse, their legal process is even worse.

The required legal process to form a legally obtained home in Peru – consist of 207 steps and 26 months.

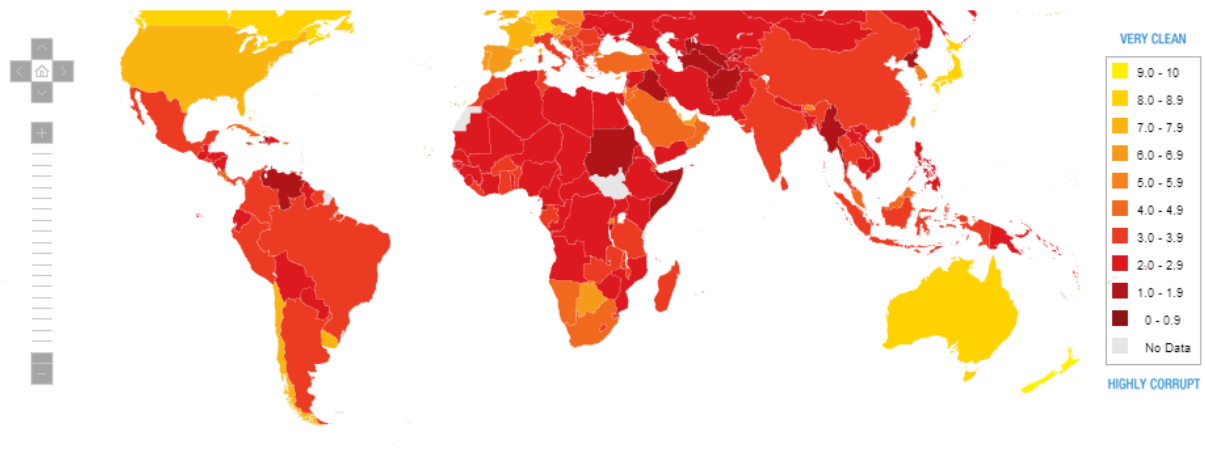
The required legal process to formalize informal urban property in the Philippines – consists of 168 steps and 13-25 years.

The required legal process to gain access to desert land for construction and register the property rights in Egypt – 77 steps and 6-14 years.

The barriers to transforming dead capital to living capital are not only real but very much prevalent. And these barriers breed corruption (which further undermines market mechanisms).

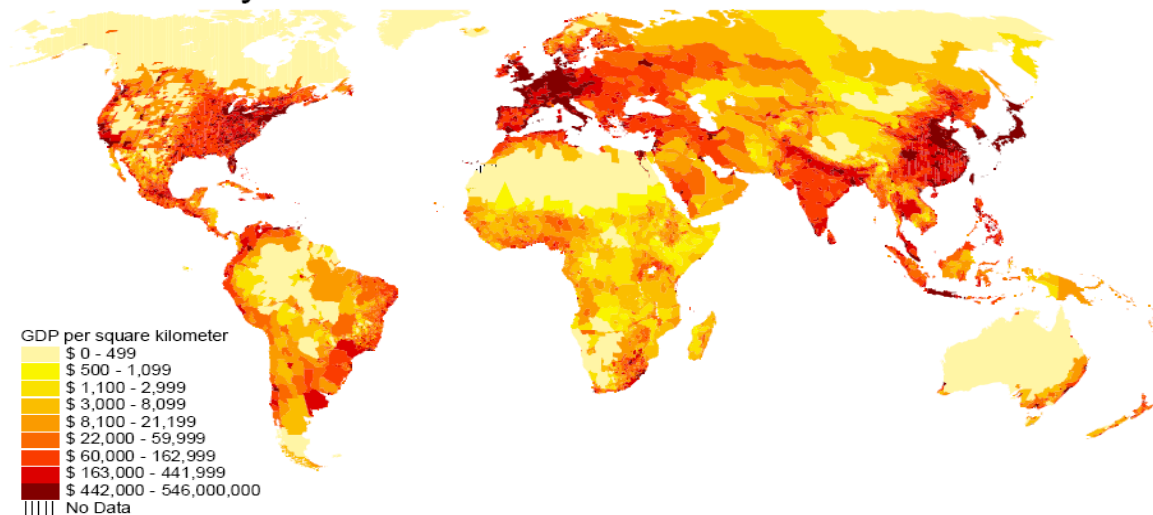
The current Transparency Corruption Perception Index is available [here](#).





Do you see any correlation with the GDP density map below?

GDP Density



So why is capitalism not widely practiced?

It is a political/legal problem and which requires a good set of private property laws that enables hard work to be transformed into living capital to support growth.

This problem is now wrecking another economy....

Zimbabwe farm output to continue sharp fall: union

Wed Jan 21, 2009 11:58am GMT

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1 of 1 **Full Size**

HARARE (Reuters) - Zimbabwe faces another huge food deficit in 2009 due to continued falls in farm production, mounting political uncertainty and economic instability, a report by a farmers' union said on Wednesday.

The southern African country is battling hyperinflation and has endured food shortages since 2000, when President Robert Mugabe's government began seizing farms from whites to resettle landless blacks.

A power-sharing deal signed by Mugabe and opposition leader Morgan Tsvangirai last September looks fragile due to bickering over control of key cabinet posts, dimming hopes the ruined economy will be rescued.

The Commercial Farmers' Union (CFU), which represents most of the few remaining white commercial farmers, said agricultural output would continue to fall sharply until the country's political crisis was resolved.

"Investment in agriculture is long-term and its risk factor very high, therefore under the present unstable conditions prevailing in Zimbabwe at the moment, production in all sectors is expected to be extremely low this season," the CFU said in a report.

The CFU added that the economic meltdown had also hit farm operations.

"The super-hyperinflation prevailing in the country and the unavailability of cash from the banks has also impacted negatively on any meaningful production this season," the union said.

The last official inflation rate, for July last year, stood at 231 million percent.

Donor agencies say more than 5 million Zimbabweans, almost half the population, currently rely on food handouts and expect the number to rise following another poor agricultural season.