# CAPITAL FORMATION IN PEASANT ECONOMIES

Brady J. Deaton*

## I. Introduction

The role of capital formation in the process of economic development has been critically appraised by economists and policy-makers.[1] Identifying sources of capital and regulating the rate of capital growth are essential tasks of economic planning in developing nations. Economic growth models, particularly two-sector models, have been developed to describe the process of economic transformation with domestic savings and investment as the key driving forces in achieving a successful growth path. The analytical abstractness of two-sector models, however, does not provide a very accurate portrayal of peasant economic behavior, particularly savings and investment decisions. This weakness has prompted several writers to call for a more comprehensive approach in analyzing the structure of and advocating policy for developing nations.[2]

The economic and cultural aspects of dualism have been thoroughly discussed by Boeke (1964), Myint (1964), Winstedt (1966), Lew (1964), Higgins (1956), and others.[3] Recent contributions by Ranis-Fei (1961-66) and Jorgenson (1966) have consisted essentially of more rigorous expositions of the economic transformation process first posited by the classic article of Lewis (1954).[4] Cheetham (1969) has built on these and made great strides toward developing a two-sector model of growth. Two-sector

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*Associate Professor, Department of Agricultural Economics and Rural Sociology, University of Tennessee, Knoxville. I have benefited from discussions with my colleagues Tom Klindt, Dave Brown and Charles Sappington who read earlier drafts of this paper.

[1]For an elaboration of this point see the discussion of Henry J. Bruton, "Economic Development and Labor Use: A Review," in Employment in Developing Nations, ed. by Edgar O. Edwards, Columbia University Press, New York, 1974, pp. 49-82.

[2]For example, see the works of Reynolds (1968), McBride (1967), and Parsons (1966). From my own perspective, the critical article by George Dalton (1968) is especially pertinent.

[3]A good summary of dualism can be found in Gerald M. Meier, ed., Leading Issues in Development Economics, Oxford University Press, 1964, pp. 48-89.

[4]Economic transformation refers to the movement from a subsistence, agrarian economy to a commercialized, industrial one. The role of dualism in this intermediate stage has received crucial scrutiny by all the aforementioned writers.

models have been more descriptive of historical changes in advanced economies than analytical of ongoing dynamics in so-called "peasant" economies. While two-sector models provide a neat dichotomy for broad generalizations, important interactions between capital and labor are hidden in the aggregates. In practically all developing countries four co-existing sectors can be identified which possess unique characteristics important to the capital formation process. These are: (1) Subsistence agriculture, (2) artisan or cottage industry, (3) commercial agriculture, and (4) modern industry.

The purpose of this paper is to first examine the savings and investment behavior of developing nations in these four economic sectors, identifying the potential role of each in contributing capital to the development process. Major attention will be given to savings behavior in the subsistence agriculture sector. Secondly, theoretical implications of the analysis will be summarized to provide a basis for policy formulation toward rural economic development.

## II. Capital Formation in Four Sectors

### 1. Peasant Savings in Subsistence Agriculture

An examination of anthropological literature suggests that the goals of peasants extend beyond the narrow perspective of profit maximization. Polanyi asserts that "... man's economy ... is submerged in his social relationships," and that "... all economic systems ... up to the end of feudalism in Western Europe were organized either on the principles of reciprocity or redistribution, or householding, or some combination of the three."[5] These three principles, or variations of them, characterize large segments of developing countries; whereas, the gearing of society to the demands of a market economy is evident only in advanced economic sectors, just as it is a recent historical phenomenon (Polanyi).

The maximization of satisfaction takes many forms under different cultural and historical conditions, and coincides very closely with profit maximization in advanced countries. As a social being, man acts to "... safeguard his social standing, his social claims, his social assets" (Polanyi, p. 46). Such actions may demand profit-maximizing behavior in advanced, industrial countries, while in peasant economies these goals are realized primarily through religious and secular ritual, kinship ties, and oth social obligatory actions.[6] Such behavior is evident in most societies,

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[5]Reciprocity refers to a myriad of social responsibilities that guarantee the sustenance of community members. Redistribution as a more general cultural trait is expressed in religious ritual, centralized community control of surplus, and in other ways. Householding consists in production for one's own use. See Polanyi, pp. 47-53.

