

The Economic Effects of Trust

Theory and Empirical Evidence

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The Economic Effects of Trust

Theory and Empirical Evidence

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door

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geboren te Den Helder

promotor: prof.dr. F.A.G. den Butter

Voorwoord

Net als tweeëneuhalf miljoen andere Nederlanders bezit ik het verlangen ooit een goed boek te schrijven, liefst een wereldveroverende roman die alle andere boeken overbodig maakt, wellicht met uitzondering van de Bijbel en het telefoonboek. Alles afwegende valt te constateren dat ik inmiddels grotendeels in die opzet ben geslaagd. Een door mij geschreven boek ligt nu voor u, al is het geen wereldveroverende roman, en mede dankzij de gelijktijdig met het schrijven van het boek verlopende ontwikkelingen op het vlak van de informatie- en communicatietechnologie is elk afzonderlijk boek – zeker in papieren vorm – overbodig geworden, het mijne inclusief. Tegen het gemak, de snelheid en actualiteit van de door internet te ontsluiten informatie is geen boek bestand. Zo beschouwd vormt dit boek in zijn verschijningsvorm hoogstens een anachronistisch artefact dat zijn oorsprong vindt in een voorbij gevloeden periode toen geluk en drukwerk nog heel gewoon waren en bovendien het promotiereglement werd opgesteld. Tezamen met de toga's, de rokkostuums en de plechtstatige formuleringen van de promotieplechtigheid zijn de gedrukte proefschriften tot ceremoniële cimbalen verworpen die als cerebrale symbolen de eeuwenoude traditie van de universele kennis verwoorden.

Voor de totstandkoming van de gedachten geuit in dit proefschrift ben ik veel mensen veel dank verschuldigd. Als assistent in opleiding ben je continu op zoek naar een nieuw stukje universele kennis en op die zoektocht blijkt vrijwel altijd dat twee mensen meer weten dan één, zeker als die tweede mijn begeleider Frank den Butter betreft. Frank was een leermeester voor mij in de meest positieve zin van het woord. Bijzonder inspirerend, een bron van slimme en bruikbare ideeën, aanwezig wanneer ik hem nodig had en mij tegelijkertijd alle ruimte biedend wanneer ik het zelf dacht te kunnen. We hebben dan ook vele artikelen samen geschreven over velerlei onderwerpen, tot in het literair-culturele *Hollands Maandblad* aan toe. Bovendien liet Frank mij uitgebreid meegenieten van zijn omvangrijke netwerk, zowel bij de KVS als bij de WRR. Kortom, een betere begeleider had ik mij niet kunnen wensen.

De eerste twee jaar had ik tevens een tweede begeleider, namelijk Jan Peter Balkenende. Jan Peter was toen al lid van de Tweede Kamer en gaf in het begin reeds aan dat hij de begeleiding van mijn promotie-activiteiten zou staken, wanneer hij onverhoopt een meer prominente rol in de politiek zou krijgen. Dat leek op dat moment, gezien de toenmalige externe en interne situatie van het CDA, een opmerking *pro forma*. Welnu, dat hebben we geweten. Uiteindelijk zag ik hem vaker dan ooit, maar enkel in kranten en op televisie. De toekomst bleek weer eens onvoorspelbaar. Niettemin heb ik ondanks zijn drukke kamerwerkzaamheden twee jaar vruchtbaar gebruik mogen maken van zijn inzicht en inzet. Daarna transformeerde hij van mijn actieve begeleider tot een dankbaar gespreksonderwerp en bliksemafleider wanneer mensen informeerden naar de vordering van mijn promotie-activiteiten.

De leescommissie bestaande uit Paul de Beer, Bernard Compaijen, Ton van Schaik, Kees Schuyt en Jan Peter van den Toren bedank ik voor hun nuttig commentaar op de eerste versie van het manuscript. Diverse storende fouten, omissies en onduidelijkheden heb ik hierdoor nog kunnen herstellen, verhelpen en verhelderen.

Geen officiële begeleiders maar wel zeer behulpzaam waren Fieke van der Lecq, Imrat Verhoeven en Rob Alessie. Fieke was officieel geen referent, maar heeft zich in de praktijk wel als zodanig ontpopt door met grote inzet en betrokkenheid grote delen van mijn proefschrift mee te lezen en te becommentariëren; Rob heeft mij vakkundig ingewijd in diverse mysteriën van de econometrische analyse en het statistische programma Stata; en Imrat is grotendeels verantwoordelijk geweest voor mijn ontluikende besef dat ook in de andere sociale wetenschappen dan de economische regelmatig zinnige dingen worden verteld (in ieder geval op het gebied van sociaal kapitaal en vertrouwen).

Nuttig waren ook het periodieke aio-overleg op de VU met collega's Udo Kock, Egbert Jonge, Peter Mulder en Jan de Kok, en de contacten met andere VU-collega's Henri de Groot, Gert-Jan Linders, Valentina Mazzucato, Hans Visser, Gerard van den Berg, Paul Frijters, Hans Bloemen, Bas van der Klaauw, France Portrait, Stefan Hochguertel en natuurlijk mijn kamergenoten Bernard Compaijen en Sabine Go met wie het goed toeven was. Co-auteur Enno Masurel (zie hoofdstuk 5) neemt daarbij natuurlijk een speciale plaats in, evenals Tinbergen Instituut directeur Maarten Lindeboom die er altijd in slaagde mij met een grote grijns en vol energie zijn kantoor te laten verlaten. Mijn waardering gaat ook uit naar de inzet van Irene Kluin die als een goede fee het secretariaat bestierde. Op congressen en seminars deed ik mijn voordeel met opmerkingen en commentaar van onder anderen Hans Keman, Jaap Woldendorp, Ton van Schaik, Sjoerd Beugelsdijk, Werner Raub en Vincent Buskens. Tenslotte kon ik met mijn vragen over de praktijk van het polder model altijd bij John Landman terecht.

Natuurlijk zijn alle nog aanwezige missers in dit proefschrift te wijten aan mijn eigen beperkt begrip en niet aan de kundigheid van bovengenoemde mensen.

Samen met onder anderen Dirk Brounen, Robert Imeson, Joëlle Noailly en Mauro Mastrogiacomo maakte ik deel uit van de eerste lichting van de 'M.Phil. in Economics'-opleiding van het Tinbergen Instituut. Gedurende het jaar bleek dat de opleiding nog een aantal kinderziekten te overwinnen had (en dat is nog zwakjes uitgedrukt). Inmiddels, vier jaar na dato, kunnen we erover lachen. Dirk, Robert, Joëlle en Mauro waren niet alleen zeer nuttig bij het concipiëren en kopiëren van thuiswerkopdrachten, maar zijn er ook als eersten ooit in geslaagd mij te verleiden tot het koken voor een groep mensen in mijn (ouderlijk) huis te Anna Paulowna. Over de vraag hoe dit smaaktechnisch uitviel is nooit een officieel verslag opgemaakt, voldoende mag de constatering zijn dat nadien nooit meer initiatieven zijn ondernomen dit experiment te herhalen. Mauro bedank ik nog eens voor het kookboek voor beginners dat ik kort daarop voor mijn verjaardag ontving.

Van bovenstaande groep ben ik overigens de laatste die zijn proefschrift voltooide. Hoewel dit uiteindelijk nog juist binnen de termijn van (netto) vier jaar geschiedde, voel ik toch een zekere morele druk hiervoor enige ontlastende verklaringen af te leggen. De eerste reden is mijn tussentijdse aanstelling aan de Wetenschappelijke Raad voor het Regeringsbeleid voor het project Nederland Handelsland. Daar trof ik het zeer goed met de twee achtereenvolgende projectsecretarissen Harry van Dalen en Paul de Beer met wie ik menige lunchwandeling heb doorlopen. Niet alleen wordt het fenomeen lunchwandeling door het Ministerie van VWS publiekelijk aangeprezen om zijn vermeend positieve werking op de fysieke gezondheid, het bleek ook een probaat middel de toestand van de wereld door te nemen en visies hierop te toetsen. Hierbij waren we het niet altijd met elkaar eens over de kwaliteit van het regeringsbeleid, het kostenbatenplaatje van het Koningshuis en in hoeverre het praktisch is om een baard te laten staan, maar telgen van Tinbergen waren we toch allen. De kracht van de WRR ligt met name in zijn multidisciplinaire karakter. Van niet-economen als Kees Schuyt, Michiel Scheltema, Frans Hoefnagel en Imrat Verhoeven heb ik dan ook minstens zoveel geleerd als van Harry en Paul.

Een kleine hobbel op weg naar de promotie lag in de opmerkelijke dingen die je meemaakt in grote organisaties. Hoogtepunt van mijn worstelingen met de lokale bureaucratie betrof – ironisch genoeg – de verdwijning van mijn bureau. Na enkele dagen afwezigheid wegens bezoek aan de Spring Meeting of Young Economists in Parijs bleek mijn bureau, dat de bouw van het VU hoofdgebouw nog had meegemaakt en gezien zijn stalen massiviteit ook enige tijd als stutpaal voor het 15 verdiepingen tellende gebouw zou hebben kunnen gediend, te zijn vervangen door een gloednieuw, in hoogte verstelbaar en ergonomisch vormgegeven exemplaar. Nu is in beginsel niets tegen onaangekondigde transformaties van dit kaliber, ware het niet dat ook de inhoud van de twee ladekasten met het bureau was verdwenen. Navraag bij de gebouwendienst leerde dat het gehele bureau wegens zijn ouderdom, dus inclusief de inhoud bestaande uit boeken, artikelen, data-CD-ROMs, fietsenbandenplakset en kantoorartikelen, direct naar de stort was afgevoerd en dus niet meer te achterhalen. Zelfs Voskuil had in Het Bureau niet zo'n bizarre belevenis vermogen op te tekenen. Overigens werd het bureau na drie weken alsnog herontdekt in een magazijn van de VU, waarna de inhoud aan de dolgelukkige eigenaar werd terugbezorgd.

Een laatste reden van vertraging ligt in het feit dat een van de tertiaire arbeidsvoorwaarden van het aio-schap is dat het de mogelijkheid biedt jezelf te ontwikkelen in meerdere richtingen. Zeker als je een proefschrift over sociaal kapitaal schrijft en weet dat elk nieuw lidmaatschap van een vereniging op allerlei manieren een positieve bijdrage levert aan de kwaliteit van je eigen en andermans leven, zou het bijzonder onverstandig zijn het eigen sociaal kapitaal te verwaarlozen. Dat heb ik dus actief getracht te vermijden. Daarbij denk ik aan mijn activiteiten binnen het CDJA, aan het organiseren van de jaarlijkse KVS debatdag voor jonge economen met onder anderen Margreet Schuit, Marga Ruitenbeek en Jenny Ligthart, aan de redactionele werkzaamheden voor het KVS jaarboek met Maarten Cornet en Ib Waterreus onder leiding van eerst Lans Bovenberg en later Casper van Ewijk, en aan de redactie van TI Magazine onder regie van Coen Teulings.

Daarbij denk ik ook aan alle VIAE-activiteiten waarbij ik betrokken ben geweest. Naast mijn hoofdredacteurschappen voor Curriculum VIAE en AEolus Magazine, staan mij met name de diverse studiereizen op het netvlies gebrand met hoogtepunten als de met Cuba Libres overgoten modeshow in Havana, de zompige weilanden rond Emmen, de meer dan copieuze maaltijden in Kraków, de gezellige binnenstad van Amsterdam, de schoonheid van Sint Petersburg, de lunch op het dak van de Centrale Bank in Ankara, het kanotochtje in Broek in Waterland waarvan de kano's volgens de folder niet zouden omslaan maar ik wel drijfmat en zonder bril en fototoestel van terugkeerde, het bezoek aan het badhuis inclusief massage door de zwartbesnorde eigenaar in Istanbul, de licht oververhitte verfbalinstructeur in de Ardennen, de hilarisch eindigende Rabobank presentatie in Moskou, en de (door omstanders) talloos geuite kortdurende beloften echt nooit meer zoveel te drinken als op de avond ervoor. Het was een groot en leerzaam feest met jullie (Roland, Laurens, Tobias, Bart, Tijmen, Harald, Marloes, Marloes, Sicco, Peter, Diana, Serena, Jasper, Jasper, Edward, Eelco, Emily, Robin en vele anderen) lid van de Vereniging voor Internationale en Algemene Economie te zijn.

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bedank ik voor de Evsaworo-diners verspreid door het land. Stefan, Ron en Jan: onze niet aflatende pogingen een zekere graad van perfectie en subtiliteit in het spel te leggen, afgezet tegen het resultaat, doen vermoeden dat tafeltennis wellicht de technisch moeilijkste sport op aarde is, danwel dat wij meer in de wieg gelegd zijn voor andere activiteiten. Ron, Jan en José hebben mij geïnfecteerd met het hardloopvirus. Hardlopen blijkt een vorm van mediteren (of vissen), waarvan je een smal koppie, zere knieën en een groot hart krijgt, en bovendien vaak goede ideeën voor het proefschrift.

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Uiteindelijk is het schrijven van een proefschrift vergelijkbaar met het lopen van een marathon. Wanneer het boek bij de drukker ligt en het finishdoek is gehaald, lijken alle geschreven bladzijden en gelopen kilometers niet zo moeilijk en zwaar meer, maar overheerst de tevredenheid en trots iets bereikt te hebben. Tegelijkertijd lonken reeds weer nieuwe verten aan de horizon. Terugbladerend in mijn aio-periode aan de Vrije Universiteit, constateer ik dat het een mooi boek was, anachronistisch of niet. Maar nu is het uit.

Robert Mosch
Anna Paulowna, 5 juli 2004

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Chapter 1

Introduction

Trust is a lubricant of cooperation.
Dasgupta (1988: 49)

The importance of trust derives directly from the nature of human beings as social animals who can only satisfy most of their needs by means of coordinated and cooperative activities.
Benn and Peters (1977: 279)

1.1 Trust

1.1.1 Definition of trust

This dissertation studies the effects of trust on economic co-operation between individual persons or organisations. Economic co-operation is taken in a broad sense, it involves all forms of voluntary exchange (e.g. exchange of labour, capital, ideas, et cetera). In this context, trust is “the willingness to permit the decisions of others to influence your welfare” (Sobel 2002: 148). ‘Others’ obtain the capacity to ‘influence your welfare’ when you engage in a co-operation with them. The goal of a co-operation with another actor is to gain something from it. Otherwise, you would not voluntarily engage in it. However, this engagement induces a vulnerability of ‘your welfare’, because the ‘decisions of others’ may damage your interests. So, if you engage in a voluntary exchange, you expect that you will gain from it, but you accept the risk that you will incur a loss. In other words, you trust the other actor to behave in such a way that you will gain instead of lose due to the co-operation.

A simple example may illustrate this. If a customer buys bread at the bakery, both the baker and the customer profit. The customer obtains bread for a price (money and time related to quality) that is lower than his opportunity costs (e.g. the costs of baking a bread himself) and the baker receives an amount of money that is higher than his combined costs of baking, marketing and selling the bread. If this transaction occurs without problems, the co-operation succeeds and both parties see their utility increase. It is possible however, that the actors incur a loss by engaging in the transaction. The baker might sell bread that is 4 days old, tasteless, and perhaps unwholesome. The customer might pay the baker with a false banknote of €20 and walk away with the change (and the bread). In this latter case, both actors expect a profitable co-operation, but are cheated. The actors would be better off if they would not engage in the transaction at all. The actors would not incur a loss, if they would, respectively, not trust the baker to sell tasty, healthy bread, and not trust the customer to pay with legal tender.

This two-sided risk (one might gain, one might lose) is an inherent element of (economic) co-operation, which is caused by radical uncertainty (Knight 1921). The difference between risk and uncertainty is, that risk implies an unpredictable future, but of which the set of alternative

outcomes and their probabilities are known, while uncertainty implies an unpredictable future of which the set of potential outcomes, let alone their probabilities, is unknown. Playing roulette at the casino involves risk: it is impossible to predict on which number the ball will fall, but all possible outcomes of the game and their respective probabilities are exactly known. Engaging in a co-operation with another actor involves uncertainty. Regardless whether one uses formal safeguards and hostages, whether one hires expensive lawyers, or whether one has been married with the other actor for twenty years, the other actor may still damage one's interests for unexpected reasons and in unexpected ways.

This uncertainty with respect to the behaviour of other people is caused by the fact that it is impossible to force other people to act in the common (or the transaction partner's) interest, given that they are not even 'obliged' to act in their own interest. People have a free will and they may use it. This uncertainty is aggravated by the fact that other people have their own perceptions of the world around them. "Since other people have their own first-hand access to the world and can experience things differently they may consequently be a source of profound insecurity to me" (Luhmann 1979: 6). Thus, the definitive action that arises from the free will and the 'free interpretation of facts' is unpredictable and inherently uncertain in individual cases. Sztompka (1999: 24) concludes that "[w]e usually cannot know and cannot control what other people will do independently of our own actions, and even more we cannot be sure and cannot completely safeguard how they will react to our actions". Moreover, external conditions can change suddenly. It may look like a sensible idea to promise to sell a cake for €10 or to promise to stay together in good and bad times, until one suddenly needs the (wedding) cake oneself or until one meets someone 'really special'.

So uncertainty can never be excluded in human interaction. However, people who engage in an economic co-operation behave like they know the future. They trust their partner to behave in such a way that they will gain a profit instead of a loss as a result of the co-operation. In other words, trust transforms uncertainty into a risk (Luhmann 1979). To trust means that one accepts this risk.

1.1.2 Importance of trust

"Trust is a lubricant of cooperation", writes Dasgupta (1988: 49). This short quote forms the key to the explanation of the importance of trust for economic welfare. In order to show the link between trust and economic performance, there are two relations to be revealed. First, why is co-operation important for economic welfare, and second, why is trust needed to lubricate this co-operation?

The answer to the first question is related to the idea that the wealth of nations hinges on the division of labour. Adam Smith's example of the pin factory lies engraved in the collective memory of all economists. Specialisation of the tasks of the workers increases the total production of pins per worker compared to the situation that all workers are making pins for themselves (and baking their own breads, fabricating their own computers, and so forth). Labour productivity increases when jobs are specialised, because people 'learn by doing' a specialised task and will sooner invent new tools and practices to enhance their production than in a state of autarkic production. Moreover, when people produce pins on a large scale, for example for a whole country, they can profitably invest in up-to-date machinery and in training the workers to operate those machines. This is known as increasing returns to scale.

However, these increasing returns increase with a decreasing rate and above a given scale the returns may even diminish. There are limits to labour specialisation and increasing scales of production, which are caused by co-ordination problems. Labour specialisation leads to higher productivity, but it creates a need for the co-ordination of the activities of the actors as

well as the need for monitoring of actors by their principals. When actors are not autarkic producers, they depend on each other for their welfare. In other words, they have to co-operate to realise the potential gains of labour specialisation. This answers the first question.

The second question is why trust is needed as a lubricant for co-operation. The answer to this question is related to the co-ordination problems that are involved with economic co-operation. There are two types of co-ordination problems. The first type of co-ordination problems refers to the fact that all actions of the actors in an economy have to be co-ordinated in the sense that all actors have to know what they are expected to do. The needs of all economic actors must somehow be recognised and signalled to the other actors. Not everybody can work in the pin factory. Some people must deliver the steel to the pin factory, some have to bake bread, and some have to fabricate computers. This first type of co-ordination is needed to make sure that all sort of jobs are fulfilled in an economy (macro level), and that all workers know their role in the production process of the firm (micro level). An example of such a co-ordination mechanism on the macro level is the 'free market', which co-ordinates economic behaviour with use of price signals. Shortages in the production relative to the consumption of particular goods lead to higher prices, which form incentives for people to produce more and consume less of those goods until equilibrium (i.e. supply is equal to demand) is reached. An example of co-ordination on the micro level are firms that (internalise separate aspects of production and) co-ordinate with use of hierarchical power.

