Finance, Capital and the Mystery of Economic Development

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What is capitalism?

There is a problem with definitions of *capitalism* that are principally in terms of:

(a) private ownership of the means of production, and

(b) markets.

The problem is that both private ownership and markets have existed for thousands of years.

So, has capitalism existed for thousands of years?

Capitalism typically refers to a more recent system, and hence its definition needs to be narrower and more specific

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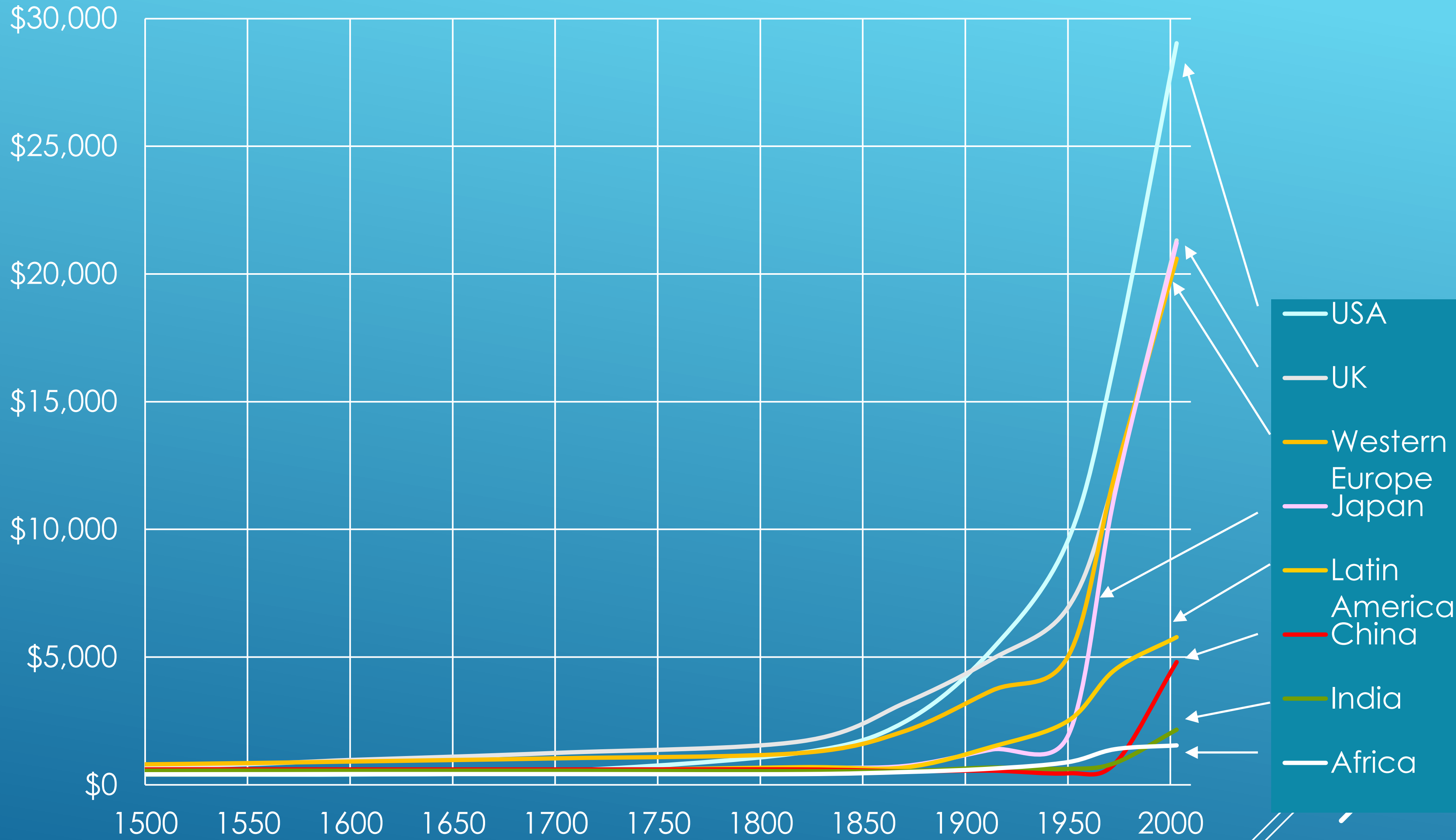


GDP per Capita

From Maddison (2007). GDP (PPP) per capita in 1990 international dollars.

Western European GDP per capita was about 20 times larger in 2003 than it was in 1700.