[6]This assertion is based on Chapter 4 of Polanyi as well as extensive documentation found in the works of Foster (1967), Wolf (1966), and Potter (1967).

but the weighting of the various motivations distinguishes peasant economies from modern or modernizing ones.

Dual theories are constructed around the interactions between a subsistence sector and an advanced industrial sector. Apparently, only those aspects of subsistence agriculture which become subject to market dependence, cash transactions, and frequent commercial activity receive appropriate economic attention in two-sector models. This rather limited perspective has led to unfounded behavioral assertions and subsequent erroneous policy proposals. Chief among these is the common assumption that capital accumulation is negligible in the subsistence sectors of developing economies (Lewis, 1954; Ranis-Fei, 1961; and Jorgenson, 1966). For example, Ranis and Fei (1961) assert:

> In agrarianism no active innovative inducement mechanism is at play, no entrepreneurial group exists sensitive to surplus-generating opportunities within and outside of agriculture. In the dualistic setting, on the other hand, there is an entrepreneurial class with decision-making power and access to land which associates its personal well-being--either as industrial consumer goods or ownership of industrial capital goods--in a clear and direct fashion with the continuous improvement of agricultural practices (pp. 39-40).

Anthropologists who have explored peasant economies in greater depth and detail do not support such sweeping generalizations. The most frequently cited anthropological evidence to the contrary is Sol Tax's (1963) description of the Guatemalan community of Panajachel where the Indian is described as "... above all else an entrepreneur, a businessman; always looking for new means of turning a penny." Schultz (1964) drew heavily on these findings to develop his theory of allocative efficiency in traditional agricultural systems. George Foster's (1967) description of Tzintzuntzan is similar in many respects.

Wolf points out that the primary incentives of the peasant are directed toward the caloric minimum and the capital replacement fund which guarantee the continued accrual of the minimum caloric intake.[7] Hence, some critical minimum level of reinvestment ($I_m$) must take place to maintain even a constant level of living. To describe the crucial nature of the replacement fund, the behavioral assertion can be made that:

(1) $\delta K = I_m$ ... where $\delta$ is the rate of annual depreciation which must be reinvested to maintain a constant minimum level of living and K is capital stock.

A secondary, but very significant, motivation is the maintenance of required ceremonial or ritual expenditures. The size of such funds will

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[7]The caloric minimum can be expanded to include the culturally determined level of subsistence which is the strongest force guiding consumption levels. See Wharton (1963) for a general discussion of these issues.

vary with the culture and with the respective conditions of each individual family. Of special importance are family size, sex of offspring, and social class. Wolf (1966) found that some families spend the equivalent of a year's wages on ceremonials. In a recent study of farmers in India, Ames and Brown (1973) reported that at least 15 percent of gross farm output was expended on festivals.

In closed societies such as Tzintzuntzan which are characterized to a greater or less degree by the "image of limited good,"[8] satisfaction-maximization becomes heavily dependent upon ritual expenditures. The perception of an economic zero-sum game can be thwarted only through ritual spending which enables a family (or individual) to achieve status and prestige and, thereby, provide the basis for a good start in life for its children (Foster, Maccoby). Hence, a large portion of potential "investment," in the strict economic sense, is continually dissipated in this manner. By the time an individual reaches a certain pinnacle of social status, much of his wealth will have been squandered. Sharing in the poverty of the community is the price of great prestige (Foster). And, based on Foster's development of the theory of limited good, it can be asserted that ritual expenditures will increase with incremental income, i.e., as income increases, proportionally more must be spent on ceremonials. A similar force identified by anthropologists with similar effect on surplus disposal is the principle of reciprocity. Reciprocal relationships often involve large financial transfers based on kinship ties within a socioeconomic group, colleague ties on equal socioeconomic levels, and patron-client relationships among different socioeconomic statuses (Foster, 1967; Diaz and Potter, 1967).