The second type of co-ordination problems refers to the fact that there is not only a need for co-ordination of information flows, but also for co-ordination on appropriate, trustworthy behaviour. When the individual needs for economic co-operation are communicated, these needs must not be exploited as a result. As was discussed above, every economic co-operation involves risks for the participants. Both actors gain if both actors behave in a co-operative, trustworthy way, but to collect this gain, people have to place trust in the other party. This trust may be exploited, which leads to a loss. Given that it is often profitable for the other actor to exploit placed trust, it is better to refrain from placing trust in most situations. However, without trust, there will never be any transaction and co-operation, and profitable (business) opportunities are missed. Thus trust is needed to enable co-operation, which answers the second question.

1.2 Research problem and structure of the dissertation

This dissertation investigates the second type of co-ordination problems. The problem 'how economic co-operation – leading to increased welfare – can be enabled by co-ordinating behaviour in such a way that co-operation is not frustrated by exploitation of the vulnerable by the opportunistic' forms the background of the research in this dissertation. In other words, it considers trust. The previous section provided an intuition that trust is important for economic co-operation, that economic co-operation is needed to reap the fruits of labour division and increasing returns to scale, and thus that trust is closely related to the economic performance of societies. This dissertation aims to provide a foundation for these intuitive claims about trust and its presumed economic effects. It therefore investigates (i) the concept of trust (what is trust?), (ii) the causes of trust (what are the sources of trust?; how does trust develop?), (iii) the economic consequences of trust (what are the effects of trust on economic performance?), and (iv) the measurement of trust (how can trust be measured?).

The chapters of this dissertation have been written as separate papers. Nevertheless, together they form a bundle of connected literature overviews, theoretical reasoning, and empirical testing that answers the questions stated above. The outline of the dissertation is as follows.

The rather theoretical chapter 3 is concerned with the questions under (i) and (ii), while the other chapters mainly reflect on the questions under (iii) and (iv). Chapter 2 studies the relation between trust, social capital, and economic performance, and pays explicit attention to the measurement problem. The chapters 4, 5, and 6 consider specific case studies of the economic effects of trust. A summary and a discussion of the main findings are presented in chapter 7.

Chapter 2 provides a broad introduction to the issue of the relations between trust, economic co-operation and societal economic performance by putting this issue in the broader perspective of social capital. Social capital “refers to features of social organization, such as trust, norms, and networks, that can improve the efficiency of society by facilitating coordinated actions” (Putnam 1993: 167). According to this definition, social capital can be seen as an umbrella concept with regard to several forms of co-ordination that improve the efficiency of society. Trust is just one of the features of social organisation that facilitates this co-ordination, but it enhances the insights of trust when it is examined in relation with the other features, such as norms and networks. Therefore, the chapter presents a small overview of the research on social capital. In the theoretical parts of this chapter, the focus is on the potential interactions between trust and the other features of social organisation. Attention is paid to membership rates of voluntary organisations, political activities, generalised trust, institutional trust, trust in inhabitants of foreign countries, norms of civic co-operation, and religion. The empirical parts of the chapter are focused on the measurement of the level of social capital and trust in the Netherlands. On the one hand, this is a practical exercise that shows the difficulties and problems of measuring social capital and trust. On the other hand, the results give clear indications about the level of social capital and trust in the Netherlands over time and in comparison with other countries. One of the main results is that, contrary to the findings of Putnam (2000) for the United States, there are no profound reasons to fear a ‘dramatic decline in social capital’ in the Netherlands.

Chapter 3 examines trust from a conceptual perspective. What is trust and how is it created and maintained in economic collaborative relationships? The field of (international) trade forms the practical framework for the analysis, but the aim of the chapter is to provide a conceptual perspective on trust that can be used for the analysis of all sorts of trust relations. It therefore brings together the insights from different research fields with regard to trust. These insights are combined in a trust typology that pays attention to the various influences on the creation of trust and the corresponding trust mechanisms. This typology makes it possible to deconstruct the empirical factors in a balanced way, such as to provide a coherent explanation for the way in which trust develops in specific situations or relations. It also forms the analytical basis a ‘contingency approach of trust’ that is proposed as an analytical method for further trust research.

After these two chapters that examine trust and economic co-operation from a rather general and conceptual perspective, the analysis of trust and its economic effects is continued by means of three case-studies. These three studies examine respectively the Dutch institutional framework of social-economic policy preparation (chapter 4), the over-representation of co-ethnic workers in ethnic minority firms (chapter 5), and international trade (chapter 6). These chapters form the applied part of the dissertation and show how trust can be used as an analytical tool for explaining economic phenomena.

Chapter 4 and 5 both study the effects of trust on labour market performance. The aim of both chapters is to contribute to the literature on trust by studying the ‘black institutional box’. The

chapters try to fill the analytical gap between, on the one hand, the game experimental research that shows that people have a certain (economical, psychological, and sociological) inclination to trust other people and to act co-operatively in laboratory settings, and, on the other hand, the macro-economic empirical research that shows that trust and social capital are associated with better economic and societal performance, by combining the relevant aspects of both approaches. The chapters look at the effects of trusting behaviour of people in the 'real world' instead of in laboratory settings, and examine the direct causal links between trust and welfare instead of the general relations between macro-economic averages.

The chapters show the different sides of the trust coin. Chapter 4 shows a case of the positive influence of trust, while chapter 5 warns for the dangers of too much within-group trust. In *chapter 4* it is argued that mutual trust among the participants in the Dutch social-economic policy preparation process was one of the main driving forces of the recovery of the Dutch economy in the 1980s and 1990s. This trust was enhanced by the institutional framework, in which government, labour unions, employer organisations, central bank and advisory bodies frequently meet each other in formal and informal networks. The resulting co-operative mood led to an effective dealing with the (collective action) problems. Trust between the individual members and the leaders of their organisations – together forming a large part of the societal midfield – facilitated the implementation of the proposed policies.

Chapter 5 studies a specific part of the labour market, namely employment in firms with an ethnic minority owner. It appears that a relative large portion of the employees in these firms have the same cultural background as the owner of the firm. The chapter searches for the rationale behind this phenomenon, and its welfare effects. In the short run, co-ethnic employment may lead to a decrease in monitoring and bonding costs because high within-group trust substitutes for more formal mechanisms of management control. However, the long term welfare effects may be negative for employees, employers, the ethnic minority group, and society as a whole, because the high within-group trust, of which co-ethnic employment is a symptom, hinders the economic and social emancipation of ethnic minority groups.

Another mechanism through which trust could lead to economic growth is that it fosters international trade. An empirical analysis of the relation between international trade and trust is given in *chapter 6*. It looks at the 'mystery of missing trade', which indicates the gap between the volume of international trade that would be optimal according to the standard neo-classical analysis and the actual volume of trade. Part of this gap may be explained by taking trust problems into account. Trust between trading partners lowers transaction costs and may therefore enhance international trade. This hypothesis is tested with use of a gravity model, i.e. a model that assumes that the volume of bilateral trade is positively related to the size of the countries and negatively to the distance between them. This gravity model is extended by adding indicators for formal and informal trust. Formal trust refers to the safeguards generated by formal, legal institutions. Similarity of legal systems is used as an indicator of formal trust, because this similarity eases the formal settlement of international (trade) disputes. Informal trust relates to forms of interpersonal trust that have an informal, normative or ethical character. It is measured with use of survey questions about the extent to which people trust the inhabitants of foreign countries. Both indicators of trust provide significant and substantial contributions to the explanation of bilateral trade flows. Hence, part of the mystery of missing trade can be attributed to the lack of trust between trading partners.

1.3 Trust in the economic literature

The ideas that are developed in this dissertation do not stand on their own. They are embedded in the innumerable ideas of economists and other social scientists that have studied trust and related issues before. This section provides an overview of how the various (economic) disciplines have been analysing trust and, at the same time, makes clear where to place the dissertation and its methodology in the existing literature.

1.3.1 Orthodox Neo-Classical Economics

The trust aspect of transactions and co-operation has, for a long time, been neglected in economics. In the orthodox 'Neo-Classical Economics', trust plays no role. Bakers and customers never cheat on each other. They even never seem to think of the option. They just do the transaction when it seems to be profitable for both, and they do not need a lawyer or a formal contract to secure the agreement. They also do not need friendship or other social bonds, nor emotions and feelings of shame or pride. According to this strand of literature, all actors simply act in their own interests and no problems result. In contrary, it leads to the benefit of all. In the famous words of Adam Smith (1776) this is stated as: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love and never talk to them of our own necessities but of their advantages".

This situation may look like an absence of trust on the one hand, but on the other hand, it may be more a situation of complete trust, because all actions and circumstances are considered to be predictable and fully known by all actors. There is no uncertainty, there is complete information and so trust is complete. Trust is a completely abundant concept in this situation, because it is always there. In this orthodox neo-classical world, transactions cause no co-ordination problems and go without transaction costs. Everything runs smoothly in the economy and optimal equilibria are the 'automatic' result.

1.3.2 Transaction Costs Economics and New Institutional Economics

The situation of perfect information, complete trust and optimal economic behaviour is tilted upside down in the literature of the 'Transaction Costs Economics' and the 'New Institutional Economics' (see e.g. Coase, North, and Williamson). These fields of economic literature use the basic notions of the standard economic approach, like rational maximisation of utility by individual economic actors who respond to material incentives, but they also question several assumptions of the orthodox neo-classical literature. The main assumptions under question are the assumptions of free and complete information, and full rationality of the actors. These assumptions ease the life of economists, because it is relatively easy to model human behaviour with use of the assumptions of orthodox neo-classical economics such as that the homo economicus maximises his utility and has full knowledge of the complete set of his behavioural options and their consequences. A disadvantage of this vision on human behaviour is that it seems to have lost touch with reality. Reality comes somewhat closer to economic theorising when the assumptions of perfect, free information and full rationality are loosened, as is done in the new institutional economics. When information is not complete, predictability of future events diminishes and uncertainty enters the analysis. Uncertainty refers to the situation that the set of potential future events is unknown and that the probabilities that these events will happen are also unknown. This implies that it is no longer possible to calculate 'expected outcomes', because these calculations depend on a known set of probability distributions. Moreover, when information is not freely available, transaction costs appear in (economic) transactions. In order to obtain information, actors have to invest

in a certain amount of information, but only to the extent that the marginal benefits of the investment equal the marginal costs.¹ Therefore, in most cases, people will not buy all information available, because the costs of acquisition do not weigh up against the benefits of this extra information. So besides the inherent incompleteness of information caused by uncertainty, this forms another reason for incomplete information: complete information is too expensive. In the new institutional economics literature, the assumption of full rationality is replaced by the assumption of bounded rationality. Bounded rationality means that actors have a limited capability of collecting, storing and processing information. As a consequence, actors do not even want complete information, since they would not be able to cope with it anyway.

So, according to the literature of transaction costs economics and new institutional economics, actors live in a world with uncertainty, transaction costs and bounded rationality. Contrary to the orthodox neo-classical world, actors lack a complete oversight of their behavioural options and their consequences, while transactions incur costs. In this situation, the motive of self-interest seeking, which was highly profitable for the common good in the neo-classical situation, turns out to be a dangerous behavioural aspect with negative externalities for the other actors in society. The conditions offer scope for opportunistic behaviour, i.e. self-interest seeking with guile, which implies that actors may suffer from the deliberate acts of others. Transacting becomes dangerous. Lawyers, courts, well-described property rights and all other sorts of institutions are needed to protect investments. The complete trust of the orthodox neo-classical economics turns into the complete distrust of the institutional economics. Actors exploit the vulnerabilities of other actors when they have the chance. Or, with some more nuances, not all people will always take advantage of others when they have the opportunity, but a proportion of them certainly will, so all people have to take care of this possibility when preparing a transaction.

In the new institutional economics, trust is a binary phenomenon. There is no trust at all or there is complete trust, but this will be exploited or cannot be considered to be 'real' trust. Williamson (1985, 1993) distinguishes between 'calculative trust' and 'blind trust'. The first type of trust, calculative trust, is the consequence of careful calculations in response to behavioural risks. An actor will only trust another actor, if his calculations show that it is beneficial for the other to act co-operatively, for example because non-co-operative behaviour is deterred by legal sanctions or reputation considerations. However, this concept of calculative trust assumes complete information about the other's options and motives, and thus assumes the absence of uncertainty, which was contested, in the first place, by the new institutional economics. Accepting calculative trust as a real phenomenon would imply a 'step back' to the neo-classical world, which is no option.

The second type of trust that Williamson distinguishes is blind trust. Blind trust is trust that originates from empathy, friendship, love, et cetera. In the world of the new institutional economics, blind trust has no chance of survival in economic markets, because it will be exploited by those actors who are not touched by these emotions, but who are only focusing on maximising their own (material) payoffs. Therefore, Williamson concludes that trust is an irrelevant concept for the study of economic behaviour.

1.3.3 Behavioural Economics and Experimental Economics

A third economic view on trust comes from the 'Behavioural Economics' and 'Experimental Economics' literature (see e.g. Camerer, Fehr, and Frey). The behavioural economics

¹ A related problem concerning information is that information is an experience good. You do not know the marginal benefit of information until you have collected it. Given that information is often not a continuous good but comes in packages, it is difficult to invest to the margin.

literature tries to encapsulate all sorts of incentives and preferences that influence the behaviour of (economic) actors in its theoretic framework. Its main unorthodox assumption – i.e. unorthodox compared to the orthodox neo-classical perspective – is that (economic) behaviour is not only guided by material incentives, but also by psychological and sociological influences.² According to this literature, people have a preference for and/or derive utility from equality, fairness, honesty, reciprocity et cetera, and let their individual behaviour at least partly depend on group norms and actions. The claims of the behavioural economists are supported by the results of behavioural game experiments in laboratory conditions (see Camerer 2003 for an excellent overview). This approach offers new views on trust and co-operation that go beyond the idea that trust and co-operation only evolve as a result of calculations of expected material payoffs. Trustworthy behaviour may also be based on shared group norms that function as ‘focal points’ for behaviour (Schelling 1960). Also psychological incentives may induce people to behave co-operatively. Although the literature is still in its developing phase and many of its results are still disputed, the behaviouralists seem to have incorporated valuable insights from other social sciences such as sociology and psychology.

An important notion from sociology for the study of economic transactions and co-ordination is the idea of embeddedness, which found its way into economics via the famous article from Granovetter (1985), who warns for under-socialised (and over-socialised) conceptions of man. Embeddedness implies that all forms of (economic) exchange are inherently embedded in social relations. A proper study of economic phenomena thus needs to take into account the social and political context in which these phenomena occur. The cultural background, the political environment, and the social ties of actors affect their behaviour, also when engaging in economic transactions. Social networks are very important in this respect. One of their main functions is that as source of information. This information may vary widely in scope and effects, ranging from specific information about job opportunities and gossip about the behaviour of others (with potential reputation effects) to general information about appropriate behaviour. This last type of information relates to norms. Norms are rules for behaviour that function as a co-ordination mechanism that is helpful in enabling co-operative relationships. (The discussion on networks and their functions, also in relation to social capital, is continued in chapter 2 and chapter 3.)

Important insights from psychology (and game experiments) are that “there are many assumptions that economists often make about human nature that behavioural and psychological research suggests are often importantly wrong. These include the assumptions that people are Bayesian information processors; have well-defined and stable preferences; maximize their expected utility; exponentially discount future well-being; have preferences over final outcomes, not changes; [and] have only “instrumental”/functional taste for beliefs and information” (Rabin 2002: 660).³ These ‘anomalies’ show that all sorts of psychological

² Classical economists of the 18th and 19th century, like Smith, Bentham, Edgeworth and Marshall, contributed considerable attention to the psychological determinants of human behaviour, but these ideas were ignored and later on forgotten by the neo-classical economists of the 20th century. See Frey and Benz (2002) for a historical account of ‘the loss of psychology in economics’.

³ For example, it is proven that people care about changes instead of levels (becoming wealthy is more important for life satisfaction than being wealthy); people are loss averse; people overreact to short-term changes and new information (situationalism); people care about others (altruism); people have a desire for social approval and try to avoid social disapproval; people care about the fairness and equity when gains are distributed; people care about intentions and motives, and want to reward/punish noble/bad behaviour (reciprocation); people exhibit time-inconsistent and present-biased preferences; people are over-optimistic; people take foregone costs into account (sunk costs fallacy); people value goods in their endowment higher than goods not in their endowment

effects interfere with the fully ‘rational’ kind of decision making in economic processes as proposed by the orthodox neo-classical approach. Especially the tendencies of people to care about fairness, equality, honesty and reciprocity are important indications that trust and trustworthiness may emerge and survive in situations in which the threat of opportunism should deter such behaviour. If people indeed have a preference for reciprocating behaviour that induces them to punish non-co-operative actors even if this involves some costs for them, it may be the opportunism that is deterred by the threat of social sanctions.

1.3.4 Network Economics

Although these insights from sociology and psychology lead to valuable improvements and adjustments of the orthodox economic view on human behaviour, it comes not without cost. It makes the use of formal modelling, which is one of the most powerful features of the economic approach, a lot more difficult. Some authors, however, do try to model these new aspects. For example, the field of ‘Network Economics’ puts considerable effort in modelling aspects of network formation and optimal network structures. The basic idea in this literature is that the formation of an (additional) link imposes some costs that have to be compared with the additional benefits. Usually, the costs are fixed, but the benefits depend on the size and structure of the network, thus leading to externalities for the entire existing network (Katz and Shapiro 1985). These models can also explain lock-in effects of existing standards (e.g. a certain type of technology), which arise because early adaptors have to bear a disproportionate share of the transient incompatibility costs (Farrell and Saloner 1986). Nevertheless, although these models take the existence of networks as a central theme and in this sense contribute to the existing economic literature, they are fully concentrated on the analysis of optimal network structures and the resulting network externalities in an orthodox neo-classical framework. The actors in these models are fully rational, have complete information, et cetera. This makes this network economics approach useless for the analysis of trust in this dissertation, which aspires to take a more realistic view of human behaviour into account.

1.3.5 Modern Neo-Classical Economics

There are some authors who have tried to incorporate ‘social’ preferences, such as altruism and fairness, in neo-classical type economic models with use of extended utility functions, and who have constructed production functions that take care of social capital (see e.g. Zak and Knack 2001, Durlauf 2002, Routledge and Von Amsberg 2003, and Wallis, Killerby and Dollery 2003). All in all, these attempts to model (sociological) structures and (psychological) preferences are scarce and their results are not extremely convincing. The reason is, of course, that in “a world in which context matters, abstract models have limitations” (Wallis, Killerby and Dollery 2003: 11). Those limitations lie in the fact that it is practically impossible to take account of all relevant variables, especially when these variables mutually influence each other.