World GDP per capita in 2003 was about 11 times larger than it was in 1700.

US GDP per capita in 2003 was about 12 times larger than it was in 1870.

Between 1800 and 2000 life expectancy at birth rose from a global average of about 30 years, to 67 years …

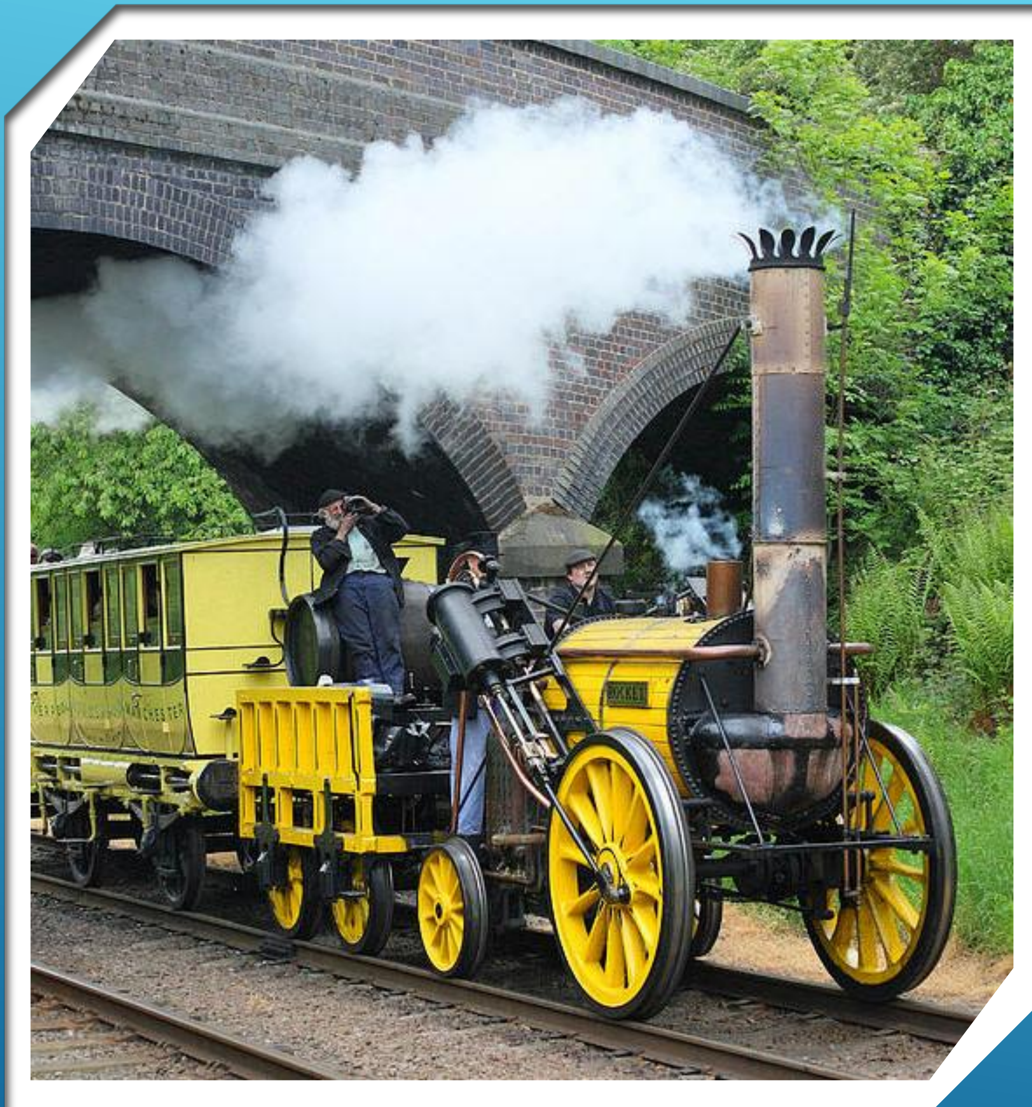
… and to more than 75 years in several developed countries (**Riley** 2001, **Fogel** 2004, **Deaton** 2013).

But global growth since 1700 has seen a widening gap between rich and poor nations (**Milanovic** 2011).

We need to look at key changes from about 1700 onwards.

What created this huge increase in entrepreneurship, wealth and productivity?

Was it due to technology?



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- Does technology explain the post-1700 take off?
- Technology was very important.

But what are the necessary conditions for the development and diffusion of new technology?