## 2. Artisan Industries

Available literature suggests that the artisan or cottage industry sector may be complementary with subsistence agriculture in the use of labor and capital. Orchard (1930) states that peasant landholders in Japan developed artisan activities to provide supplementary employment for seasonal agricultural labor. When agricultural activity decline, an increase in the production of artisan goods could be expected.

The artisan sector has been ignored by theorists building two-sector models of economic development. Yet, the artisan sector occupies a unique position vis-a-vis the subsistence agriculture sector. No known research has attempted to analyze the ability of the artisan sector to compete with ritual and ceremonial expenditures for available "surplus" funds.

Hirschman (1957) has recognized the critical role of the artisan sector. He warns that the expansion of the industrial sector is often associated with a decline in artisan activity for two reasons: (1) Industrial products often compete with those of the artisan sector, and (2) the expansion of the industrial sector increases the demand for food. The

[8]A world view in which almost all desired things in life "... exist in absolute quantities insufficient to fill even minimal needs of villagers" (Foster, p. 123).

subsequent food price increase may stimulate additional investment and labor input into the production of food products at the expense of the artisan sector. This relationship would appear to depend on a shortage of underemployed labor in the subsistence sector.

The artisan sector is hypothesized to serve as a cushion to soften the impact of rapid economic change, thus providing an additional degree of security in the subsistence sector. In this sense it may effectively compete with ritual and ceremonials for available surplus since the functional goals are very similar, i.e., a low-risk, legitimate source of prestige and security.

Myrdal (1968) devotes substantial attention to the role played by crafts and small-scale industry as a cultural force in India and as a source of employment that instills pride and self-esteem in its owners. He argues that modern techniques can be adopted in artisan production along labor intensive lines and encourages research into this problem. Obviously, these dynamics have escaped the attention of most economic theorists.

Economic growth programs are frequently associated with inflation as higher wages in the emerging industrial sector attract labor from the subsistence agricultural sector. Wage rates in excess of the value of average agricultural product create a price increase for food and other products. With surplus or seasonal labor and a complementary artisan sector, this "inflationary" demand may be offset by the production of virtually "free goods," if two conditions hold:

1. Most workers engaged in artisan production are members of agricultural producing families and, thereby, exert no recursive demand for additional food.

2. The artisan sector's inputs consist, in large part, of capital assets with zero opportunity costs which command no economic return in the marketplace.

Under these conditions, the subsistence sector may recapture a portion of the surplus generated by agricultural producers (i.e., perhaps the same group of people).

Also, the artisan sector may include production units devoted to the basic rudiments of the local agricultural production technology which complement the need for increasing labor productivity in agriculture as food demands grow. Hence, what first appear as inflationary policies, may result in stimulated demand for reinvestment in agricultural production. These conditions are consistent with China's emphasis on each commune producing its own tools for agricultural production. Tool production becomes an investment substitute for "wasteful" surplus (i.e., ritual and social obligation expenditures); and the common economic purpose, increased production, substitutes, in social welfare terms, for the social returns heretofore derived from investments in ritual and social obligation expenditures. Conditions are provided under which development may "take off" with simultaneous increases in productive investment and real consumption.

This may explain why some African countries, notably Ethiopia, have launched national programs to stimulate the development of cottage industry.

## 3. Commercial Agriculture Sector

The emergence of a commercial agriculture sector tends to be somewhat disruptive with respect to rural employment, but very positive with respect to agricultural production and capital accumulation. In modernizing countries the commercial agricultural sector provides a source of foreign exchange earnings and produces surplus food for the cities. This process is enhanced by the availability of imported farm machinery, fertilizers, new seeds, etc. Old tenure patterns which traditionally provided subsistence and security to a large number of tenants give way to commercialization usually at the cost of increasing unemployment and underemployment (Haney, 1969). Even though peasants from the subsistence sector often supplement their income by working part-time in the commercial agriculture sector, the net effect of commercialization historically has been declining employment opportunities in commercial agriculture.