Does this mean that the neo-classical economic methodology is a poorly qualified tool to analyse human behaviour (and trust)? No, it does not. Although several assumptions of the orthodox neo-classical approach are dismissed by psychological and sociological insights, the two core tenets of the neo-classical economic methodology are untouched and may even

(endowment effect); people react different in logically completely identical but differently framed context (framing effect, mental accounting); and people have emotions that influence their (short-run) decisions (sic) (see the overviews in Fehr and Falk 2002, Frey and Benz 2002, Rabin 2002, Tirole 2002, and Glaeser 2003).

prove insightful for other scientific disciplines. The first is that people respond to incentives under conditions of constraints. The second is that returns are equalised across different activities in equilibrium (cf. Frey and Benz 2002, and Glaeser 2003). Together, these tenets form a general analytical framework for the linking of (all sorts of) supply to exogenous returns. Although other social sciences might be able to document the effects of social influence, they experience problems in explaining the supply of social influence. Often they are in danger of explaining the social situation in terms of other, earlier social situations, thus leading to the problem of infinite regress (Glaeser 2003). When the goal is to understand the world however, one has to be able to explain both the effects and the supply of social influences in order to prevent ad hoc explanations. In this sense, the economic methodology offers tools that are applicable to all areas of human behaviour.

This dissertation builds on the neo-classical economics methodology, but with an eye for the contributions of the other social sciences. Therefore, it extends the neo-classical framework a little, just to be able to embed, more fruitfully, the concept of trust.

Chapter 2

Social capital – theory and measurement

The causal arrows among civic involvement, reciprocity, honesty, and social trust are as tangled as well-tossed spaghetti.

Putnam (2000: 137)

[S]ocial capital is a totally chaotic, ambiguous, and general category that can be used as a notional umbrella for almost any purpose.

Fine (2001: 155)

Of all the nations in Europe, the Dutch, the most commercial, are the most faithful to their word.

Adam Smith (1766, Lectures on jurisprudence)

2.1 Introduction

Social capital is closely related to trust and economic co-operation. Some authors even seem to equate these concepts to each other (see e.g. Paldam and Svendsen 2000, and Fukuyama 1995b), but their approaches involve a too strict definition of social capital. Although social capital can be seen, just like trust, as a lubricant of co-operation, it is more than just trust. Networks and norms are also essential elements. In this chapter we explore the relations between trust, (economic) co-operation and economic performance from the broader perspective of social capital. The ideas of Putnam stand central in our analysis, although the term social capital in its now familiar meaning was already used by the social reformer Hanifan in 1916.¹ Furthermore, social capital first appeared in economics in the writings of Loury (1977), and also the sociologists Bourdieu (1986) and Coleman (1988, 1990) developed influential ideas on this subject before Putnam published his two books on social capital.² Nevertheless, they did not draw as nearly as much attention as Putnam did. Putnam's book on the differences in social capital between the northern and southern regions of Italy – *Making democracy work* – delivered a kick-start to (renewed) scientific attention for social capital and its presumed blessings. The definitive breakthrough of Putnam as 'leading social capital scientist' resulted from his second book about declining social capital in the United States – *Bowling alone*; this book delivered him the attention of the American president and many other laymen, who were sensitive for his claim about the perturbing effects of the

¹ Hanifan (1916: 130) writes that local school performance could be enhanced by "those tangible substances that count for most in the daily lives of people: namely good will, fellowship, sympathy, and social intercourse among the individuals and families that make up a social unit ... If an individual comes into contact with his neighbor, and they with other neighbors, there will be an accumulation of social capital, which may immediately satisfy his social needs and which may bear a social potentiality sufficient to the substantial improvement of living conditions in the whole community."

² See Woolcock and Narayan (2000) for a historical account of the use of the term social capital.

decline of civic life and the weakening of social bonds. Fine notes that “Putnam has become the crown prince of social capital” (Fine 2001: 18). Whether a hereditary title should be seen as a recommendation in this perspective is questionable, however, the more because Putnam himself is constantly hammering on the virtues of democracy and political participation of citizens. We wish to stress that we take Putnam’s research as a starting-point of our analysis because it has inspired so much other social capital research and discussions, and not because we are convinced that it conveys the sole truth.

2.1.1 Defining social capital

There are many different definitions of social capital and they vary widely in scope and meaning. Coleman (1988: 95) broadly defines social capital as the “ability of people to work together for common purposes in groups and organizations”, while for example Paldam and Svendsen (2000: 342) choose a rather narrow definition when describing social capital as the “density of trust existing within a group”. Some authors regard it as a collective, macro-level resource, e.g. Woolcock (1998: 155) who defines social capital as a “broad term encompassing the norms and networks facilitating collective action for mutual benefit” and Fukuyama (1995b) who sees it as “the component of human capital that allows members of a given society to trust one another and cooperate in the formation of new groups and associations”. Other authors see it as a primarily individual, micro-level resource, e.g. Glaeser, Laibson and Sacerdote (2002) who define social capital as “a person’s social characteristics – including social skills, charisma, and the size of his Rolodex – which enable him to reap market and non-market returns from interactions with others” and Portes (1995: 12) who states that social capital “refers to the capacity of individuals to command scarce resources by virtue of their membership in networks or broader social structures”. In this small summing-up of definitions, we already see the problem rising, that “social capital is a totally chaotic, ambiguous, and general category that can be used as a notional umbrella for almost any purpose” (Fine 2001: 155).

In order to focus more, we constrain ourselves to the two definitions given by Putnam. He argues that social capital “refers to features of social organization, such as trust, norms, and networks, that can improve the efficiency of society by facilitating coordinated actions” (Putnam 1993: 167), and, a few years later, that social capital refers “to connections among individuals – social networks and the norms of reciprocity and trustworthiness that arise from them” (Putnam 2000: 19). We thus choose for a social capital concept that puts more stress on the societal than individual effects of social capital. However, the individual effects are often closely related to societal effects, as a result of the external effects originating from individual behaviour. The distinction between the two is therefore often more of a theoretical than a practical value.

According to these definitions, three elements stand out. The first is the network element, which forms the structural part of social capital. Social capital is about connections between people, so it is not an individual asset but a collective resource that is generated by and creating value for a group of people. The value of social capital for society lies in its power to improve social organisation by increasing society’s capabilities to overcome social co-ordination problems. The other two elements, norms and trust(worthiness), are the necessary ingredients to make this happen and can be considered as the moral part of social capital. We will see later in the empirical parts of this chapter that the two moral elements are sometimes hard to distinguish from each other, but are clearly distinguishable from the structural element.

Networks, communities, associations and other groups of people are at the core of social capital. This implies that network externalities occur. The effects of individual behaviour

extend to the other members in the network. When there are positive externalities, the benefits of individual investments in social capital cannot be fully appropriated by the individual investors, because part of the investments accrues to all group members. The dangers of free-riding and consequential underinvestment in social capital may therefore threaten the creation of an optimal amount of social capital.

The distinction between networks, norms and trust indicates that social capital can be seen from different angles. Researchers try to link these angles, as the concept of social capital comes to full blossom when it links the social, economic, psychological and political spheres of life with each other. Research of social capital is therefore interdisciplinary by nature, which makes it vulnerable of becoming “totally chaotic, ambiguous”, et cetera. In the words of Woolcock (1998: 196), “ordinarily, a theory’s parsimony – i.e., its capacity to explain the most with the least – is a desirable property; in this instance, however, a single term is being adopted indiscriminately, adapted uncritically, and applied imprecisely.” Ockham’s razor might have cut to deep with respect to social capital. We therefore have to be careful in adopting, adapting and applying the concept social capital. We start with an analysis of how Putnam discriminates between the elements of social capital.

Putnam regards the three elements (networks, norms and trust) as more or less equal constituting elements of social capital in his earlier work. In his later work, he regards norms and trust as the result of social networks. Putnam’s wrestling with cause, effect and essence of social capital reflects the continuing discussion in the literature in theorising about the precise causal relationships between social capital, networks, norms, trust and their effects on the efficiency of economies and the functioning of democracies. Is social capital the structure – the medium – or its message? (Woolcock 1998). We agree with Woolcock that functionalist definitions of social capital, which are focused on the consequences of social capital and are therefore in danger of becoming tautologies, are less functional than definitions that stress the sources of social capital, but in this case it is a chicken-and-egg problem in optima forma: networks are at the basis of the creation of norms and trust, while at the same moment networks cannot survive without them. Although the ability to trust is now generally seen as an important element of social capital, while networks are regarded as the essential framework for the development of trust and social capital (see e.g. the reviews by Nooteboom 2002 and Sobel 2002), it is not likely that the theoretical discussions about the causal arrows will cumulate in a definitive conclusion, because causality works both ways in this case. Nevertheless, empirical research might offer clues of which causal relations are the most important. We therefore have to find a way of how to measure social capital.

2.1.2 Measuring social capital

“There is a long academic tradition that something is not fully understood until it can be measured, and the concept of social capital presents serious problems of definition, let alone measurement” (Temple 2001: 83). Temple makes a good point, but Solow (1995) already made exactly the same argument six years before. It is unfair to say that there has not been made any progress between 1995 and 2001. As a matter of fact, a lot of empirically based studies appeared in the international journals and conferences. There is a parallel with the concept human capital. Just as it took some time to find proper, generally accepted definitions and ways of measurement for human capital, it may take some time to find these for social capital. Although we have not reached such a stage right now, this does not imply that the concept social capital is worthless at the moment. In general, there have been developed three promising ways of measuring (elements of) social capital over the last decade: (i) game experiments that measure actual behaviour, (ii) surveys that measure trust and norms, and (iii)

surveys that measure Putnam's instrument, i.e. the density of voluntary organisations (cf. Paldam and Svendsen 2000). The first two methods are pointed at measuring the moral part of social capital, the third at the structural part. We look at the three approaches and consider their advantages and disadvantages.

The first way of measuring social capital is by conducting (micro economic) game experiments – e.g. prisoners' dilemma games, trust games and collective action games. Game experiments provide direct answers to the questions to what extent people tend to co-operate, tend to place trust, and tend to be trustworthy and reciprocating. The advantage of this method is that people have to exhibit their 'revealed preferences' and cannot hide behind socially accepted 'say-behaviour'. The clinical approach of these experiments also makes it possible to clear out all disturbing external influences. This allows the researchers to devise the experiments in such a way that they can focus on very specific elements of, for example, norm driven behaviour. The big disadvantage of this method to measure social capital is that it takes a lot of time and money per respondent, which forms a serious impediment for doing these experiments on a world-wide scale with substantial numbers of local respondents per region.³ Furthermore, four methodological problems arise when we try to compare the results of cross-cultural experiments, apart from the practical problems that surround the set-up of world-wide game experiments (see Camerer 2003: 68ff). The three minor ones consider the problems how to control for stakes (correct for differences in purchasing power between countries), language (make sure that the meaning of the instructions is exactly the same in every used language) and experimenter effects (the identity and behaviour of individual experimenters possibly influence the results; when the same experimenter conducts the experiments in several countries, one can control for this). The major problem comes from identification problems, arising from the effects of culture related variables. For example, if you use students for your experiments, your results could be blurred by the fact that the student population in one country is quite different from the student population in another country. The average age of students depends on whether they have to do military service before they go to college and in some country only people from wealthy families can afford higher education (this example is from Camerer 2003).

The second way of measuring social capital is by asking people about their trust, norms and co-operative behaviour. The advantages and disadvantages of this method are the inverse of those of the game experiments. It is relatively cheap to question many people on an international scale, but there may be a discrepancy between the things people say they do and the things they actually do. People are inclined to give socially accepted answers or have problems in adequately imagining their reaction when the proposed situation occurs. The same survey question may be interpreted differently by the same respondent at different

³ For reasons of convenience and budget, students are often chosen to participate in these experiments. They are widely available at the universities where the experiments are taking place and they are cheap. This might negatively affect the representativeness of the research population and thus the validity of the research outcomes, because students are relatively young and relatively high-educated compared to 'the average person' in a country. In the case that economic students are the main participants of game experiments, the question can be raised whether this specific population is biased to rational and opportunistic behaviour. This may be caused by self-selection (rational and opportunistic people have a preference for studying economics) or by the fact that these students are trained to act in this way. The results from the empirical literature are mixed. Frank, Gilovich and Regan (1996) find evidence of an education effect in prisoners' dilemma games, but Frey and Meier (2002) conclude from a natural experiment that rational choice theory does not indoctrinate students. A self-selection effect is found by Frank and Schülze (2000) and Frey and Meier (2002), but Laband and Beil (1999) find no differences in co-operative behaviour between economists and non-economists. Finally, Yezer, Goldfarb and Poppen (1996) conclude that economic students are more co-operative than other students.

moments (see e.g. Paxton 1999, Putnam 2000). For example, what does it mean when the respondent answers to be less trusting in 1990 than in 1981? It could be that (i) trustworthiness of other people declined, that (ii) the trustworthiness of other people remained stable but that the respondent became more paranoid, or that (iii) the trustworthiness stayed the same but that the media coverage of corrupt and criminal behaviour soared.

Many different questions are used to measure social capital in these surveys. The World Bank even proposes a questionnaire that consists of 95 questions (Grootaert, Narayan, Jones and Woolcock 2004)). The most common questions are the loan question and the generalised trust question. The loan question is stated as: “Consider the circle of the $m=100$ people (outside close family) you know best. How many in this circle would you trust with a personal loan amounting to $n=5\%$ of your income?” (suggested by Paldam and Svendsen 2000). The trust question comes from the World Values Survey and is widely used as a proxy for generalised trust. It reads: “Generally speaking, would you say that most people can be trusted or that you can’t be too careful in dealing with people?”

The third way of measuring social capital is by using Putnam’s instrument, i.e. the density of voluntary organisations (Paldam and Svendsen 2000). Contrary to the two measures of the moral social capital elements above, this measure refers to the structural component of social capital. Putnam’s instrument relates to the number of organisations of which a person in a society is a member. This can be easily measured by asking people about their memberships. This should lead to one ‘objective’ number, because there is hardly room for (culturally based) misinterpretations and because there are no incentives for responders to lie since it does not involve a socially loaded question. Another advantage of this measure is that it can be checked by comparing the sum of the individual results with the reported membership figures of the voluntary organisations themselves.

Problematic with respect to this measure could be that some memberships are secret (e.g. membership of some Masonic lodges or of illegal organisations) or unclear (e.g. are you a donor or a full-fledged member of an environmental organisation like Greenpeace when you pay ten euro per year?). A more important problem is that the intensity of membership varies between different organisations. Putnam argues that more intensive activity with much face-to-face contacts has more beneficial effects on network formation and trust creation than low intensive ‘send-a-check’ memberships. So, one should correct for the intensity of the membership, when measuring the density of voluntary organisation. However, this measure of social capital still neglects other structures in which intensive face-to-face contacts take place, such as school and work, which may have the same beneficial effects as voluntary organisations.

We conclude that all methods have their particular advantages and disadvantages. Could a combination of these methods create a method of measurement without problems? With regard to the measurement of trust, Fehr, Fischbacher, Von Rosenblatt, Schupp and Wagner (2003) claim to have found a way to use both surveys and experiments, which overcomes the crucial weaknesses of both approaches. This is done by adding a trust game to the survey in which the roles of A and B are randomly assigned to the survey participants. Players A and B do not have any contact with each other, but are matched ex post by the researchers. Although the first results of this hybrid approach are promising, it is still too new to have inspired other researchers to any, let alone widespread, imitation.

Despite the problems of both definition and measurement, several researchers have conducted empirical studies on (elements of) social capital that show its beneficial effects on the functioning of societies. Putnam (1993) points at the striking differences in economic welfare and political and social participation between the citizens in the northern and southern

regions in Italy. Knack and Keefer (1997), LaPorta, Lopez-de-Silanes, Shleifer and Vishny (1997), and Zak and Knack (2001) provide evidence, for several countries, that trust leads to higher aggregate economic activity and better societal performance. We return to this issue later. At this point it is sufficient to conclude that the level of social capital seems to have a substantial impact on the performance of societies and is therefore worth studying, even in the presence of definition and measurement problems. This conclusion is buttressed by the amount of attention social capital receives from international economic institutions, like the World Bank and the OECD (World Bank 1998, Temple 2001). These institutions face even more challenging problems, because they intend to devise and implement policies that foster social capital. This intention confronts them with practical policy problems, such as whether social capital forms an untouchable part of a centuries old cultural heritage of a society or whether social capital is something that can be actively built by governments (and if so, how?). There is ample scope for further research in these fields.

The analysis of social capital is further challenged by recent research that indicates that social capital may have different effects in different societies. See e.g. Bjørnskov (2003), who reports on the relation between social capital and life satisfaction.⁴ He finds that social capital is important for rich and poor countries, but in a different way. For poor countries, social capital seems to be a substitute for malfunctioning formal institutions. In this way it enhances society's capacity to deal with co-ordination problems, fosters economic activity, raises national income and increases life satisfaction through the economic channel. In economically advanced societies, social capital has a more direct influence on people's happiness. This influence seems to be even bigger than the influence of people's income, which could form an indication for a kind of Maslow or 'postmodernisation' effect (Inglehart 1997). When the basic economic needs are fulfilled, happiness is increased by peaceful contacts with other trustworthy, norm abiding citizens. This argument is questionable, however. Given that the 'basic economic needs' seem to be quite fulfilled in most Western societies, it is still somewhat naïve to think that the Western people now only care about 'higher values' and 'self-expression' instead of material gains. The opposite seems to be true if we look at current work and consumption patterns.

We conclude that our overview of the social capital research unveils many problems in the areas of definition, causality, effects, and measurement of social capital. Nevertheless, the link with better social co-ordination and economic performance is seldom disputed. It seems reasonable therefore to examine more closely the relationships between social capital, trust, co-operation and economic performance. Which elements of social capital are the most important? In order to investigate this problem, we start by using the definition of Putnam, who distinguishes between trust, networks and norms. These elements of social capital are discussed in respectively section 2, 3, and 4. As a special case of a situation in which structural and moral elements are both present, religions are examined on their relationship with other forms of social capital and economic performance in section 5. Every section starts with a critical assessment of why this specific element should be considered part of the social capital definition, how it relates to other social capital elements and how it affects economic performance. This is followed by empirical explorations of the theoretical statements. Moreover, special attention is paid to the measurement of social capital in the Netherlands. Section 6 concludes.

⁴ Bjørnskov (2003) forms an index of social capital by using factor analysis on 'generalised trust', 'civic participation', and 'perceived corruption'.

2.2 Trust - the first element of social capital

In this section, we make a distinction between interpersonal trust and institutional trust. We first look at the theoretical considerations and empirical results (from game experiments and surveys) with regard to interpersonal trust. Thereafter, we continue with institutional trust.

2.2.1 Interpersonal trust: theory

Social capital and trust are closely related. Some authors consider trust as a part of social capital, while others regard trust as a direct consequence (or the dividend) of social capital. The definitions of trust vary widely. The economist Sobel (2002: 148) uses a rather sober definition centred at the decision of the trustor – “trust is the willingness to permit the decisions of others to influence your welfare” – while the political scientist Newton (2001: 202) puts the emphasis on actions of the trustee – trust is the “actor’s belief that, at worst, others will not knowingly or willingly do him harm, and at best, that they will act in his interest”. Others extend the focus of trust to include far more than just the bilateral relationship between trustor and trustee, as is done by e.g. the sociologist Barber (1983: 165), who sees trust as the “socially learned and socially confirmed expectations that people have of each other, of the organizations and institutions in which they live, and of the natural and moral social orders, that set the fundamental understandings for their lives”.

