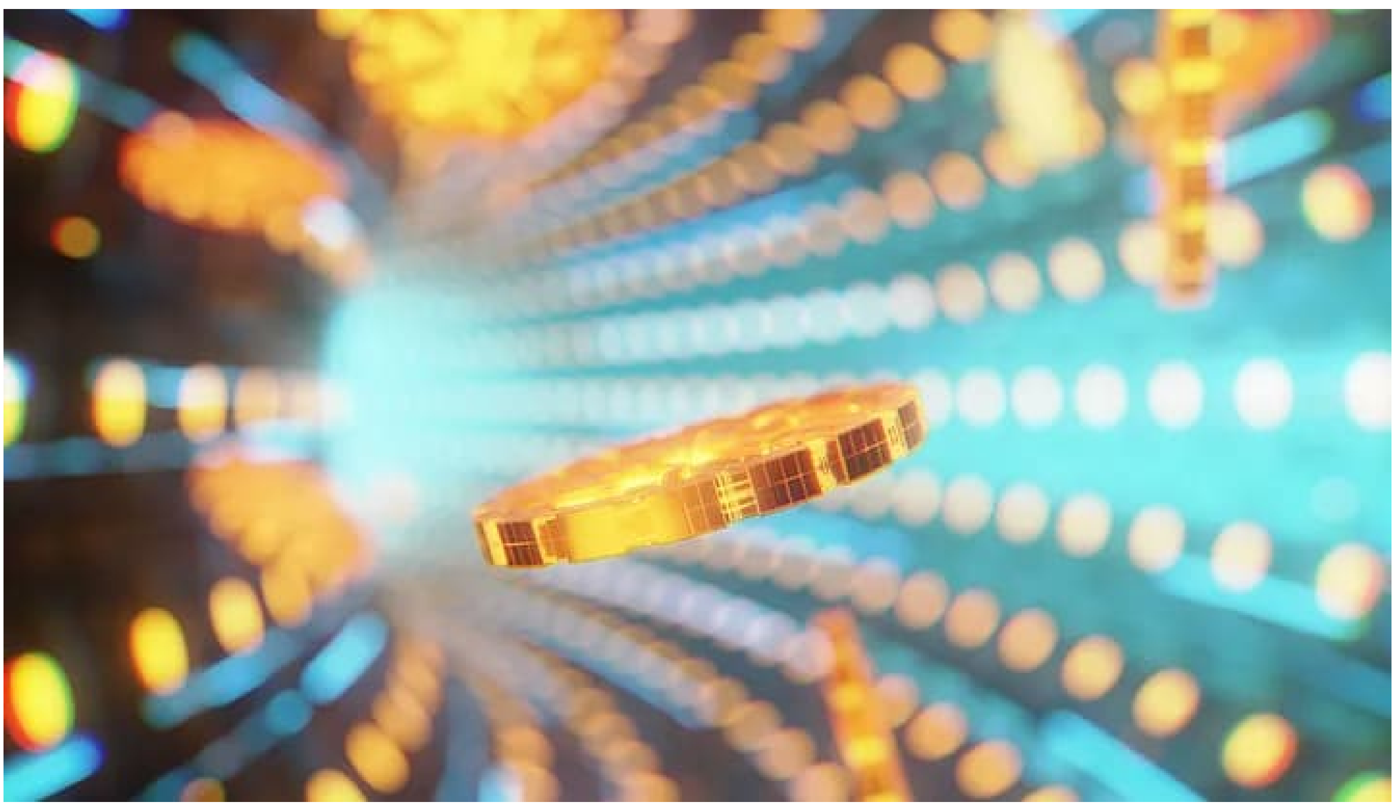
When Decentralization Does Not Last

Research on DAOs found what works — and what doesn't

Texas McCombs · Follow
Published in Big Ideas
3 min read · 6 days ago

Based on the research of Michael Sockin



On today's internet, decentralization has become a major battle cry. In reaction to established social media platforms and search companies like Facebook and Google, where users have no say over policies, some are creating alternative platforms they can run collectively. The best-known examples, cryptocurrencies, offer payment systems that bypass central banks.

But decentralized platforms face a major stumbling block, according to new research from Texas McCombs: It's hard to keep them that way.

"They're supposed to be more egalitarian and democratic, but you often end up with power in the hands of a few individuals or institutions," says Michael Sockin, assistant professor of finance.

Sockin, along with Wei Xiong of Princeton University, modeled one kind of platform, known as a decentralized autonomous organization (DAO). It works like this:

· Instead of raising money from investors, it sells tokens to its users.

· Tokens entitle them to services from the DAO and to a vote on its policies.

· To be transparent, every transaction gets recorded on a blockchain.

On one successful DAO, Filecoin, the service is data storage. Users exchange tokens to rent storage space from other users, as alternatives to cloud companies such as Amazon.

Sockin and Xiong modeled how DAOs evolve over time, comparing them to centralized platforms with investors. They found several lessons for what works and what does not.

Small is beautiful. Selling tokens works best for small groups that are passionate about a specific purpose. Such DAOs have formed for targeted goals like buying digital art or raising aid money for Ukraine.

Recruiting more users risks pulling in people who are less committed and less likely to contribute services. "It's like a neighborhood association," Sockin says. "If not enough people are willing to help to fix the fences, the community doesn't do well."

Decentralization is economically fragile. Centralized platforms are more likely to survive an economic downturn, because big investors can put in more money. For a

DAO, "No one is going to step up and say, 'I'm willing to pour $10 million into this thing,'" says Sockin.

Tokens draw speculators. Another problem arises when a DAO allows users to buy and sell tokens. That activity can attract speculators who care more about profit than the community's purpose.

Sockin points to cryptocurrencies, which were meant to be used for buying things. Instead, they get held as investments. "The ability to get high returns has hurt cryptocurrencies as mediums for payment, because people don't want to spend it," he says.

Over time, Sockin's models predict, a few entities tend to accumulate both tokens and control. "They can easily take us back to being like Amazons and Apples, which is the whole issue we were trying to move away from," he says.

Ultimately, Sockin hopes his lessons can help DAOs become more stable and effective. "This concept is trying to solve some real problems, but it's still in its early stages," he says. "We're raising some issues that we think creators and the community haven't fully thought about."

"Decentralization through Tokenization" is published in The Journal of Finance.

Story by Steve Brooks

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