The principle of maximizing satisfaction in this sector often takes the form of achieving prestige through the utilization of the most advanced techniques whether economically justified or not. Heavy capitalization yields high prestige as a status symbol to the "modern" entrepreneur (CIDA, 1966, p. 490). At best, mechanization increases the demand for occasional laborers while decreasing the need for permanent ones. Accordingly, migratory labor becomes an essential input into this sector, albeit an increasing social problem.[9]

## 4. Modern Industrial Sector

The borrowing of techniques from abroad may impose overly capital-intensive methods of industrialization on developing countries which are unjustified by factor prices in the domestic economy (Eckaus, 1963). Even if justified by factor prices, the expansion of such industry does little to solve the problems of unemployment in the country (Lewis, 1964; U.S. Senate, 1969). If the latter is a predominant problem, then "growth for growth's sake" must be questioned, or at least a redirecting of investments toward more labor intensive techniques may be appropriate (Navarrette, 1963). Rapid rates of population increase have aggravated the problems of unemployment and political instability. Parsons asserts that for many countries "... there is simply no prospect in decades of increasing industrial employments at a sufficiently rapid rate to absorb the surplus population" (1969, p. 61).

Unless goals of employment are incorporated into development plans, then the growth process will produce simply an island of prosperity amidst a sea of squalor. A crucial aspect of the problem involves capital

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[9]All too often labor is dismissed "en masse" with no thought given to the welfare of those dismissed (CIDA, Case No. 24, pp. 523-525).

flights to the more advanced countries. The magnitude of these often offset all efforts of foreign assistance and, it is feared, depend on foreign assistance as a source of funds.[10]

## III. Theoretical Foundations for Rural Economic Development

### 1. Ritual as an Investment

The critical assertion of this paper is that ritual expenditures can be more properly interpreted as a form of investment, rather than consumption. Anthropological literature seems to support the idea that peasants use ritual expenditures to generate a future reciprocal flow of benefits. Whether enhancing the quasi-legal, patron-client relationship or providing an ample dowry for an eligible daughter, the peasant expects these "investments" to be returned at a future date. In this manner, the expected values of discounted returns from alternative "income" streams are estimated. Ritual investments provide a secure, time-tested form of social fulfillment as well as social and economic security. These future "income" flows can properly be viewed as consumption, while the expenditure which guarantees the flow is accordingly viewed as an investment.

From an operational viewpoint, the rather simplistic savings identity used in most growth models must be modified to reflect ritual investment ($I_r$) and the replacement fund ($I_m$). That is, the familiar with investment

$$(2)\quad I = S = Q - \bar{w}L$$

(I) and savings (S) viewed as the residual after subtracting an average per capita consumption level ($\bar{w}L$) from total product per capita (Q), must be modified to reflect the following:

$$(3)\quad I_n + I_r + I_m = Q - \bar{w}L \text{ or } I_n = Q - \bar{w}L - I_r - I_m$$

when $I_n$ is the net capital fund available for productive investment. The investment level ($I_n$) results in monetary returns to the economy, while $I_m$ maintains productive capital stock, and $I_r$ generates a flow of benefits (income, prestige, or combinations of these) realized in terms of reciprocal gifts and ceremonial.

### 2. Policy Implications for Rural Development

The major conceptual shift implicit in the view of ritual as an investment is to direct attention to the characteristics of, and property

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[10]The magnitude of these flights compared to the U.S. assistance efforts for Colombia are documented in U.S. Senate, 1969. See especially pp. 166-167.

rights associated with, the future income stream and to minimize the policy focus on manipulating factor proportions or work-leisure tradeoffs as a means of promoting economic development. That is, an effective policy designed to divert a portion of ritual expenditures into productive investment in the monetary economic system must fulfill the functional expectations heretofore met by the traditional reciprocal mechanisms of the peasant society. The following would seem to be minimum conditions:

1. Low-risk investment opportunities in a system of production that is geographically near and psychologically familiar to the peasant.

2. Sources of investment which embody an ideological commitment by the community at large in order to provide enhanced social legitimacy and command the mutual respect of fellow villagers.

3. Strong asset preference suggests that the control of the diverted surplus be maintained in some manner by its original owner.

These conditions could, in part, be met by designing financial systems and capital markets to allow those who generate the surplus (peasants) to maintain ownership over the ultimate benefits in proportion to their relative contribution. For example, a regional marketing/industrial development authority could issue stock to families or communities equal to the value of tax collected or the difference between domestic and higher foreign prices for export crops. The surplus could be managed by experts with a rate of return going back to the original producers of the wealth who hold certificates of ownership in the businesses established with the capital.