In order to keep the analysis relatively simple at this point, we limit our attention in this section to bilateral, interpersonal trust relationships.⁵ These simple bilateral trust relationships have in general three common aspects (Coleman 1990: 97-99). First, the trustee has a choice to honour or abuse trust, after this trust has been placed by the trustor. Second, honoured trust leads to a benefit for the trustor, whereas abused trust leads to a loss, as compared to the situation that no trust was placed. Third, the trustor and the trustee do not act simultaneously. It takes a while before the trustee reacts on the trust giving by the trustor. Together, these three aspects imply a risk for the trustor to engage in the transaction. The risk arises from the possibility for the other transaction party to act in an opportunistic way, which means that the other agent could gain an extra benefit at the expense of his transaction partner (the trustor). In these situations, trustworthiness is regarded as the characteristic of a party to refrain from opportunistic behaviour, or even better, to act in accordance with the letter *and* spirit of the agreement. Trust is the expectation of the actor that the other will behave trustworthily. Sometimes, it is argued that a fourth aspect is necessary to talk about ‘real’ trust. There should be an absence of formal safeguards to protect the trustor’s vulnerability. However, this is an unnecessary restriction, which impedes a complete analysis of trust relationships. All relevant circumstances should be taken into account (Mosch and Verhoeven 2003a, also see chapter 3).

Trust is positively related to the economic performance of societies. High trust between the individuals in a society facilitates co-operation, lowers transaction costs and enhances flexibility. High trust facilitates co-operation, because it forms a co-ordinating device for inherently uncertain human behaviour. In a society where people tend to trust each other and behave trustworthily, it is an optimal strategy (or focal point) to behave trustingly and trustworthily yourself, because this enables you to reap higher pay-offs. It thus forms a lubricant of co-operation. A general expectation that people can be trusted lowers transaction costs, because it removes the need for expensive formal safeguards to protect investments, for detailed contracting of agreements, for the close monitoring of the other party’s behaviour, and so forth. High trust enhances flexibility, because it allows transaction partners to deviate

⁵ Chapter 3 is entirely devoted to the phenomenon of trust, its causes and its effects, in all its dimensions.

from the letter of the agreement to perform in the spirit of the agreement. The benefits of high trust are not restricted to the economic sphere of societies. Putnam (2000: 137) claims that people “who trust others are all-round good citizens”, because trust strengthens pro-social behaviour and is associated with more civic and democratic, political involvement.

Turning to the empirical results with respect to trust, we first look at the empirical results from game experiments. Thereafter, we continue with an empirical analysis using survey based trust data.

2.2.2 Interpersonal trust: empirical results from game experiments

Interpersonal trust: general results from game experiments

In the orthodox neo-classical economics, actors behave fully rationally. In these analyses, there is no room for ‘irrational’ behaviour that is related to trust, reciprocity or fairness, because actors will just try and maximise their self-interest. Their utility is influenced by direct material payoffs, not by emotions or concerns about the utility of others. A wide range of game experiments in laboratory conditions shows that these assumptions are not tenable. Camerer (1997), Fehr and Gächter (2000) and Ostrom (2000a) (among many others; see the excellent overview of game experiments in Camerer 2003) present evidence on the existence of trusting and trustworthy behaviour by human beings, who seem to be influenced by notions of fairness and reciprocity.

Two of the most used experiments are the ultimatum game and the trust game. In the ultimatum game, player A (the Proposer) receives an amount of money and divides this between a player B (the Responder) and himself. If B accepts this division, both get the amount as proposed by player A. If B rejects the proposal, both players receive nothing. Economic theory suggests that B should accept every proposal of A as long as it more than nothing, while A should offer the tiniest amount of money larger than zero. The general result of this type of game experiments is that most Proposers offer nearly-equal splits, while offers of 20 percent and lower are frequently rejected by the Responder. Apparently, low offers are seen as unfair by the Responders, who react by punishing the Proposers, even though this is costly for themselves (negative reciprocation).

In the trust game, player A (the trustor) receives an amount of money. The amount of money M that player A gives to player B (the trustee) is multiplied by the experimenters by a number x (x is usually 2 or 3). Player B is free in deciding what proportion of xM he repays to player A. Economic theory reasons that player B will never return any money; player A foresees that B will not return any money, so A will not send any money to B. However, the general result of this experiment is that players A ‘invest’ about half of their money and that players B return an amount of money that is equal or slightly less than the amount of money they received from A. Apparently, players A trust that players B will pay back, while players B behave trustworthily in the sense that they indeed send back part of the money.

The measure of trust that is found by using game experiments comes close to an indicator of basic trust. We call this basic trust, because nothing indulges the players to be trusting or trustworthy than a personal inclination to do so. The games are devised in such a way, that the players are strangers for each other (no social ties), often do not even see each other, play single-shot games (no reputation effects), and formal sanctions and group pressure are excluded. Even the introduction of very high pay-offs for the players, up to the level of several monthly salaries, do not change the general outcomes of these types of experiments. The research also provides clues about which circumstances are favourable for the development of trust: face-to-face contact, small groups in which reputation effects may

develop, and the possibility to punish free-riders. Moreover, these experiments clearly establish the link between more trust on the one side and higher individual and collective payoffs on the other side, because trusting players manage to prevent getting stuck in the suboptimal Nash equilibrium of prisoners' dilemma games and other types of co-ordination games.

Interpersonal trust: the Netherlands

Although this strand of research is very useful in finding the precise links between incentives, external circumstances and actual behaviour, it is, up to now, less useful for determining the exact level of trust and the comparison of these levels of trust between different regions and time periods. The few cross-cultural ultimatum game experiments that have been deployed in Western countries do not show much variation in offers and rejection rates, with the exception of Roth et al. (1991) who find that offers in ultimatum games in Israel and Japan are about ten percent lower than in the United States and Slovenia, and of Willinger et al. (2003) who find, with use of a one-shot investment game, that the level of trust is higher in Germany than in France, but that the level of reciprocity (an indication of trustworthiness) does not significantly differ between the two countries. Clearly deviant results are only found in small, socially and economically isolated communities like those of the Machiguenga farmers in Peru (very low offers) and the Lamelara whalers of Indonesia (very high offers, on average even more than half) (Henrich et al. 2002). There are no indications that trust and trustworthiness (as measured in game experiments) in the Netherlands are different from trust and trustworthiness in other Western countries. So, for an analysis of trust between countries and over time, we have to turn to survey based trust data.

2.2.3 Interpersonal trust: empirical investigations with use of survey based trust data

Interpersonal trust: general empirical results from surveys

Most of the authors who try to establish a (macroeconomic) relationship between trust and economic indicators use the results from the World Values Survey for their measure of trust (e.g. LaPorta et al. 1997, Knack and Keefer 1997, Zak and Knack 2001). The World Values Survey is a series designed to enable a cross-national comparison of values and norms on a wide variety of topics across the globe. The Survey has been held in 1981-1983, in 1990-1993, and in 1995-1997 in more than 50 countries all over the world. In each country over 1,000 randomly selected people were surveyed. The attention of the researchers is centred on the so-called generalised trust question: "Generally speaking, would you say that most people can be trusted or that you can't be too careful in dealing with people?" The percentage of people answering that most people can be trusted is used as a measure of social trust within a country.

There are some indications that this measure of trust is relatively robust (Knack and Keefer 1997). The correlation across countries' scores on WVS trust in the 1981 wave and in the 1990 wave is rather high (0.91). The results of the trust question also highly correlate with the results of some questions on norms of civic co-operation. Furthermore, this measure of trust strongly correlates with the results of the 'wallet test': the amount of lost wallets in a city that is returned to the rightful owner. Moreover, several authors have tried to uncover the link between (game) experimental trust and survey-based, stated trust. Glaeser, Laibson, Scheinkman and Soutter (2000) find that standard attitudinal survey questions about trust predict trusting behaviour to a reasonable extent, but predict trustworthy behaviour even much better. Somewhat in contrast with this finding, Bellemare and Kröger (2003) conclude

that stated trust measures *do* closely correlate with experimental trust measures. Also Fehr et al. (2003) provide evidence that questions about past trusting behaviour and direct questions about people's trust are the best indicators for actual experimental trusting behaviour.

A review of the empirical research reveals the following macroeconomic relations with survey-based, generalised trust. First, trust is positively related to higher economic performance (LaPorta, Lopez-de-Silanes, Shleifer and Vishny 1997, Inglehart 1997, Knack and Keefer 1997, Zak and Knack 2001). Higher trust leads to higher yearly growth of income per capita. This link between trust and economic growth seems to be stronger for poorer countries. A reason could be that trust plays a larger role in developing countries, because it functions as a substitute for lacking or bad-functioning legal systems and official sources of credit. Trust also positively and significantly correlates with production output, capital investments and average level of education. The data suggest that the causal relationships run from trust to higher incomes and from trust to better schooling instead of the other way round.

LaPorta et al. (1997) find positive effects of trust on government effectiveness. They measure government effectiveness with use of (subjective) estimates from investor surveys of the efficiency of the judicial system, corruption, bureaucratic quality, and tax compliance. Higher trust also correlates with other elements of well-functioning societies, such as higher infrastructure quality, lower infant mortality, and higher educational achievement. This confirms the findings of Putnam's study (1993) of the differences between the northern and southern regions in Italy.

Third, LaPorta et al. (1997) find a large effect of trust on large firms' share of the economy. This corroborates Fukuyama's (1995a) hypothesis that trust in 'strangers' is necessary for the development of big firms in a society. Fukuyama roughly divides the world in high trust and low trust societies. In low trust countries, people are strongly family orientated: they only trust people from their own (extended) family and people who are close friends (e.g. neighbours and former school mates). In this type of society, most firms are family firms and the top managing positions are reserved for family members. When the younger generations lack the entrepreneurial skills or the discipline of the founder of the firm, or they do not avail of the knowledge that is necessary for managing a growing firm, this severely impedes the development of the firm. In high trust societies, in which people have a relatively high trust in 'strangers' (people who do not belong to your family, clan or close friends), firms hire strangers as managers and specialised staff, which enables them to grow. Trust in strangers hereby replaces the family ties as a mechanism of co-ordination.

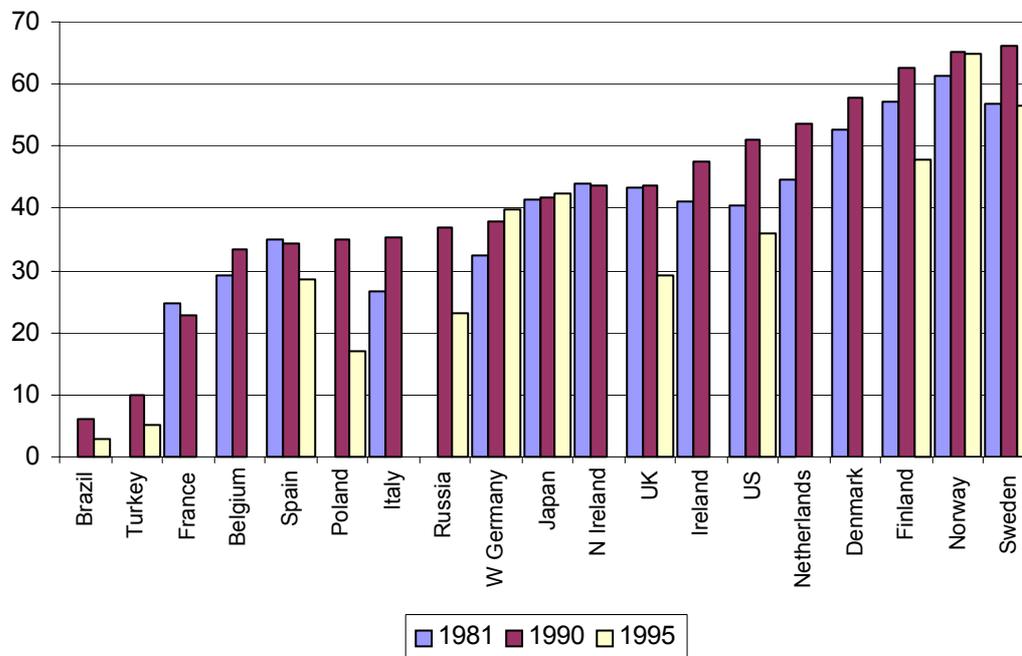
A problematic feature of this type of research is that the model results exhibit a high sensitivity to the used dataset and selection of included countries. Beugelsdijk, De Groot and Van Schaik (2002) point at the weak general robustness of the Knack and Keefer (1997) findings, while the inclusion of low income countries is necessary to find a positive relationship between trust and economic growth in the Zak and Knack (2001) study. In a study on 54 (economically advanced) European regions, Beugelsdijk and Van Schaik (2003) find no relation between trust and economic growth. In line with this, Bjørnskov (2003) provides evidence that the effects of social capital on growth are stronger in poor than rich countries. Already in 1996, Helliwell (1996) reported to have found a *negative* effect of trust on growth in a sample of 17 OECD member countries. Thus, although several authors have found strong indications that trust is related to economic growth, we have to be careful in assuming a direct and clear relationship between these two variables, especially when considering rich countries.

We investigate levels and development of trust in the Netherlands and some other developed countries in the next subsection.

Interpersonal trust: the Netherlands

Figure 2.2.1 gives an overview of the World Values Survey trust scores for different countries and for the three ‘waves’ of the WVS. The Netherlands participated in the first two waves. The third wave was largely focused on developing countries that were not surveyed in the waves in the beginning of the 1980s and the 1990s. Low trust countries, according to this measure, are developing countries, East-European countries and South-European countries. High trust countries are the Scandinavian countries, closely followed by the Netherlands. Trust in the Netherlands rises from 45 to 53 percent between 1981 and 1990. Possibly the economic tide is (partly) responsible for this increase. In the beginning of the 1980s the Netherlands were in a recession, partly as the result of the second oil shock in 1979. This downturn had been overcome at the beginning of the 1990s (see also chapter 4 about the Dutch Miracle). The resulting positive mood may have found its way into the trust scores.

Figure 2.2.1. Generalised trust

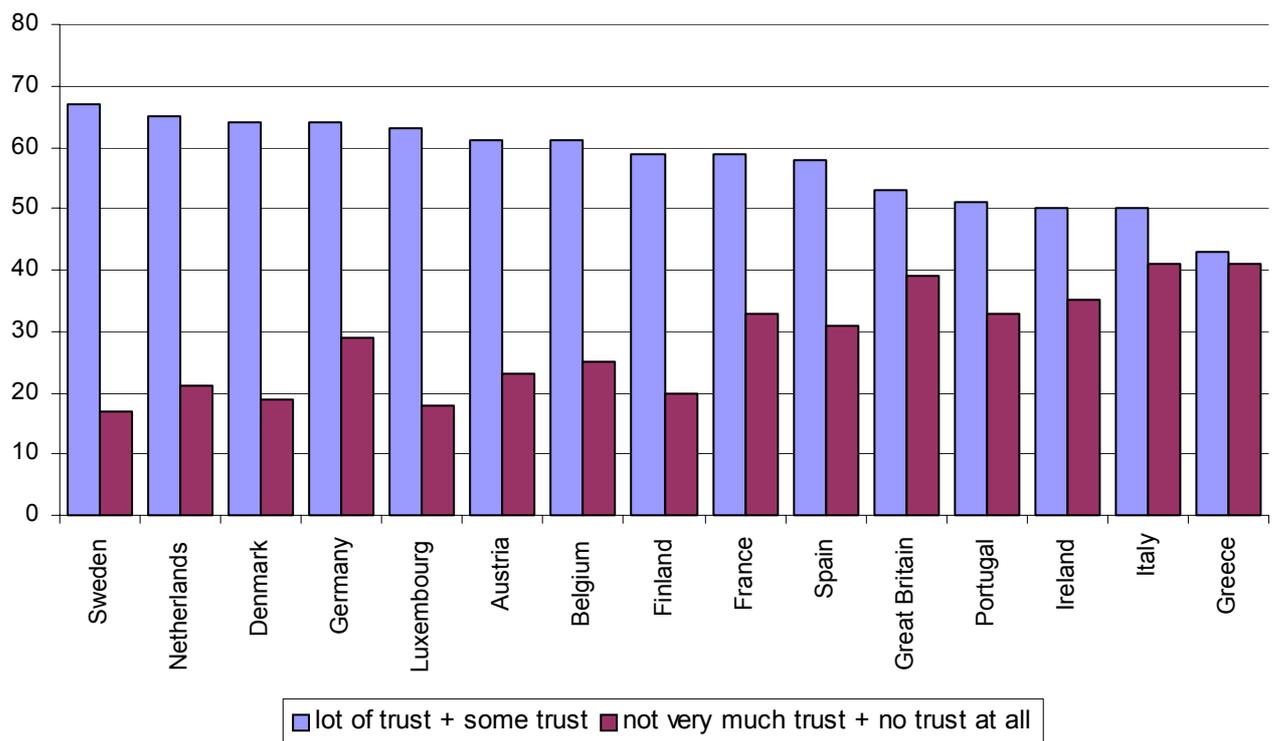


Source: World Values Survey 1981, 1990 and 1995.

An unexpected message from this overview is that several countries experience quite substantial drops and rises in trust from wave to wave. The East-European countries and Russia saw their trust levels strongly decline between 1990 and 1995. This drop is a result of the dismantling of the communist political system in the beginning of the 1990s and the entrance of free market capitalism (Humphrey and Schmitz 1998, Paldam and Svendsen 2001). The political change resulted in the disappearance of the old system of control and order, while it was not replaced by a new one. The remaining legal system was insufficiently financed and weakly organised. It did not form a credible threat to abhor people from criminal acts, nepotism and corruption in a period – the transition period – that offered a lot of chances and incentives to earn a lot of money by neglecting the law. At the same time, the other potential source of trust – networks – did hardly exist. During its reign over more than half of the century, the Communist Party had quite successfully followed a policy to suppress

voluntarily organised networks, clubs, societies and associations, because they could form a source of resistance against the communists' political supremacy. Moreover, also the moral norms had been eroded under communism, because "to "beat the system", to outwit the authorities, to evade public regulations, rules, laws [became] one of the widely recognised virtues" (Sztompka 1993: 90). Thus, when the formal institutions of law and order broke down with the collapse of the communist system, no substitute in the form of informal networks was available and norms were focused on cheating instead of co-operating. As a result, generalised trust dropped.

Figure 2.2.2. Average trust of EU-countries in the inhabitants of specific countries, 1996

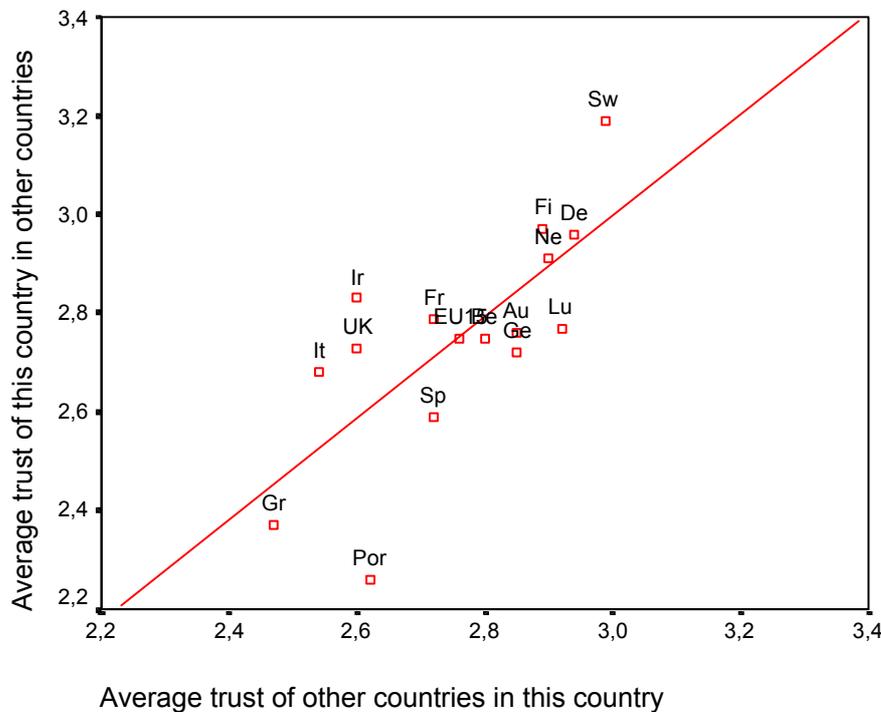


Source: EuroBarometer 46.0 1996.