- communities of scientists and engineers, to scrutinize, share, and develop ideas.

- political conditions, developed financial institutions, property rights, patent laws, etc..

Was the take-off caused by ideas? – Deirdre McCloskey

Yes, of course.

But ideas germinate and spread on an institutional soil.

Ideas need institutions to be noticed, filtered, selected, adopted, laid down in habits, promoted and empowered.

We need to focus on institutional changes in the 1600s and 1700s in leading capitalist countries.

These two centuries saw the development of key financial institutions, notably in the Netherlands and the UK.

These included banks, mortgaging, markets for debt, stock markets …

The importance of finance capital for capitalism

Capital-ism

The evolution of financial intitutions

The role of financial institutions in the (early) Industrial Revolution in Britain is often underplayed.

Michael Postan (1935) "the pioneers of the factory system had to draw almost entirely on their private savings, or on the assistance of friends"

Sidney Pollard (1964) "banks provided little long-term capital because little long-term capital was demanded."

Pollard estimated that the value of fixed capital (goods) was often low.

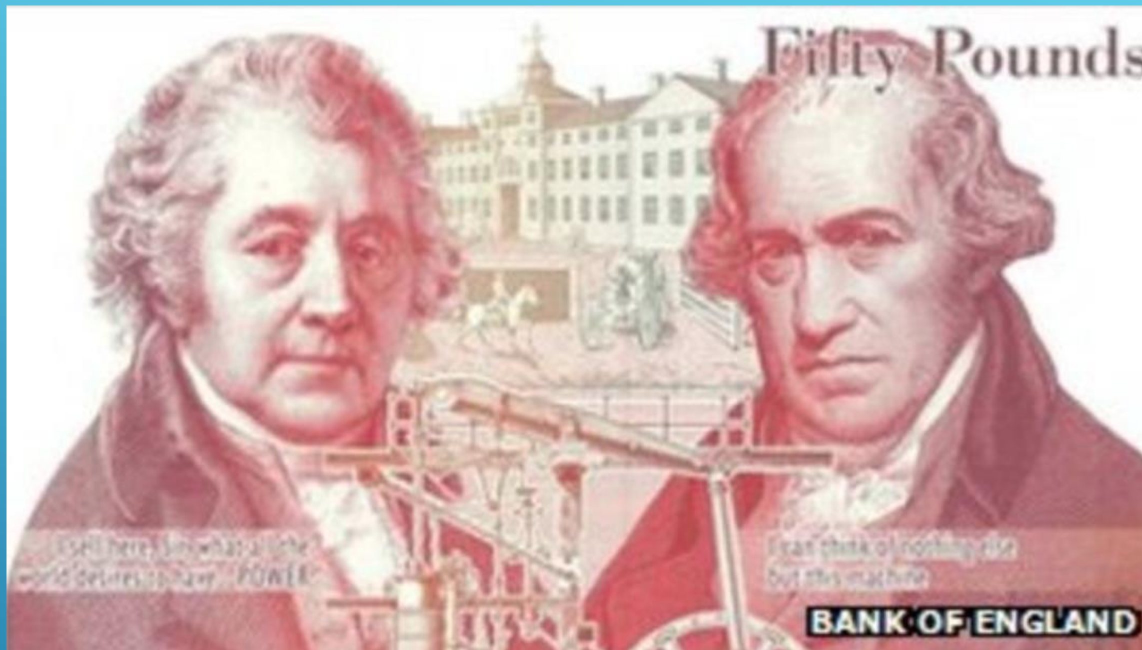
Pollard concluded that the demand for long-term (finance) capital was low.

Challenging the conventional wisdom ….

Alex Trew (2010) noted that the conventional wisdom concerning finance in the British Industrial Revolution

"runs against the large body of empirical evidence … that suggests that financial development is strongly correlated with, and perhaps leads, the level of economic growth."