Strong asset preference is due largely to the need for a traditional, secure, remunerative social structure. Economic development tends to uproot peasant structures and threaten the most treasured aspects of the traditional social fabric. Consequently, the peasant has not been a willing participant in the development process of most nations. The multitude of observable peasant movements around the world may properly be viewed in Wolf's terms as "... merely occasional open manifestations of the latent opposition which divides the peasant from those who siphon off his surplus funds" (Wolf, p. 106).

The traditional pattern of ritual and ceremonial expenditure is guided by an institutional structure which provides for local autonomy and participation. The view has been perpetuated that economic development entails the siphoning off of surplus funds from the peasant to be used by an emerging entrepreneural sector, an institutional framework totally alien to the peasant. This view is an institution-bound, misinterpretation of economic realities. Surplus generation through a capital squeeze on agriculture may be a prerequisite to industrialization and economic modernity, but the squeeze need not separate the <u>ownership</u> of surplus from the producers of the agricultural products. Their ultimate control over the surplus can be facilitated by the political structure of society. The common view that price policies and taxation should be used by the government to capture potential surplus for productive reinvestment is to state the issue in a manner that is popular among the leadership and financial elites (who ultimately, of course, will manage the funds) of developing nations. For example, Johnston and Mellor have argued:

> One of the simplifying assumptions of the two-sector model is that expansion of the capitalist sector is limited only by shortage of capital. Given this assumption, an increase in rural net cash income is not a stimulus to industrialization but an obstacle to expansion of the capitalist sector (p. 580).

Lewis similarly states:

> Anything which raises real wages in the capitalist sector will, therefore, reduce the capitalist surplus and the rate of capital accumulation, unless it at the same time more than correspondingly moves the terms of trade against the subsistence sector (p. 172).

Contrary to these assertions, it can be shown that an increase in rural net cash income may provide cash reserves for rapid capital accumulation if opportunities exist for peasants to invest in new industry. A major shortcoming of rural development policies is the inability to develop systems that demonstrate to insecure farmers that they can have a part in expansionary industrial activities.

A number of alternative financial mechanisms have been successfully used under diverse conditions to demonstrate their usefulness in promoting economic development programs under the control and direction of broad segments of society. Industrial development authorities can be created jointly with regional marketing boards to rechannel economic surplus into rural or artisan industries. The returns from profitable investments can be controlled by the original agricultural producers if the mechanisms are properly designed.

In the United States, Kelso's (1967) two-factor theory and a range of community development corporations (Abt Associates, 1972; Deaton, 1975; Patterson and Deaton, 1976) have served similar purposes in promoting capital ownership and encouraging community participation in financial ventures. Under a properly designed financial system a diversion of funds from ritual to productive reinvestment would be expected to occur whenever the value of future earnings is at least as great as before, with a minimum of risk attached. <u>Opportunities</u> for profitable investment are strategic factors influencing the rate of capital formation. Direct participation in the ownership and benefits derived from profitable economic ventures are critical factors which may alter the development potential in many countries and subregions.

## 3. Conclusions

The thrust of this analysis has been to identify potential sources of savings in four sectors of a modernizing society and to suggest mechanisms whereby the savings can be channeled into productive reinvestment which contributes to economic development. The availability of savings beyond the level generally identified by economic theorists suggests that developing nations have far greater economic potential than generally recognized in the literature. Contrary to popular economic thinking, there may not be an inherent conflict between the capital contributions of the subsistence sector and its increased purchasing power--both may occur if existing ritual expenditures can be diverted into capital ownership in the industrial and artisan sectors.

Insight could be gained on these issues by further research on the economic interrelationships among the four sectors, and by further case studies of innovative approaches to promoting property ownership and local participation in economic ventures. From a policy perspective, any viable rural investment plan must be compatible with the cultural setting. Financial and bureaucratic institutions must be sufficiently flexible to provide feasible alternatives within culturally defined bounds.

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