More difficult to explain is the decline in trust in countries such as the United States, Finland and the United Kingdom over the same period. With regard to the United States, Putnam (2000) wrote a book full of graphs and statistics to show that the 'alarming and dramatic' – according to Putnam – decline of social capital could be seen on all fronts of civic engagement starting as early as 1960. Putnam mainly put the attention on the decrease in membership rates of all sorts of voluntary organisations. We come back to this point in the next section about networks. Here we conclude, based on the above presented WVS data and Putnam's research, that substantial rises and declines in trust levels appear to be possible over periods of just decades or even years. This may form an incentive for governments to be very careful with the preservation of the 'stock' of trust in their country, because trust and its widespread positive external effects can, apparently, easily fade away. This finding is in sharp contrast with Putnam's earlier work (Putnam 1993) in which he argues that social capital and trust are formed in processes that take centuries to develop, that social capital and trust should be considered as part of a region's culture and, thus, that they are highly constant factors that cannot be changed easily. This reasoning is irreconcilable with the empirical results presented in Figure 2.2.1.

As another indicator for trust, we use the results of the EuroBarometer survey 46.0 (EB) held in 1996, of which one of the questions was: “I would like to ask you a question about how much trust you have in people from various countries. For each, please tell me whether you have a lot of trust, some trust, not very much trust or no trust at all?”. The question has been answered by the inhabitants of the 15 EU-members in 1996 (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, the Netherlands, Ireland, Spain, Sweden, Portugal and the United Kingdom). Figure 2.2.2 provides a graphical presentation of the results. This gives an indication about the trustworthiness of the people from a certain country as perceived by the inhabitants of the other European countries. The least trusted are South-European countries such as Greece, Italy and Portugal, but also Ireland and the UK. Most trusted countries are the northern countries, like Sweden, the Netherlands, Denmark and Germany. The Dutch, apparently, are not only highly trusted by their fellow citizens but also by their neighbouring countries.

Figure 2.2.3. Average trust in inhabitants of foreign countries and average trust by inhabitants of foreign countries, 1996



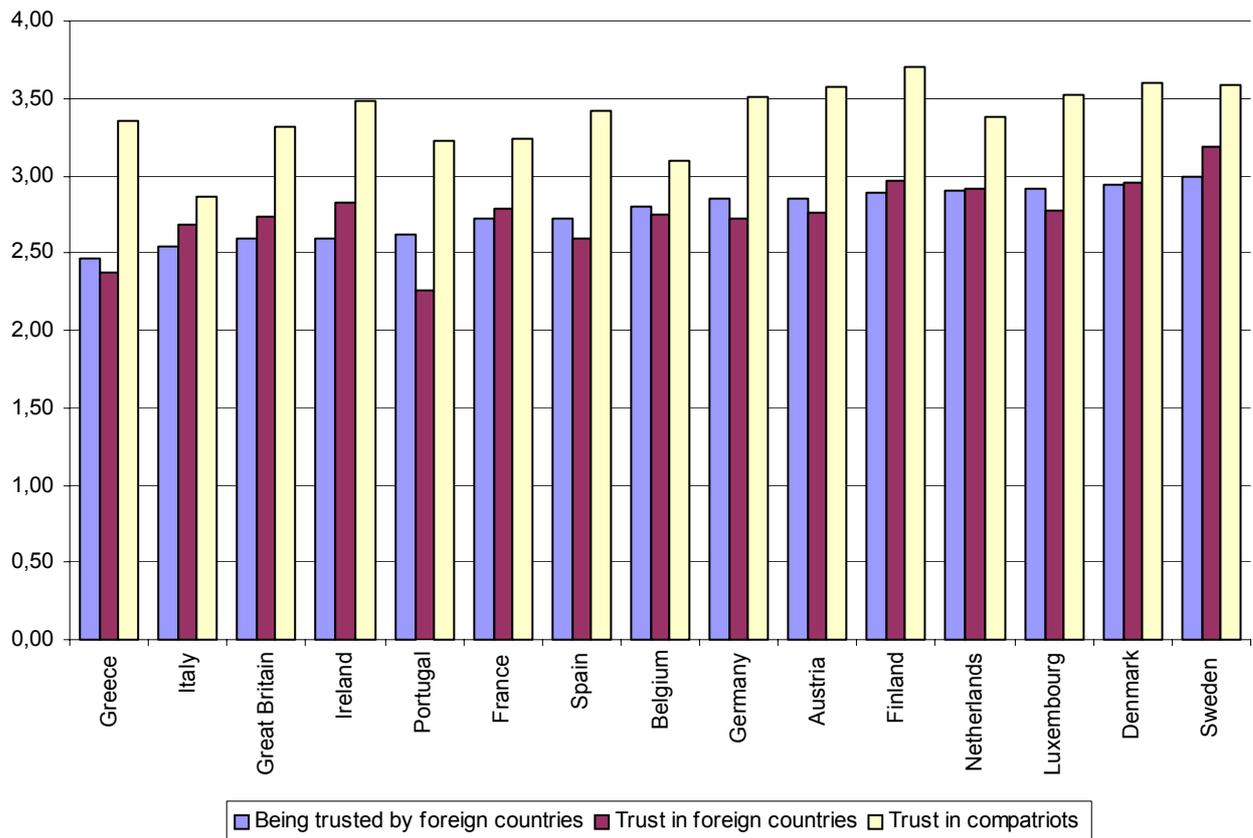
Source: EuroBarometer 46.0 1996.

In Figure 2.2.3 we present a graphical illustration of the relationship between ‘average trust in inhabitants of other countries’ and ‘average trust by inhabitants of other countries’.⁶ Most countries appear to be on the ‘diagonal’, which implies that the trustworthiness of the inhabitants of the country as perceived by inhabitants from other countries is about equal to the amount of trust the inhabitants of the country themselves exhibit in foreign peoples. However, there are some exceptions to this rule. The Swedes have a very high trust in people from other countries, but are themselves somewhat less trusted by other nations, although

⁶ We calculated means by applying the coefficient four, three, two and one respectively to the various answer codes; “no reply” answers have been excluded from the calculation. The mid point is then two-and-a-half. Below this level, the negative answers predominate and above, the positive ones.

their perceived trustworthiness is the highest of all countries. The same applies to the United Kingdom and Ireland. They trust other peoples more than other peoples trust them. For Portugal it is the other way round. Inhabitants of other countries relatively trust this country more, than the Portuguese trust foreign peoples.

Figure 2.2.4. Average trust in inhabitants of other countries, average trust by inhabitants of other countries, trust in compatriots



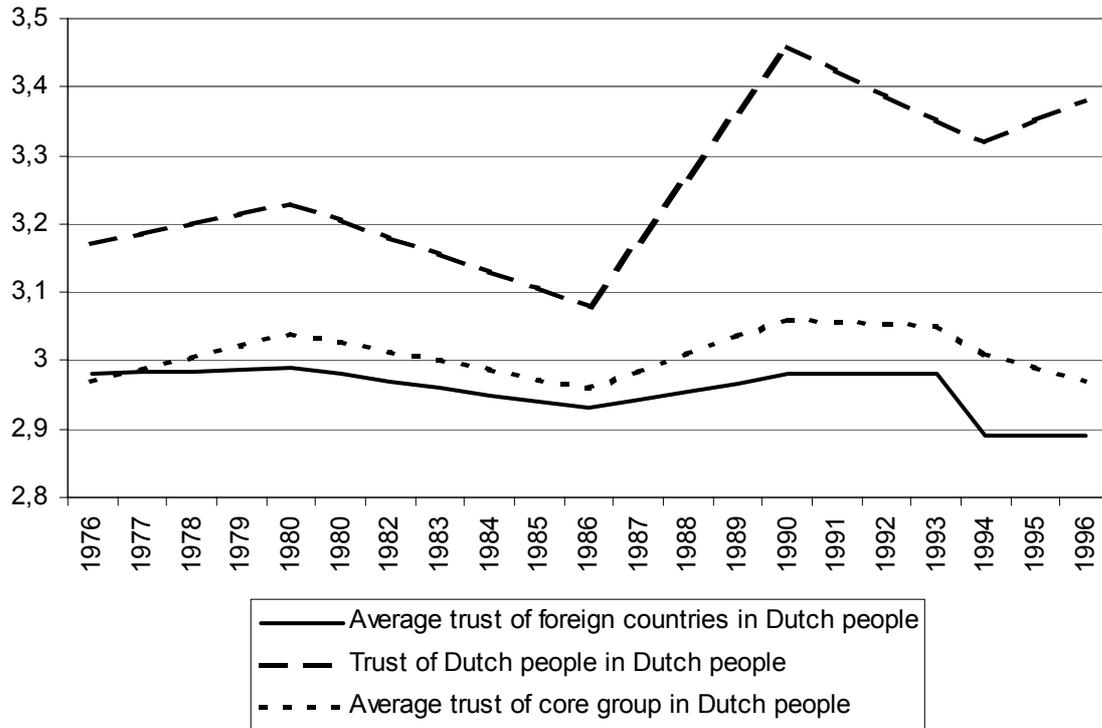
Source: EuroBarometer 46.0 1996.

A last way to look at these EuroBarometer survey results is by comparing the three types of trust measures we can distil from it: (i) average trust in inhabitants of other countries, (ii) average trust by inhabitants of other countries and (iii) trust in people from your own country, see Figure 2.2.4. This third measure is comparable to the WVS trust question. A general result is that people within a country trust each other more – to a considerable extent (23 percent) – than they trust the inhabitants of other countries and than they are trusted themselves by other countries. We conclude that, also on the scale of nations, within-group trust is much stronger than between-group trust. A shared (within-group) culture, history and language probably account for this. This finding forms the basis for one of the main arguments explaining the home bias of international trade (see chapter 6). High trust in compatriots lowers the transaction costs of trading with compatriots (relative to the costs of trading with foreigners) and thus enhances intra-national trade.

A second conclusion is that trust in compatriots is only weakly related to the levels of trust in foreign people and being trusted by foreign people. Apparently, the measures of trust in foreign countries and trust by foreign countries give other results than the measure of

generalised trust. They provide extra information on the tendency to trust and the perceived trustworthiness of people, and it is therefore remarkable that these indicators are not used more often in social capital research.

Figure 2.2.5. Development of average trust by foreign countries in Dutch citizens and trust of the Dutch in the Dutch, 1976-1996^a



^aThe ‘foreign countries’ are: 1976: France, Belgium, West Germany, Italy, Luxembourg, Denmark, Ireland, UK; 1980: 1976 sample plus Greece; 1986 and 1990: 1980 sample plus Spain and Portugal; 1993: 1986 sample plus Norway, with West Germany replaced by (united) Germany; 1994: 1993 sample without Norway; and 1996: 1994 sample plus Finland, Sweden and Austria. To calculate “average trust of foreign people in Dutch people, we took the unweighted average of foreign country averages of trust in the Dutch. The ‘core group’ consists of the seven countries that were present in all surveys: France, Belgium, Italy, Luxembourg, Denmark, Ireland and the United Kingdom.

Source: EB 06 (1976), EB 14 (1980), EB 25 (1986), EB 33 (1990), EB 39.0 (1993), EB 41.1 (1994), EB 46.0 (1996).

The above presented observations about the high trust of foreigners in Dutch citizens and the high trust of the Dutch in compatriots only apply to the year 1996. Based on a range of EuroBarometer Surveys, Figure 2.2.5 depicts the development of these variables over a 21-year period, from 1976 to 1996. Over this period, the trust of the Dutch in the Dutch has somewhat increased, while the trust of foreigners in the Dutch has slightly decreased. Part of this latter observation could be explained by changes in the group of foreign EU countries as a result of the expansion of the European Union with new member states, and the unification of West and East Germany in 1990. In order to correct for this, we added the variable ‘average trust of core group in Dutch people’. This core group consists of countries that were present in all surveys: France, Belgium, Italy, Luxembourg, Denmark, Ireland and the UK. The average trust of this core group remains more or less stable between 1976 and 1996. The fluctuations in the trust that the Dutch people have in their fellow compatriots are more substantial. The

pattern shows a decrease between 1980 and 1986, followed by a sharp increase from 1986 to 1990, continued by a minor decrease and finally stabilisation in the 1990s.

The same pattern, but less pronounced, can be seen in the development of trust by foreigners. Part of the explanation of this pattern probably lies in the similar development of economic growth in this period. Highs and lows in the economic tide correspond remarkably well to the ups and downs in trust. The economic upswing at the end of the 1970s was halted by the second oil crisis in 1979. The Dutch economy was in a recession in the beginning of the 1980s, but showed strong growth at the end of the 1980s. A small recession occurred in the beginning of the 1990s (partly as response to the outbreak of the first Gulf War), but after 1993 the economy took off again (see chapter 4). This could also explain the fact that the changes in trust by the Dutch are larger than the changes in trust by foreigners. The changes in Dutch economic growth directly influence the Dutch mood; optimism and trust probably go together. However, because the economic cycles are not exactly the same (in timing and severity) in different countries, the direct effects are averaged for a group of foreign countries, which results in a smoother development of trust.

2.2.4 Institutional trust: theory

The above described forms of trust are forms of horizontal trust, i.e. trust of people in other people. In this paragraph we focus the attention on vertical trust, i.e. trust of people in institutions. Institutions are here narrowly defined as all formal organisations, like the church, the police, the army, private companies, the press et cetera. Trust in institutions is a difficult kind of trust, in the sense that it is much easier to trust a person than an abstract, anonymous organisation. At the same time, and this is a paradox, institutions need to be trusted to be effective, especially when they are created to foster trust. For example, the food-inspection agencies increase the trust of the people in the safety of the food offered in restaurants and shops. Autonomous central banks foster the trust of the public in the stability of the financial system and the value of the currency. But these institutions can only fulfil their jobs if they themselves are considered to be trustworthy by the public. If the food-inspection agencies are trusted, people rely on that institution for the safety of their food. As a result, people will not check the safety of the food themselves anymore and the society economises on the transaction costs of inspecting the safety of food. Furthermore, if the producers and sellers of food also trust the food-inspection agencies in delivering a good job, they will not even try to produce or sell unsafe food. Therefore, the level of vertical trust or 'institutional trust' is a major indicator of the efficiency of a society. Although vertical trust does not neatly fit in most social capital definitions, it is commonly thought to be part of it, also because of the often found strong link between interpersonal, generalised trust and trust in institutions.

A special institution in this context is the government. Taken in a broad sense, the government includes the government in a narrow sense, the political parties, the civil service, the parliament and overarching governing structures as the European Union and the United Nations. Putnam (1993) argues that the striking differences between the efficiency of the government in North and South Italy are strongly related to the differences in interpersonal trust, institutional trust and political participation. His argument is that, in egalitarian, non-hierarchical societies, interpersonal trust is combined with civic virtues like reading the newspaper, discussing politics and voting during elections. This political participation leads to more responsive and efficient government policies, because the politicians know that their words and deeds are closely followed by the press and the public, and that the public will sanction them for eventual malpractices in the next elections. As a result, the public institutional trust in the politicians and the government rises. In the words of Sztompka (1998:

8): “Democracy breeds the culture of trust by institutionalizing distrust”. When the democracy functions well, virtuous circles emerge in which government efficiency and public trust in the government rise together. Vicious circles appear, when the public loses its trust in politicians and the government, and lowers its interest in politics. As a result, ‘bad’ politicians are less restrained by democratic control and may drive out ‘good’ politicians.

This lesson of trust is clearly understood in Dutch politics, in which government officials always try to find the support of the ‘societal midfield’ for new policies. Proposals in the field of social-economic affairs are, for example, discussed by the social partners and crown members in the Social Economic Council, often at the request of the government (see chapter 4). The advices of the Social Economic Council are taken into serious consideration by the government, because the effectiveness of the proposed legislation is known to be highly dependent on the co-operation by the societal midfield.

2.2.5 Institutional trust: empirical investigations

Table 2.2.1 shows the results of an EU-wide survey about trust in institutions in 1999. Average trust in institutions is remarkably high in the Netherlands compared with other European countries. Trust in all features of government (government, parliament, civil service and political parties) is the highest in the Netherlands. The Netherlands also have the highest trust in all forms of the news media that report about politics and other events (television, radio and written press). Strikingly, the Dutch social partners (trade unions and big companies), who are relatively closely attached to the Dutch government through their participation in the Social Economic Council, are also considered to be the most trustworthy of all European countries. Remarkable is the low trust of Belgians in their government, parliament, justice and political parties, which is even lower than the trust in Italy. This can be seen as the inheritance of the frequent scandals in Belgian politics and the failing of the justice system (think of the murder of the prominent politician Cools, the unsolved crimes of the ‘Bende van Nijvel’, corruption among politicians, the case Dutroux et cetera).

In his book on the decline of American social capital, Putnam (2000) proposes a measure of distrust, which is somewhat related to the issue of institutional trust. It is the number of lawyers in a country. Putnam regards the juridification of society as a sign of growing distrust between people. For the United States, he shows that the number of lawyers per 1000 employed civilian workers is stable for most of the 20th century at around 4. After 1970, a kink appears in the graph and the number of lawyers is rising to about 7.5 in the 1990s. The same trend can be seen for the Netherlands, when we look at the number of lawyers per 100,000 inhabitants, see Figure 2.2.6.

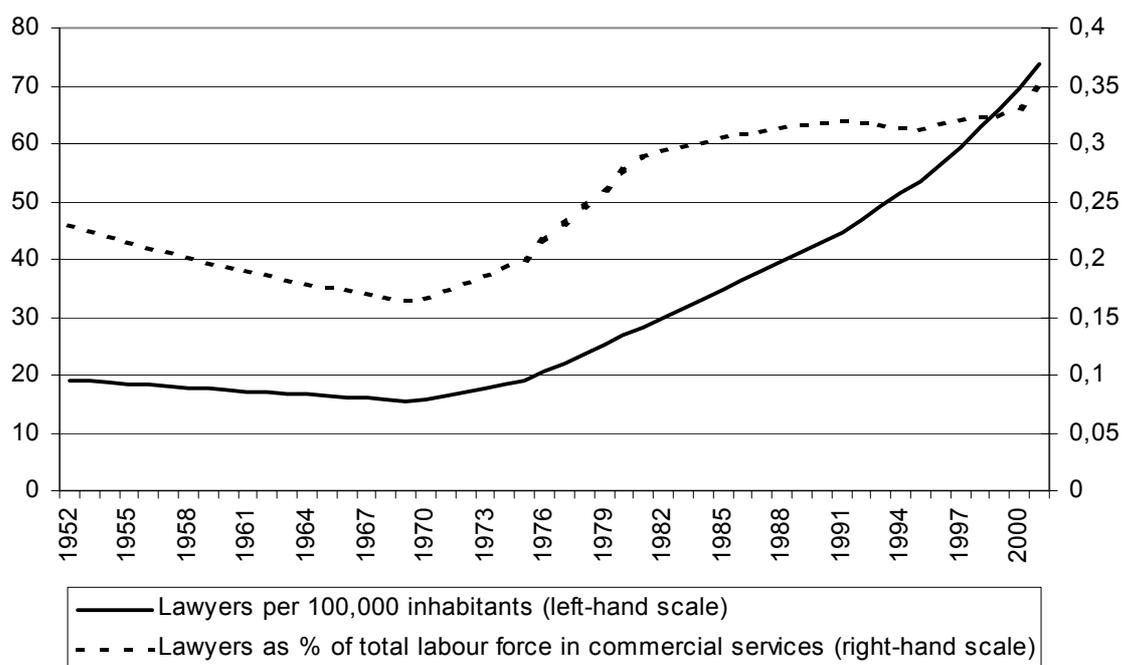
It is questionable however whether this is a good measure of distrust in a society. In the first place, the use of the legal system, of which the number of lawyers is a symptom, is not inherently detrimental to interpersonal trust (also see chapter 3). Contracting and legal protection also have beneficial effects on trust, because they lower the vulnerability of the trustor. In the second place, the number of jobs has increased in the total commercial services sector, not only those in legal services. The source of this development lies in the economic development of countries, the related increase in labour specialisation, and the resulting switch of labour from the primary and secondary sector to the tertiary service sector. The dotted line in Figure 2.2.6 corrects for this switch. We still see the rising trend, but it is less substantial. The ratio of lawyers to the total labour volume in commercial services increases over the period 1970-1980, but stabilises after 1980.