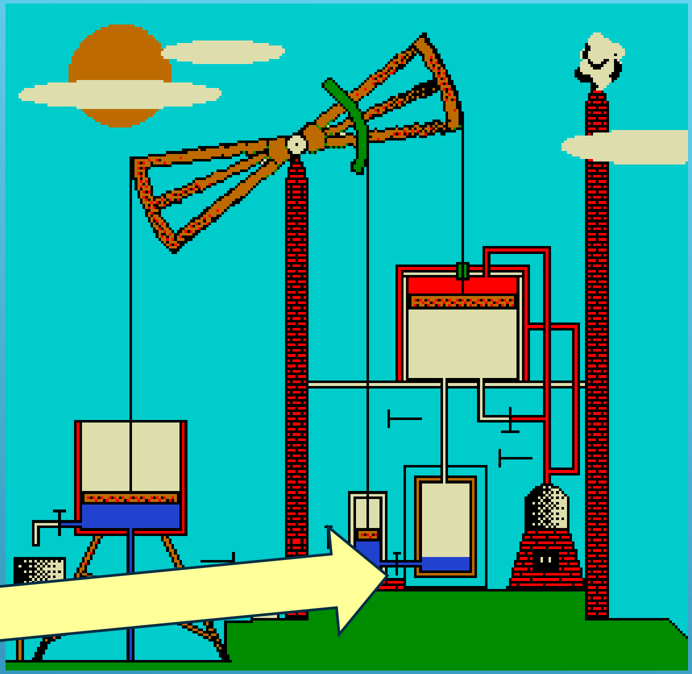
Detailed studies of different entrepreneurs also suggest a different picture.



Matthew Boulton and James Watt

Formed a steam engine business near Birmingham in 1775.

James Watt developed a steam engine that improved on a previous design by **Thomas Newcomen** (circa 1710)



Watt added a separate condenser, more than doubling fuel efficiency.

Boulton and Watt patented this design and sold it for use in Cornish tin mines, where coal was expensive.

Sushil Khanna (1978) “the requirements of fixed investment were very modest and the threshold of entry into factory production quite low … there was no ‘capital scarcity’ in 18th century England.”

Following **Pollard** (1964), **Khanna** (1978) noted “how low the capital-labour ratio was during the industrial revolution”

Khanna (1978): “Boulton and Watt, who had the monopoly of steam engines for 25 years, launched their firm in 1775 with a capital of only £3370.”

But at the start of their business, **Boulton and Watt** did not manufacture steam engines!

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This did not mean that Boulton and Watt had adequate finance capital

Eric Roll (1930) noted their “serious lack of capital which … hampered the growth of the business and more than once presented the partners with the prospect of immediate collapse.”

There is not necessarily a correlation between fixed capital goods and (long term) finance capital.

The conventional wisdom that borrowing from “family and friends” was sufficient is based on thin evidence.

Sometimes we find a confusion between **finance capital** and **capital goods**.

There is insufficient attention to the institutional conditions required for the development of mortgaging as a means of financing loans.

Mortgages

Because of a defective definition of property merely in terms of control, the "economics of property rights" (**Armen Alchian**, **Yoram Barzel** etc..) downplays the issue of legal title and ignores the issue of mortgaging.

In England, mortgages were rare until a reform of mortgage law around 1670.

A market for mortgages also required a market for debt, which developed in the 1700s, aided by state legislation.

Financial institutions and economic development

Financial institutions and legislation were vital.

The slow development of financial institutions may help to explain slow growth in 1770-1820.

In 1770-1820, industrial output per capita grew by 0.7 per cent.

In 1820-1870, industrial output per capita grew by 2.0 per cent.

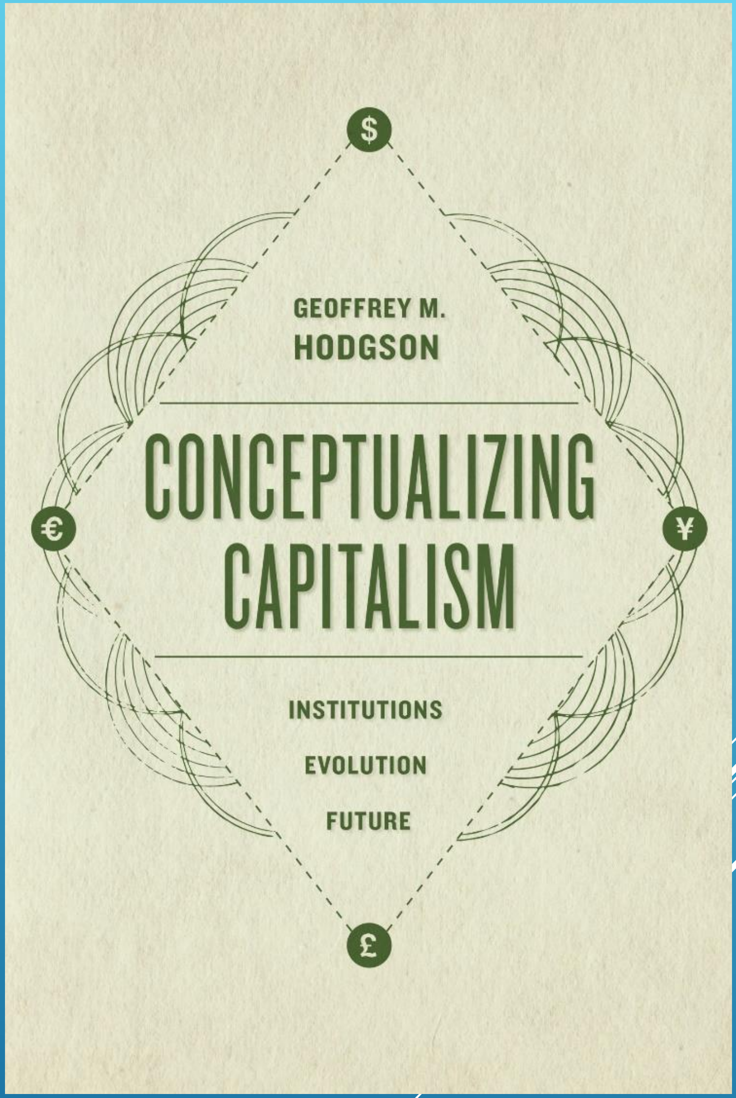
Financial institutions and economic development