Table 2.2.1. Trust in institutions in seven European countries in 1999, in percentages^a

	Nl	Be	Ge	Fr	UK	Dk	It
Television	86	79	69	59	71	73	60
Radio	81	77	68	70	67	79	56
Press	75	65	50	63	26	58	46
Charities	74	51	53	67	69	64	62
The police	72	43	67	56	67	85	60
The army	71	45	65	58	78	75	59
The (national) government	66	25	47	39	41	42	31
The (national) parliament	65	28	49	41	41	56	33
The United Nations	64	47	45	50	55	70	57
Trade unions	62	39	37	36	41	51	30
Justice/ the (national) legal system	61	23	53	37	50	72	38
Civil service	60	40	46	46	50	52	29
Non-Governmental Organisations	58	40	39	46	35	33	44
Big companies	55	38	33	40	30	48	44
The church	48	32	45	38	58	70	58
The European Union	46	44	36	42	23	33	59
Political parties	42	18	20	12	18	28	17
Tend not to trust any institution	2	6	5	5	4	1	6
Average trust in institutions	64	43	48	47	48	58	46

^a “I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust or not to trust it?” Shown are the “tend to trust”-answers in percentages of total numbers of answers. Highest scores per category in **bold**.

Source: Dekker 2001: 14, Eurobarometer 51.0 1999.

Figure 2.2.6. Lawyers in the Netherlands, 1952-2002

Source: Vogels, Baukema, Donkers and Melchior 2002 and CBS, *Statistical Yearbook 1952-2003*.

2.3 Networks – the second element of social capital

Networks, i.e. the structures of social ties between people, are generally seen as the core of social capital. Nevertheless, this theoretical attention for the importance of networks stands in shrill contrast with the empirical attention this structural element of social capital receives. Most empirical studies immediately reach for the trust question to measure and explore social capital. We aim to do better. In the theoretical part of this section, we discuss the potential positive and negative external effects that arise from social networks. This theoretical discussion results in two questions. First, is it possible to distinguish between ‘Putnam’ and ‘Olson’ type of networks, and do they have different external effects on economic performance? Second, is the intensity of membership related to the extent of external effects? In the empirical part, we try to answer these questions. We first provide an overview of the empirical research on the macroeconomic relations between networks and economic performance. Thereafter, we investigate, mostly at the micro level, (i) trends in network participation and voluntary work in the Netherlands and other Western countries, (ii) the relation between network participation and political participation, and (iii) the relation between network participation and interpersonal trust.

2.3.1 Networks: theory

Positive externalities of networks – the Putnam view

With regard to networks, the works of Putnam are, again, highly influential. In his 1993 study on economic performance and governmental efficiency in the northern and southern regions of Italy, Putnam argues that social networks “instil in their members habits of cooperation, solidarity and public-spiritedness” (Putnam 1993: 89). In other words, social networks generate general reciprocity and mutual trust. Virtuous circles of rising trust and trustworthiness result. The norms of reciprocity and trustworthiness – that emerge between members of a network as a result of frequent face-to-face contact and working for a common goal – are reinforced by the social control and sanction mechanisms of the network. To behave in a trusting and trustworthy way is also for newcomers the optimal strategy when they enter a network (or region) with trusting and trustworthy members (or inhabitants), because their trust will be rewarded and untrustworthy behaviour will be punished. This path dependency also works the other way. When one enters a network (or region) in which the people are untrustworthy, it is better to be very careful (and not to be too trusting) to prevent being exploited.⁷

According to Putnam, all types of associations, voluntary organisations, and clubs in which people interact with each other create positive external benefits for society, because the norms of co-operation that are formed *in* the associations spill over to other parts of society *outside* the associations. So, bowling associations, birdwatch organisations, choirs and football clubs should have the same positive effects on the creation of social capital as for example professional associations, political parties and women’s right groups. The reason for the existence of the association or the goal of the social network is not important, only its structure is. Putnam distinguishes between horizontal networks and vertical networks. He argues that horizontal networks, in which the members are of equivalent status and power, have higher trust and civic norms generating capacities than vertical networks. Vertical networks are networks with a hierarchical power structure. In the latter type, people may feel

⁷ Slemrod and Katuscak (2002) provide empirical evidence for this argument. They find that the effect of trustworthiness on individual income is negative, unless one lives in a country where the level of generalised trust is high.

restrained in commenting on and correcting each other's behaviour, especially when the other appears to be one's superior. Further, the dissemination of information is lower in vertical than in horizontal networks, because there may be strategic, career involved reasons for individual members to keep some information private. For both reasons, hierarchical networks cope with obstacles for the creation and reinforcement of civic virtues, trust, and norms of reciprocity and fairness, because learning and control are impeded.

Learning and control are the two mechanisms through which networks generate behavioural rules for the members. "Learning indicates the extent to which a trustor can modify her expectations about characteristics of a trustee from observing his behavior in past transactions. Control indicates the extent to which the trustor can influence the trustee's behavior via sanctions anticipated by the trustee" (Buskens 1999: 11). These mechanisms of learning and control can also be recognised in the distinction between voice networks and exit networks (Hirschman 1970). Voice networks enable actors to learn about the trustworthiness of potential transaction partners by forming a channel of communication. Exit networks give opportunities for control by switching to other transaction partners. Voice and learning together may form a powerful reputation mechanism that prevents non-co-operative behaviour. A 'good' reputation, i.e. a reputation that one can be trusted, is valuable, because this facilitates new transactions, while a 'bad' reputation may make it difficult to have a prosperous social and business life.

Up to this far, we only looked at intra-network connections. Of course, there are also connections between networks. In this respect, Putnam (2000) and Woolcock and Narayan (2000) introduce the difference between bonding and bridging social capital. Bonding social capital refers to the density and homogeneity of the network. Bridging social capital relates to the 'bridges' or connections between heterogeneous people and networks. For example, a close family network involves a high level of bonding social capital, because this homogeneous group has a high within-group trust and is inward looking. From an individual perspective, one can say that bonding social capital is 'good for getting by'. However, the same network probably involves a low level of bridging social capital, because it is not outward looking and does not encompass people across diverse social cleavages. The bridging type of social capital is thought to be the most valuable for society, because it glues the different parts together. For individuals, bridging social capital is 'good for getting ahead'. It prevents the isolation of particular groups in society and makes resources available to a larger share of people.

Unfortunately, the size and external effects of bridging versus bonding social capital are hard to measure at the level of society. Nonetheless, this can be measured at the level of individuals. For example, Burt (1992) points to the importance of middlemen who fill the 'structural holes' between separate networks. These positions are very valuable, because the middlemen have access to the streams of information and resources of both networks, and thus play a strategic role in the inter-network communication. Moreover, it appears that strong network links – a term closely connected to bonding social capital – offer less valuable information about vacancies and job opportunities than 'weak ties' (Granovetter 1973, Lin, Ensel and Vaughn 1981). Weak links are the connections with people from outside your core network. These people are somewhat different from yourself, e.g. they live in another region, work in other organisations or have made more progress in their career. These differences enable them to provide you with (unexpected) information and opportunities that lay outside your direct working and living environment.

Another channel through which associational activities lead to better societal and economic performance considers political participation. The idea is that a higher associational activity

leads to higher political participation of citizens, which implies more democratic control of politicians, which results in better government policies, which finally leads to a higher economic performance. Sociologists and political scientists have been assuming a positive relationship between social and political participation for many years, dating back to Alexis de Tocqueville's (1835, 1840/1990) writings on the links between American democracy and high American membership rates of voluntary associations (Almond and Verba 1963, Van Deth 1997, Putnam 2000). According to these theories, citizen membership of any non-political organisation leads to a higher political competence and political participation of these citizens. Political participation is seen as a major contributor to the democratic environment of a society and government efficiency. Bad politicians would have a smaller chance to arrive and stay in positions with political power, when the citizens are more politically involved, i.e. when they read the newspapers and watch the television news to follow political developments, discuss politics with their friends, sign petitions, call their district representatives in parliament, attend demonstrations, become member of political parties, make use of their voting rights, et cetera.

Three types of individual effects are at the basis of this presumed relationship between social participation and political participation (Dekker and De Hart 2000). The first is that people who participate and do voluntary work in social networks meet other active people who may ask them to become politically active, to sign a petition, to help organising a demonstration, and so forth. Second, socially participating people come in contact with political information through their social activities. Political issues may be raised when playing the 19th hole or in the sermon of the preacher. This raises the knowledge of political issues and perhaps also the interest in them. Third and probably most important, socially active people learn civic skills that are also useful for political action. They develop organisational and communication skills, like how to write a professional letter or to hold a speech in public.

Negative externalities of networks – the Olson view

Up to here, we have only examined the beneficial effects of networks. They create norms of reciprocity and trust on the scale of society, they provide resources, such as job information, for individual members, and they foster political participation of citizens. However, some contrasting opinions exist about the above sketched favourable effects of social networks and associational activity. The main argument comes from Olson (1982). Although he strongly agrees that networks deliver benefits for the individual members of networks, he has serious doubts about the positive character of the external benefits for society, just because these networks provide benefits for individual members. In his *Rise and decline of nations* he sets up an extensive argument about the detrimental effects of associations for societal welfare. A first thought may be that his argument relates to all types of criminal and racist associations. These closed networks create strong within-group norms and trust, which enables the members to co-operate in order to achieve their illegal goals. Almost by definition, these networks turn out to have negative externalities on society. However, Olson's argument goes a lot further as he also suspects all types of legal organisations to impede societal welfare. In his view, associations must be seen as 'special interest groups'. Special interest groups try and promote their special interests by lobbying at the government to install new laws that protect their interests and that worsen the interests of their antagonists. This argument is a reflection of the well-known words of Adam Smith (1776): "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."

For example, the producers of strawberries have a common interest (protection of the interests of homeland producers of strawberries) and unite in an association of strawberry producers. This association lobbies for investment subsidies and tax breaks for strawberry producers, export subsidies for home made strawberries and import taxes for strawberries from abroad. All these measures imply a welfare rise for the members of the strawberry producers association, but a net loss for society. However, because the average benefits per strawberry producer are much higher than the average loss per citizen, the strawberry producers have a good reason to organise themselves and protect their interests, while free-rider problems block the action of the individual inhabitants of society.

This lack of ‘countervailing powers’ leads to the growth of ‘distributional coalitions’ such as labour unions, professional associations, trade associations and lobby groups that protect their special interests. As a consequence, they form an ever rising burden for societal economic performance. Because these organisations have clear incentives to survive and expand their influence, strong disruptions in a society, e.g. a war, may be necessary to get society (radically) freed of them. According to Olson (1982), this would explain the strong economic growth of countries after they have been defeated in a war, e.g. Germany and Japan after the Second World War. This claim is however hard to prove, since it is hardly distinguishable from other explanations for fast post-war economic growth. A simpler economic explanation would be to point to an ‘ordinary’ catch-up effect. Somewhat paradoxically, in the sense that Olson and Putnam have contrasting ideas about the externalities of associational activity, also Putnam offers an explanation for this phenomenon of fast post-war growth. Putnam (2000, 2002) argues that large traumatic events, such as a war or the 9/11 terrorist attack, create a bond between people. As a result, they feel united against an enemy and this increases the willingness to co-operate, for example by doing voluntary work, raises the level of trustworthiness, and enhances political participation, all leading to better societal and economic performance. The Putnam and Olson views on associational activities do not collide in this respect, because Olson does not say that social networks are inherently bad. They only become detrimental to societal performance, when they grow in number and power, as occurs in stable, peaceful societies.

In peaceful situations, Olson argues that only in two cases the welfare impeding activities of special interest groups might be halted. The first is when associations become too large, in the sense that the negative effects on national welfare start to hurt the association more than it benefits from the direct gains of their lobbying policies. For example, this occurs when the interests of nation-wide operating labour unions start to entangle with the general national economic situation. The special interest organisations then become ‘encompassing organisations’ whose dominant strategy is to behave in order to promote the common interest of the country, since they have become such a large part of it. The hump-shaped curve that depicts the relationship between the extent of centralisation of the wage bargaining structure and the macroeconomic performance in OECD countries forms an illustration of this idea (Calmfors 1993). The second case in which reforms can be enforced is when the inefficiencies of the system become too large and too well-known by the public. So, there are two ‘checks’ on the detrimental effects of associations, but it is unclear whether these checks are effective in curbing special interests.

How can we reconcile the ideas of Putnam and Olson? An idea is to make a distinction between Putnam type associations (the associations with presumed primarily positive externalities for society) and Olson type associations (the associations with presumed negative externalities for society) (see e.g. Knack and Keefer 1997, Knack 2003, Beugelsdijk 2003). Candidates for the Putnam type are the associations in the field of e.g. youth work,

sports and culture. These organisations do not seem to have their primary goal of existence in redistributive lobbying. At the other side of the spectrum, we have the Olson type of organisations: all associations that bring together producers, professionals, labourers and lobbyists. This approach is not without drawbacks. For example, Putnam (2000) points at the example of Silicon Valley, in which the dense clustering and linking of companies, workers, suppliers and customers lead to a continuous sharing of information, experiences and ideas that benefit the economic progress of the whole region, despite the fact that they seem to resemble the Olsonian type of networks. Bergsten (1985) and Knack (2003) add to this, that even lobby groups might have positive external effects in the way that they establish ethical codes and standards, and reduce transaction costs by circulating information. Olson (1982), in his turn, is even highly suspicious of sports and culture associations, because these informal interactions create bonds among the participants. In other contexts, these informal bonds prove helpful for the creation of collusive agreements between traders and for formally organised disruptive collective actions such as strikes.

Disappearing networks?

From the theoretical discussion above, we cannot extract a clear conclusion about whether Putnam or Olson is right. This is troublesome, because the answer determines whether we should worry or welcome a decline of social networks in society. Of course, Putnam regards a decline as highly problematic. He therefore sounds the alarm bell in his book *Bowling Alone*, when he ‘discovers’ a decline of social bonds and networks in the United States over the last quarter century. According to Putnam (2000), US citizens bowl alone instead of together, they do not picnic anymore with each other, membership rates of Elks clubs have diminished, voluntary work is at its lowest point since decades, voter turnout decreases, donations to charity fall, people do not feel responsible anymore for the public good, they read fewer newspapers, and so forth and so on. The virtuous circle of rising civic involvement and mutual trust might stand at the brink of collapsing to the reverse, in which trust, political interest and moral values dwindle. A major cause of this development might be that the societal midfield, i.e. the family, school, neighbourhood, church and civic organisations, is disappearing as a result of the rise and professionalisation of the welfare state (Vinken and Ester 2003). Other culprits are the widespread dissemination of electronic entertainment (passive television and computer game entertainment instead of actively doing things together), pressures of time and money (husband and wife are both working), suburbanisation and commuting, and generational change (Putnam 2000).

This last argument forms Putnam’s main explanation. He argues that the decline in civic virtues, civic engagement and associational activity is closely related to the year of birth of people. Older generations, especially those born for the Second World War, appear to have much more social capital than the younger generations. “It is as though the post-war generations were exposed to some anticivic X-ray that permanently and increasingly rendered them less likely to connect with the community” (Putnam 2000: 255).

This generational argument has been attacked on many fronts (see Vinken and Ester 2003 for an overview). The most remarkable attack comes from a group of authors who sees the young generation as the solution to civic engagement problems instead as the problem itself. In their view, the new generation is strongly civic-minded, optimistic and energetic. This constitutes the same generational argument, but in reverse. Both streams make a strong case of showing the malevolent or benevolent common characteristics of certain generations, but do not give an answer to the question why generations are different from each other (McLean 2002).

A second attack comes from authors who point to the ‘darker side’ of the ‘civic champions’ of the past (Vinken and Ester 2003). It may be true that the old generations were more involved community members, but they also favoured rigid value systems of right and wrong, traditional gender roles, authoritarian power balances, and intolerance against other religions, ideologies and races. This is a reflection of the general problem of the two sides of the network coin. A dense and closed network breeds a lot of within-group trust and is capable of enforcing high moral values and norms among its members, but by definition these benefits can only be guaranteed with distrust of strangers and new ideas.

The third point of criticism is that the systems of civic involvement have changed. “Classic indicators of civic involvement may very well have less significance to younger generations that are likely to express alternative forms of engagement that are both more meaningful and more functional to them” (Vinken and Ester 2003: 5). This argument can easily be reconciled with the first one. Younger generations might be as much (or more) participating in civic and political activities as older generations, but in other than traditional ways, which are neglected by Putnam (also see Schudson 1996, and Skocpol 1999). For example, they are not member of a bowling association, but spend more time with colleagues on their work and chat with people in Internet chat rooms. And instead of participating in demonstrations, they might send emails to politicians or support the work of environmental organisations in a financial way.

Even if the last argument is true, there is no reason for relief, because this development can be seen as a shift between different types of organisations with different effects on social capital. Primary organisations consider the very intense family relationships. Secondary organisations are the so-called ‘face-to-face’ organisations, because membership of these organisations implies joint actions and many personal contacts, for example in church and sport activities. Finally, there are the tertiary organisations which are called ‘paper-and-pencil’, ‘check-and-mail’ or ‘mailing-list’ organisations. For example, most of the members of environmental organisations like Greenpeace do not meet their fellow members once a week to discuss environmental issues, but just donate a particular sum of money once a year, and receive a magazine in return. All three types imply ‘involvement’ and create network externalities, but to a different extent. Because repeated personal interaction is the necessary ingredient for the creation of norms of reciprocity and trust, membership of tertiary organisations has less beneficial effects for the emergence of mutual trust and civic norms than secondary (and primary) organisations. If the rise in membership rates only accrues to tertiary organisations, while the secondary organisations lose members, the net effect for society of this switch between organisations on the creation of norms and trust might be negative.

We conclude that the theoretical overview has raised several unanswered questions about networks. The most important are: (i) do networks have positive or negative external effects and does this depend on the type of network (Putnam versus Olson) and/or on the intensity of membership?; (ii) does the decline in networks also occur in the Netherlands and/or is this mainly a switch between different types of organisations? We examine these questions in the next empirical subsection, starting with the last question.

2.3.2 Networks: empirical investigations of network trends

Given the depressing picture sketched by Putnam for the United States, what do the data tell us about civic involvement in Europe and the Netherlands? We start with the broad picture for the Netherlands. Table 2.3.1 shows the trend in membership rates of large voluntary organisations in the Netherlands over the period 1980-2000. The general trend is upward, although some organisations lost a substantial number of members and supporters during this

period, especially the political parties, women rights groups and religious associations. Consumers associations and organisations in the field of health, international solidarity and environment and nature experienced a very strong growth in membership rates. At a population of about 16 million people, the total amount of members rose with about 30 percent from 27 to 35 million. Even when one controls for the increase in population of age above 15 years with 18 percent over this period, this still means a rise of about 16 percent in total memberships (WRR 2003b). We note however, that there seems to be a switch between secondary and tertiary organisations.

The amount of money these organisations collected through fundraising rose spectacularly, from 535 million euro in 1991 to 1,729 million euro in 2001, a rise from 0.20 to 0.44 percent of GDP in ten years (Dekker, De Hart and De Beer 2004). The trend is upward, but this might be seen again as an indication of the trend from face-to-face to check-and-mail associational activity.

This pessimistic interpretation is contradicted by the recordings of voluntary work in the Netherlands. The definition of voluntary work among policymakers and researchers in the Netherlands is the “non-compulsory and unpaid work that is performed in some form of organised context for the benefits of others or of society” (Dekker 2000: 5). Data from several sources over the period 1975 – 2000 show no pattern of a decrease in voluntary work in percentage of population aged 18 and over, nor in time spent per week per volunteer (Dekker 2000, WRR 2003b), see Table 2.3.2.

Table 2.3.1. Members and supporters (x 100,000) of voluntary organisations in the Netherlands with at least 50,000 members or supporters, 1980 and 2000

	1980	2000	Change (%)
Political parties	3	2	– 33
Women	3	2	– 33
Churches and religion	95	80	– 16
Employees	36	34	– 6
Sport and leisure	15	18	+ 20
Broadcasting	41	47	+ 15
Employers and self-employed	2	3	+ 50
Elderly	4	5	+ 25
Consumers	32	48	+ 50
Health	16	36	+ 125
International solidarity	19	44	+ 132
Environment and nature	4	30	+ 650
Abortion and euthanasia	0	2	+ .
Total	270	352	+ 30

Source: WRR 2003b, table 3.10.

Table 2.3.2. Participation in voluntary work: numbers of volunteers and time spent by volunteers, Dutch population aged 18 and over, 1975 - 2000

	1975	1980	1985	1990	1995	2000
Volunteers according to questionnaire (%)	.	45	42	41	46	45
Volunteers according to diary (%)	28	33	32	29	32	26
Time spent by volunteers (hours per week)	4,6	4,3	4,8	5,2	4,9	4,7

Source: Dekker 2000, table 2; WRR 2003b, table 3.9.

The participation in voluntary work in the Netherlands is relatively high when seen in an international perspective. About 50 percent of the Dutch answer 'yes' to the European Values Study question whether they participate in voluntary work. This is only slightly less than the score in Sweden (56 percent), but considerably larger than participation in Great Britain (43 percent), Denmark (37 percent), Belgium (36 percent) and Germany (a meagre 21 percent) (WRR 2003b: 83).

An international comparison of membership rates is provided in Table 2.3.3. The Netherlands appear to have the highest membership rates in 9 out of 16 types of voluntary organisations, varying from religious and cultural organisations to environmental and sports associations. Furthermore, the average membership rate is far above average membership rates in other European countries. We conclude that civic involvement in the Netherlands is remarkably high in an international perspective.

Table 2.3.3. Proportion of population that say to belong to a voluntary organisation, for seven European countries, 1999, in percentages^a

Voluntary organisation	Nl	Dk	Be	GB	Ge	It	Fr
Social welfare services for elderly, handicapped or deprived people	22	6	12	18	4	7	6
Religious and church organisations	35	12	12	10	14	11	4
Education, arts and music and cultural activities	46	16	19	10	8	10	8
Trade unions	23	54	16	8	7	6	4
Political parties or groups	9	7	7	2	3	4	2
Local community action on issues like poverty, employment, housing, racial equality	7	6	5	4	1	3	2
Third world development or human rights	25	4	10	6	1	3	2
Conservation, the environment, ecology, animal rights	44	13	11	9	3	4	2
Professional associations	19	11	9	8	5	7	3
Youth work (e.g., scouts, guides, youth clubs et cetera)	7	7	8	18	2	5	2
Sports or recreation	50	33	24	6	31	12	17
Women's groups	4	2	9	3	4	1	0
Peace movement	3	1	2	4	0	2	1
Voluntary organisations concerned with health	10	4	6	12	3	5	3
Other groups	10	14	12	.	4	3	8
Average	21	13	11	8	6	6	4

^a "Please look carefully at the following list of voluntary organizations and activities and say: a) which, if any, do you belong to?; and b) which, if any, are you currently doing unpaid voluntary work for?" Percentages of yes to a) and or b). Nl = Netherlands, Dk = Denmark, Be = Belgium, GB = Great Britain, Ge = West Germany, It = Italy, Fr = France. Highest scores in **bold**.

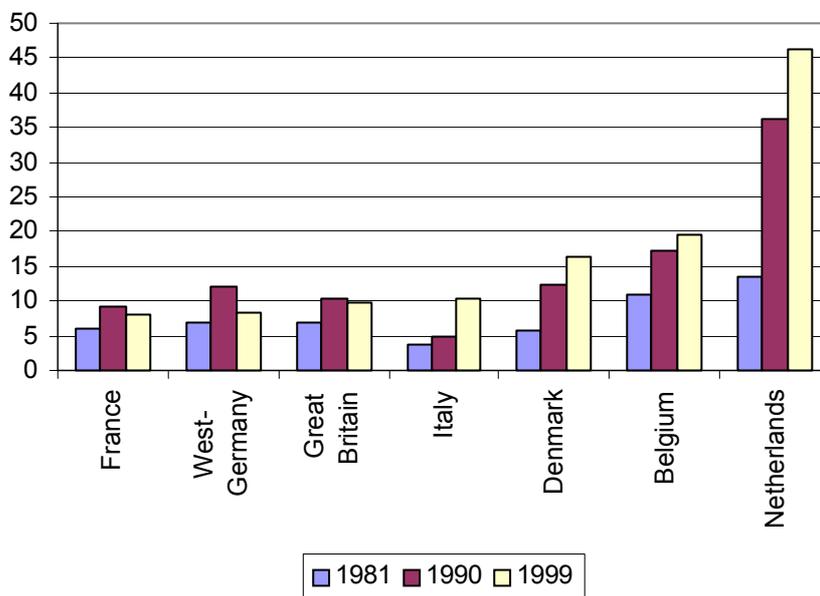
Source: Dekker, Ester and Vinken 2003, table A8.1.

Table 2.3.3 presents a general overview of international associational activity, which might be subject to several types of measurement problems. A 'clean' measure of membership of voluntary associations is provided by Dekker, Ester and Vinken (2003). They correct the dataset for three problems. First, they argue that membership has to be voluntary. If membership is not voluntary, it is not a good approximation of civic involvement but a consequence of the institutional and cultural design of a society. To give this voluntary aspect a chance, people must be offered the possibility to choose. Therefore, monopolistic institutions like state churches are not considered to be associations of voluntary civic engagement. The second problem they account for is, that the terms membership or 'belonging to' (the phrase used in the European Values Study questionnaire) can mean different things. If you belong to an environmental organisation, does that mean that you

donate ten euros a year to Greenpeace (passive check-and-mail membership) or that you come together biweekly with a group of people to form action plans to save the *Cricetus cricetus* (common hamster)⁸ from extinction (active face-to-face membership)? In order to address this problem, they exclude the organisations that are suspected to be of the tertiary kind. A third problem is that political self-interest may interfere with pure civic involvement: the Olson argument. So, they exclude Olson type of organisations. Taking care of these three problems results in a measure of civic involvement that comes closest to the ideal of Putnamesque civic involvement: membership of voluntary organisations that involve a lot of face-to-face interaction, but that lack direct political goals. It is ‘leisure participation’: belonging to and/or volunteering for education, arts and music and cultural activities, and/or sports and recreation. Note that this measure almost similar to the classification of Putnam groups by Knack and Keefer (1997) and Knack (2003). We present the main results of civic involvement measured by leisure participation in two figures.

Figure 2.3.1 shows the proportions of leisure participation in seven countries for three waves of the European Values Study. These countries are Belgium, Denmark, France, Great Britain, Italy, the Netherlands and West-Germany. Two things come to the fore. First, there is no general decline in civic involvement among the chosen seven European countries. One could even say that the general trend is upward. Second, the amount of civic involvement in leisure activities in the Netherlands is relatively high, which is a result of the extraordinarily high membership rates of Dutch cultural and sports associations.

Figure 2.3.1. Leisure participation in seven countries, 1981-1999

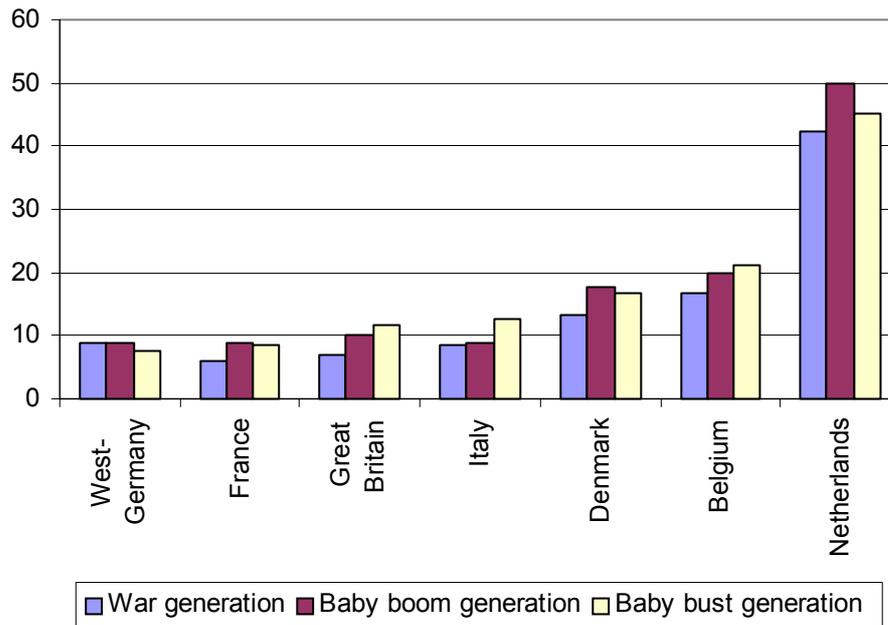


Source: Dekker, Ester and Vinken 2003, table 8.4.

⁸ This animal – in Dutch: ‘korenwolf’ – received national attention in the Netherlands, when the small environmental organisation ‘Das en Boom’ managed to delay and almost prevented the construction of large infrastructural works, because these works would threaten the hamster’s wildlife existence on Dutch soil.

Figure 2.3.2 shows leisure participation in the same seven European countries in 1999 differentiated for three generations: the War Generation – born before the start of the Second World War; the Baby Boom generation – born during or right after the Second World War; and the Baby Bust generation – born after 1959. The anti-civic X-ray that tormented the American Baby Boom and Baby Bust generations apparently did not cross the Atlantic. There is no sign of less civic involvement of the younger generations in the European countries, except for West-Germany.

Figure 2.3.2. Leisure participation in seven countries for 3 generations, 1999^a



^a War generation born before 1940; baby boom generation born 1940-1959; baby bust generation born after 1959.

Source: Dekker, Ester and Vinken 2003, table 8.4.

As a last form of associational activity, we look at political participation. As mentioned in the theoretical part of this section, the common thought is that there exists a general positive relationship between social participation and political participation. However, a deviation from this general pattern seems to develop in the United States (see Dekker 2000: 2-3). A new generation wants to do volunteer work, but does not want to get involved with politics. Local civic life is no longer automatically complementary to political participation in the US, but starts to form a substitute for politics or even a refuge from politics. This anti-political or politics-neglecting movement may form a danger for the functioning of the democratic system. Do we discern signs that the same trend occurs in the Netherlands? As a matter of fact, it cannot be denied that several indicators of active political participation, such as membership of political parties, attending meetings of political parties, and voter turnout at elections, have all decreased over the period 1975 – 1998 (Dekker 2000). Over the same period however, other indicators of political participation show the opposite trend. The percentage of people that claim to be interested in politics, to read about politics in the newspaper regularly, to have signed a petition, to have joined in an action group, or to have attended a demonstration has been stable or rising. This means that we notice some shifts in forms of political participation, but not a general trend of increased indifference in politics.

This shift from forms of ‘political support’ to ‘political protest’ can even be interpreted as an indication that people have become more critical of political parties and their functioning.

The assumed Putnam relationship between associational activity and political involvement at the individual level is examined by Dekker, Ester and Vinken (2003). Although they find positive statistical effects between their measure of civic involvement – leisure participation – on the one hand and political participation at the other hand, these effects are small. The level of education appears to be a better predictor of political action.

However, a general problem with this kind of statistical analyses is that they are designed for finding one-way relationships, while in reality two opposing mechanisms may occur (Dekker 2000). An example is the above mentioned ‘new’ trend in the American society that people want to do civic volunteer work for the benefit of community, but – or even because – they do not want to get involved in politics, while volunteer work is a stepping stone to political involvement for a lot of other people. These opposing relationships may cancel each other out in statistical tests, while they are very substantial phenomena in themselves. Thus, we have to be very careful in interpreting the empirical results from this type of research. A small result could be a small net result of two large opposing effects.

2.3.3 Networks: empirical investigations of Putnam and Olson effects

An overview of macroeconomic research

The contrasting ideas of Putnam and Olson have been tested in several cross-country empirical research projects. Choi (1983) finds that older, more stable nations, i.e. nations which had the chance to accumulate more special interest groups, show slower economic growth over the 1950-1973 period. Heckelman (2000) finds a negative correlation between the prevalence of interest groups and economic growth in countries over the 1970-1980 period. Knack and Keefer (1997) find no connection between associational activity and income per capita growth, nor between group memberships on the one hand and trust and civic norms on the other hand over the 1980-1992 period for 29 countries. A small negative effect is found between group memberships and investment’s share of GDP. In contrast with this research, Beugelsdijk and Van Schaik (2003) provide evidence that (active) group membership contributes to economic growth in Europe on the regional level.

Knack and Keefer suggest that the trust enhancing network effects of membership of associations and their positive effects on economic performance are countered by the economic productivity hampering effect of rent-seeking and lobbying organisations. In order to test this, they divide the WVS data on group memberships in two groups: memberships of the supposed harmful Olson groups and memberships of the supposed beneficial Putnam groups. They classify the (i) professional associations, (ii) trade unions, and (iii) political parties or groups as Olson groups. The Putnam groups are groups in the field of (i) educations, arts, music or cultural activities, (ii) local community action on issues like poverty, employment, housing, racial equality, (iii) youth work, e.g. scouts, guides, youth clubs, et cetera, and (iv) sports or recreation associations. For a dataset of 29 countries, they find the surprising result that the Olson type groups seem to have no effects on economic performance, but that the Putnam type groups have a small negative (sic) effect on investments. The study of Knack (2003) is an elaboration of this study, extended to economic growth over the 1980-1999 period and with more careful treatment of measurement errors and robustness issues. His results offer some support for the Putnam relationship between group membership and generalised trust, and meagre support for the Olson relationship between associational activity and economic performance. Again, membership of Putnam groups seems to have a larger negative effect on investment levels than Olson groups. In a similar

way, Beugelsdijk and Van Schaik (2003) test the effects of Putnam and Olson groups for 54 European regions. Only the Olson groups seem to have a positive (sic) effect on economic growth, but this result is not statistically significant when country-specific effects are included.

We conclude that the macroeconomic evidence on the relation between associational activity and economic growth is ambiguous. Most research indicates a negative or neutral relationship between organisational density and economic performance, with the exception of Beugelsdijk and Van Schaik (2003) who find a clear positive association. However, we have to be careful in interpreting their results, since their research on European regions might be plagued by data problems. They indicate themselves a 'lack of proper regional economic data' and their data on associational activity do, in large, not predate the economic data. Further we conclude that also the distinction between Putnam and Olson groups does not offer convincing results, but that there are some indications that Putnam groups are less related to positive economic performance than Olson groups. Although these empirical results raise doubts about a direct relationship between network activity and societal performance, this does not exclude the possibility of an indirect influence. For example, network activity might generate higher political participation or higher mutual trust. We investigate these possible relationships below with use of micro data.

Microeconomic relations between networks and trust

For an indication of how associational activity influences trusting behaviour, we depict the general relationships between the two in Table 2.3.4. For eight different types of voluntary organisations and one 'other' category, the proportions of the population answering "tend to trust" to the trust question are related to their state of membership: active, passive or no membership. Active membership implies doing unpaid voluntary work for the organisation, passive membership does not. The results come from the World Values Surveys and we combine the waves of 1981 and 1990 to obtain enough observations in each category. Especially the number of people that are an active member of a political party or a church is particularly low in some countries. The general picture can be seen in the column 'ten countries'. The average results for these ten Western countries form the benchmark for the analysis. As we see, this benchmark is in line with the Putnam thought. There is a positive relationship between membership and trust: members of associations always have a higher tendency to trust than non-members. Moreover, active members are more trusting than passive members, except in the case of political parties, environmental organisations and professional organisations. Do we see a glimpse of an Olsonian mechanism here? All three types of organisations can be considered to be special interest organisations, which may act as distributional coalitions and be a burden for society. If these organisations indeed function as distributional coalitions, the people who are active member of these organisations are probably aware of their 'dismal' influence on society. Apparently, they have accepted their role in this system (otherwise they would have quit) and see this 'dismal' behaviour confirmed by the people surrounding them in their own and similar organisations. This may lead to a lower perception of the moral behaviour and trustworthiness of other people, implying a lower tendency to trust. Active membership in these types of organisations thus leads to the negative externality of lower generalised trust.

This Olsonian mechanism seems to be even stronger in the Netherlands. In the Netherlands, the tendency to trust is lower for active members than passive members in six out of nine organisations, while its tendency to trust is even lower than that of non members with regard to political parties, professional associations and charitable organisations. The

perverse effects of active membership on trust outweigh the positive effects in these cases. This phenomenon only seems to exist in the Netherlands. This is a remarkable finding that raises serious doubts about what is happening in Dutch political parties, professional associations and charitable organisations. Do these organisations attract people with a misanthropic view of life or is there something inherently ‘bad’ in doing unpaid voluntary work for these organisations that results in the decay of people’s tendency to trust?

These simple frequency findings are intriguing enough to test them with use of the more advanced multinomial logit regression technique. This allows us to control for gender, age and education. The relationship we are mostly interested in is the relationship between trust and membership of organisations. The results are stated as odds ratios, see Table 2.3.5. A ratio higher than 1 indicates that the chance that the event occurs (“tend to trust” instead of “can’t be too careful”) is positive in comparison with the benchmark or base situation. Ratios smaller than 1 indicate negative relationships.