We need to investigate:

1. The extent to which finance for entrepreneurship was provided out of savings or by borrowing from family or friends.
2. The extent to which finance for entrepreneurship was provided through lending intermediaries, banks or other financial institutions.
3. The extent to which landed and other property could be, or was used, as collateral to obtain loans.

All this has important implications for economic development today.

Geoffrey M. Hodgson, (2015) *Conceptualizing Capitalism: Institutions, Evolution, Future* (Chicago).



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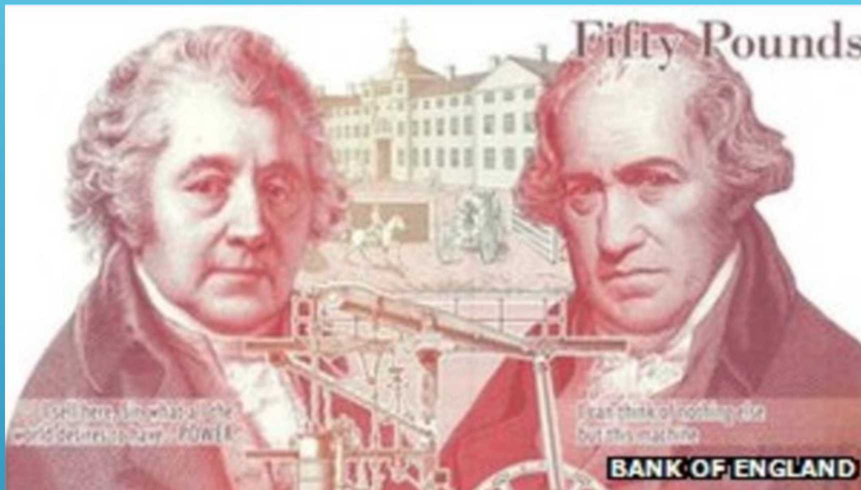

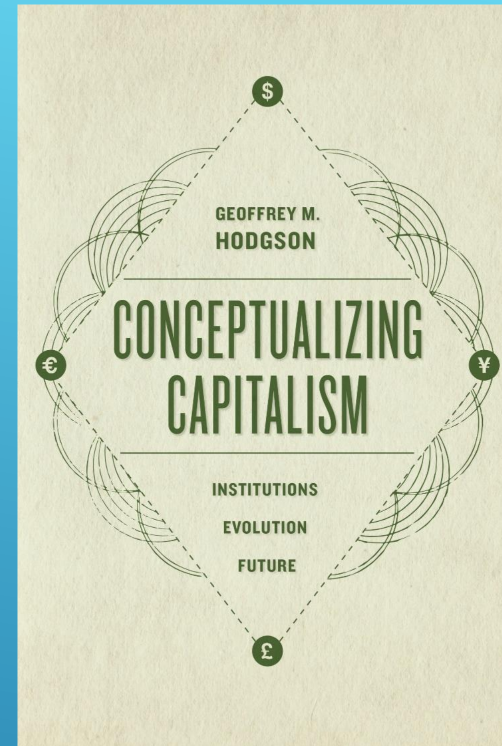

Thank you!