Table 2.3.4. Proportion of people answering “tend to trust” to the trust question, sorted by associational activity, for the Netherlands, West Germany, Belgium and a group of ten countries, 1981 and 1990 combined, in percentages^a

Type of association	Membership	Netherlands	W Germany	Belgium	10 countries
Church or religious organisation	Active	64.0	49.5	47.5	51.1
	Passive	48.1	34.8	44.1	45.4
	Don't belong	47.3	34.6	30.5	36.4
Sport or recreation organisation	Active	52.3	39.2	43.3	50.7
	Passive	62.7	40.7	42.7	49.7
	Don't belong	48.5	36.7	31.2	37.3
Art, music or educational organisation	Active	61.0	40.0	46.8	53.7
	Passive	60.6	46.3	43.9	53.7
	Don't belong	45.1	35.0	30.1	36.8
Labour union	Active	48.0	46.9	43.3	49.9
	Passive	54.5	32.6	34.5	45.6
	Don't belong	47.8	36.0	31.7	37.4
Political party	Active	45.7	48.4	51.9	52.4
	Passive	62.6	37.2	37.1	52.7
	Don't belong	47.9	35.2	31.8	37.7
Environmental organisation	Active	48.6	52.8	48.2	50.5
	Passive	63.4	45.2	51.3	59.6
	Don't belong	46.1	35.2	31.2	37.6
Professional association	Active	42.4	52.8	39.4	52.3
	Passive	63.3	41.4	43.0	52.9
	Don't belong	47.7	34.9	31.7	37.4
Charitable organisations	Active	47.4	36.7	44.7	48.4
	Passive	51.2	37.4	30.8	43.7
	Don't belong	48.8	35.6	31.6	37.8
Any other voluntary organisation	Active	62.8	49.2	42.9	52.3
	Passive	62.1	40.0	32.4	48.2
	Don't belong	52.3	37.0	33.3	39.0

^a The group of “10 countries” consists of: the Netherlands, West Germany, Belgium, France, Great Britain, Denmark, Italy, United States, Spain and Ireland.

Source: World Values Survey 1981 and 1990.

Although, this is not the topic of our research, we report three general results with regard to the control variables. First, gender does not matter. Second, the relationship between trust and age has an inverted U-shape: trust rises with age, but declines when the age becomes higher than 54. This result is also found with regard to organisation membership by Putnam (2000) and Glaeser, Laibson and Sacerdote (2002). A possible explanation is that young people have an incentive to invest in the accumulation of (personal) social capital, but that the returns of social capital decrease at the end of people's life and career. Thus, investments are less beneficial after a certain age, will decrease as a result, and finally lead to a decrease in the level of social capital, when the new investments no longer offset the depreciation of social capital. If trust is related to network participation, the same inverted U-shaped profile over the life cycle can be found for trust. Third, trust rises with education. This result is also found by Alesina and La Ferrara (2002). We can relate this to the study of Glaeser, Laibson and Sacerdote (2002) who find a uniformly positive relationship between education and organisation membership. Human capital and (personal) social capital are often complements, so people who invest in human capital often also invest in social capital. Then the same argument applies; if trust is related to network participation, and if network participation is related to education, then trust is related to education.

As mentioned, we are especially interested in the relationship between trust and membership. For church or religious organisations, we see that the chance that a person tends to trust is higher when he is an active or passive member than when he is not a member. For the Netherlands we even notice that this chance is higher for active than passive members.

Table 2.3.5. Determinants of trust: odds ratios^a

		10 countries Netherlands	
Gender	Male	1.0	1.0
	Female	<i>Base: 1</i>	<i>Base: 1</i>
Age	18-24	0.9*	0.9
	25-34	0.9*	1.0
	35-44	1.1*	1.1*
	45-54	1.1*	1.2*
	55-65	1.0	1.0
	65+	<i>Base: 1</i>	<i>Base: 1</i>
Age finished at school	12	0.7*	0.7*
	13	0.8*	0.8*
	14	0.8*	0.8*
	15	0.9	0.9
	16	1.1	1.1
	17	1.3*	1.2*
	18	1.2*	1.2*
	19	1.3*	1.3*
	20	1.4*	1.4*
	21	2.0*	2.0*
	Don't know	<i>Base: 1</i>	<i>Base: 1</i>
Membership of church or religious organisation	Active	1.4*	1.7*
	Passive	1.4*	1.4*
	Not member	<i>Base: 1</i>	<i>Base: 1</i>

^a Multinomial logit regression. Dependent variable: "tend to trust strangers" instead of "cannot be too careful". Significant odds ratios ($p < 0.10$) are flagged with *.

Source: World Values Survey 1981 and 1990.

Table 2.3.6 sums the results of a further exploration of the relationship between social trust and membership of voluntary organisations in the Netherlands. The results differ somewhat from those found with the frequency tables of Table 2.3.4. We now find that passive membership is related to more trust than active membership for six types of organisations, and that non-membership leads to more trust than active membership in three cases, but some of the first and all of the latter relationships are not statistically significant. In the case of labour unions, political parties, environmental organisations, and professional associations, passive membership is related to more trust than active membership. This corroborates our ideas about the Olsonian perverse effects of active membership in Olson types of voluntary organisations.

Table 2.3.6. Active, passive and non membership as determinants of trust in the Netherlands: odds ratios^a

Type of association	Active membership	Passive membership
Church or religious organisation	1.7*	1.4*
Sport or recreation organisation	0.9	1.4
Art, music or educational organisation	1.6*	1.5*
Labour union	1.0	1.3*
Political party	0.9	1.8*
Environmental organisation	1.0	1.7*
Professional association	0.8	1.5*
Charitable organisation	1.1	1.2
Any other voluntary organisation	1.4	1.4

^a Multinomial logit regression. Dependent variable: “tend to trust”. Benchmark is “no membership”. Significant odds ratios ($p < 0.10$) are flagged with *. Controls for gender, age and education not reported. Source: World Values Survey, wave 1981 and 1990.

However, we also note that for some types of associations, the assumed positive Putnam relationship between associational activity and mutual trust holds. Especially active and passive members of church and religious organisations and art, music and educational organisations have a far higher tendency to trust than non-members. Also Dekker, Ester and Vinken (2003) find a small positive statistically significant effect between their ‘clean’ measure of civic involvement (leisure participation) and trust. We conclude that both Putnam and Olson effects on trust may appear from membership of organisations, depending on the type of the organisation. For the Netherlands, especially religious and cultural organisations seem to enhance trust, while the active involvement in labour unions, political parties, professional associations, and environmental organisations is associated with lower trust. These contrasting effects may explain the fact that there is no relation found between associational activity and economic performance in macroeconomic research.

A second conclusion that we draw from our empirical research is somewhat besides the main argument of this section, but interesting in itself. Although we did not find unequivocal and statistically significant relations between trust and associational activity for all types of associations, we did so for education. Trust appears to be strongly related to the level of education. With use of another dataset, Dekker, Ester and Vinken (2003) reach the same conclusion. Our findings support their claim that “policymakers who care about the loss of social trust and political involvement may better keep focused on their tiresome efforts to improve educational changes than simply join the call for community and the revival of associational life” (Dekker, Ester and Vinken 2003: 244).

2.4 Norms – the third element of social capital

2.4.1 Norms: theory

The third part of Putnam's definition of social capital, after trust and networks, considers norms. A norm is "a prescribed guide for conduct or action which is generally complied with by the members of a society" (Ullmann-Margalit 1977: 13). Norms are the concrete elaborations of the group's values, which are the abstract, ethical principles that lie at the roots of cultures. Putnam gives special attention to norms of generalised reciprocity. These norms refer to "a continuing relationship of exchange that is at any given time unrequited or imbalanced, but that involves mutual expectations that a benefit granted now should be repaid in the future" (Putnam 1993: 172). In other words, "I'll do this for you, without expecting anything immediately in return and perhaps without even knowing you, confident that down the road you or someone else will return the favour" (Putnam 2000: 134). Besides these norms of generalised reciprocity, Putnam (1993) also considers a broader range of norms that consist of civic virtues and norms of civic co-operation.

These norms of civic co-operation and generalised reciprocity are inherently 'good' in the sense that they exhibit positive externalities. They tell you to be honest, to be fair, to be trustworthy, to care for the weak, to read about politics in the newspaper, to use your voting right, to help people in need, to obey the law, to bring the wallet you found to its rightful owner, not to steal, not to harm other people, and so forth and so on. Since these norms have positive externalities, there cannot be too much of them and they cannot be too much obeyed. Their beneficial effects can be analysed in the game theoretic framework of the prisoners' dilemma, see Figure 2.4.1. The societal optimum would be reached if both agents A and B would behave in line with the norms of civic co-operation, i.e. to produce instead of to steal. However, the individual rational behaviour for both would be to discard the norms, i.e. to steal, with the result that this small society ends up in the Pareto suboptimal Nash equilibrium in which both agents steal.

Figure 2.4.1. Prisoners' dilemma

		Behaviour B	
		<i>Produce</i>	<i>Steal</i>
Behaviour A	<i>Produce</i>	2, 2	0, 3
	<i>Steal</i>	3, 0	1, 1

It is not necessary however that norms are 'inherently good' to be beneficial for society. Another type of norms also helps to lower transaction costs in society. These are the 'pure' co-ordination norms. For example, there lies no ethical or economical principle behind the norm to drive on the right or left side of the road in a country, but the efficiency and safety of transportation are well served by obedience to a common norm that settles this issue. The same applies for the specific language that is spoken in a country. From an economic point of view, we cannot say whether it is more efficient to speak Dutch, French, German, Greek, Italian, Spanish, Portuguese, Danish, Finnish, Swedish or English. However, there are strong indications that transactions costs (e.g. with regard to translation and misinterpretation) can be lowered by co-ordinating on speaking just one language in a specific, for example European,

region. So, the capacity of ‘co-ordination norms’ for creating positive external effects is independent of their specific contents, but hinges completely on the proportion of people that comply with them. In game theoretic terms, there is a social co-ordination problem with multiple optimal solutions. Each optimal solution has in common that all players choose the same strategy, see Figure 2.4.2. Social norms act as the guidelines that co-ordinate people’s behaviour in reaching these optimal solutions.

Figure 2.4.2. Pure co-ordination problem

		Behaviour B	
		<i>Dutch</i>	<i>English</i>
Behaviour A	<i>Dutch</i>	2, 2	0, 0
	<i>English</i>	0, 0	2, 2

So, norms function as a mechanism that co-ordinates the behaviour of people and that prevents them from getting stuck in the suboptimal Nash equilibrium of the prisoners’ dilemma (Den Butter and Mosch 2003c). Putting this in a broader perspective, we can see social informal norms as one of four types of incentives that influence people’s behaviour, see Figure 2.4.3 (De Beer and Mosch 2004).

Figure 2.4.3. Four types of incentives that influence people’s behaviour

		Character of incentives	
		<i>Material</i>	<i>Immaterial</i>
Source of incentives	<i>Extrinsic</i>	(4) Formal norms: legal sanctions	(3) Informal norms: social sanctions and rewards
	<i>Intrinsic</i>	(1) Absence of norms: material self-interest	(2) Internalised norms: feelings

Source: De Beer and Mosch 2004.

We distinguish between the character and the source of incentives. Starting with the character, we distinguish between material and immaterial incentives. Material incentives consist of ‘objective’, formal rewards and punishments, e.g. in the form of a monetary reward, a business profit, a loss, a fine or an imprisonment. Immaterial incentives are more of a ‘subjective’ and moral kind. Examples of these are public praise, looks of disapproval from bystanders, a heartening welcome in a group, exclusion from a group, a feeling of delight and pride, et cetera. The second distinction considers the source of incentives, which is extrinsic or intrinsic. An extrinsic incentive emerges from outside the individual. This can be a formal authority (in the case of material incentives: quadrant 4 in Figure 2.4.3), but also members of the informal social peer group to which the individual belongs (in the case of immaterial incentives: quadrant 3). The source of an intrinsic incentive is the person himself. It is his sensitivity that determines a person’s reaction to incentives. The homo economicus of the classic economic theory (quadrant 1) only weights the material pros and cons of his behaviour

for his own well-being without taking the approval or disapproval of others into account. A morally high-developed person, on the contrary, acts solely on the base of his own moral judgements about good and evil, and is also, in that sense, insensitive to the opinions of others (quadrant 2).

Of course, this distinction between four types of incentives is too rigid for any practical application, but is useful for the clarity of analysis at this point. In reality, people are influenced by all four types of incentives at the same time. Moreover, the different incentive types overlap and mutually influence each other. For example, social norms and properly designed and upheld legal norms may reinforce each other, while wrongly designed formal norms may crowd-out informal ones (see chapter 3).

Because norms are conducive to the solution of social co-ordination problems and thus have (positive) external effects, markets may fail to produce the optimal quantity of them. This public good aspect of norms forms an indication that government intervention may be required to reach the 'optimal' provision of social norms (Den Butter and Mosch 2003c). It is not easy for governments to do such a thing. By definition government policies are based on formal norms and work with formal norms. Formal norms have the tendency to crowd-out informal ones (also see Bowles and Gintis 2002). A high equilibrium situation in which informal norms enable people to work together for the provision of a particular public good may easily be disturbed by formal rules that try to strengthen or professionalise the informal system. The idea that the provision of the common good is a problem of the whole community, which implies that the whole community is morally obliged to partake in its provision, may easily be swept aside by the idea that the outsiders (e.g. the government) have taken over the responsibility to fulfil this task. When for some reason the new system does not work properly or disappears after some time, the old norms of co-operation are not easily re-installed. Like trust that comes on foot and leaves on horseback, also norms of co-operation are difficult to build but can be ruined easily.

We give two examples to illustrate this point. The first comes from Ostrom (2000b). She studies irrigation projects in villages in developing countries. Irrigation is a typical social co-ordination problem. It would be best for all villagers if everybody would partake in the building and maintenance of an irrigation system, but there are individual incentives to free-ride. However, most of the villages have managed to create and uphold a social norm that guarantees the provision of this public good. Ostrom describes how these old irrigation systems became replaced by modern irrigation systems that were financed and set-up by national governments and foreign aid agencies. Better materials and paid maintenance led to improved irrigation. However, when the projects ran out of cash or were simply stopped because of changed governmental priorities, the new systems quickly collapsed because the villagers did not know how to keep it afloat. Even worse, the old system did not return. The new system of irrigation had eroded the old norms of co-operation and the villages were worse off than in the situation before the new irrigation project started. Ostrom (2000a: 147) concludes that "norms seem to have a certain staying power in encouraging a growth of the desire for cooperative behaviour over time, while cooperation enforced by externally imposed rules can disappear very quickly".

A second example comes from Frey (1993), who describes the work attitude of Swiss professors. They are required to teach 8 hours a week. Some professors teach more, some teach less. The government decides to install new rules to control the work attitude of the professors. As a result, the professors who used to teach less than eight hours extend their teaching to reach the required minimum. However, the professors with the high intrinsic moral and work attitude who used to teach more than eight hours feel 'betrayed' and 'mistrusted' by the government. Their intrinsic motivation collapses under the new formal

monitoring system and they decrease their teaching efforts to precisely eight hours. The perverse effect dominates and the total amount of teaching time drops.

2.4.2 Norms: empirical research

It is problematic to test the Putnam claim about the beneficial effects of norms of civic co-operation, because it is hard to find an appropriate measure of ‘civic norms’. Knack and Keefer (1997) construct the following measure, based on the responses to the World Values Survey questions “about whether each of the following behaviors can always be justified, never be justified or something in between: a. claiming government benefits which you are not entitled to; b. avoiding a fare on public transport; c. cheating on taxes if you have the chance; d. keeping money that you have found and e. failing to report damage you’ve done accidentally to a parked vehicle” (Knack and Keefer 1997: 1256). They award 1 to 10 points per question (1 = never justifiable, 10 = always justifiable) and sum the results, leading to a 10 – 50 points scale with a mean value of 39.4 and a standard deviation of (just) 2, see Table 2.4.1. According to this measure of civic norms, Italians and US citizens have the highest norms of civic co-operation, while the French, Belgian, and Dutch people score relatively low on this measure of social capital. These results contrast with our findings of national levels of social capital in terms of trust and associational activity. According to those measures, the rankings of the Netherlands and Italy are the reverse.

We are a little doubtful about the validity of this civic norms measure, because it has two major drawbacks. First, it is very susceptible to the inclination of the respondents to provide socially accepted answers. If this inclination differs between countries, it disturbs the measure’s validity. This could potentially explain the remarkable high score of Italy and the low score of the ‘permissive’ Dutch society. Second, the measure is susceptible to factual differences between countries and over time. For example, norms on ‘avoiding a fare on public transport’ are probably closely related to the extent to which public transport is available in a country, to the price of a fare, and to the level of control. Thus, a low score on this measure does not necessarily imply a lack of morality, but could also be the result of a specific set of external conditions that perhaps provides many incentives to avoid a fare (densely mazed tram network, no conductors on the train, low chance of being caught, high fare prices). These problems urge us to a careful interpretation of its results.

Moreover, we doubt whether this measure provides any additional information about the level of social capital in countries. From a theoretical perspective, the norms of civic co-operation are closely connected to the norms of trusting and trustworthy behaviour. This is confirmed by the empirical finding, that trust and norms of civic co-operation are strongly correlated. The relations between norms of civic co-operation and economic performance also resemble the found relations between trust and economic performance (Knack and Keefer 1997). For example, a four point rise in norms of civic co-operation is associated with 1 percent higher economic growth. Civic norms are also associated with higher investments per capita.

In general, it may be not too surprising that these ‘inherently good’ norms of civic co-operation are associated with better economic performance. According to our reasoning above, however, also inherently neutral (neither good nor evil) co-ordination norms should have positive external benefits for society. The capacity of these norms to realise their potential beneficial effects only depends on the proportion of people that endorse these norms. It is hard to find data on the ‘average endorsement of norms’ in a society, but we can probably approximate this measure by looking at the homogeneity of societies. This implies that we make the assumption that more homogeneous societies (in terms of race, language, religion,

social-economic status, et cetera) subscribe to more homogeneous norms. So according to this argument, when a society consists of one homogeneous group, we expect that this society will subscribe to more generalised norms than a society which consists of several heterogeneous groups. If generalised norms lead to better co-ordination and more homogeneous societies subscribe to more generalised norms, then more homogeneous societies should have a better economic track record.

Table 2.4.1. Norms of civic co-operation and ethnic homogeneity^a

Country	Civic norms	Ethnic homogeneity
France	36,26	94
Belgium	38,08	57
Netherlands	38,36	99
Spain	38,75	75
Germany	39,83	99
UK	40,07	82
Denmark	40,34	95
US	40,55	81
Italy	41,23	99

^a Countries sorted on ascending order of civic norms. Civic norms are norms of civic co-operation. This measure is based on responses to World Values Survey questions “about whether each of the following behaviors can always be justified, never be justified or something in between: a. claiming government benefits which you are not entitled to; b. avoiding a fare on public transport; c. cheating on taxes if you have the chance; d. keeping money that you have found and e. failing to report damage you’ve done accidentally to a parked vehicle.” Ethnic homogeneity measures the percentage of the country’s population that belongs to the largest ethno-linguistic group.

Source: Knack and Keefer 1997, p. 1285.

This hypothesis has been put to the test by Zak and Knack (2001). As measures of heterogeneity they use (i) Gini coefficients for income inequality; (ii) Gini coefficients for land inequality; (iii) intensity of economic discrimination; and (iv) ethnic homogeneity. The first three indicators are economic ones, which raises doubts about cause and effect if we relate them to economic performance. Only the fourth measure seems to be independent of economic circumstances. These data on ethnic homogeneity come from Sullivan (1991) and measure the percentage of the country’s population that belongs to the largest ethno-linguistic group, see Table 2.4.1. We immediately see that this measure is a very doubtful one. Since it only focuses on the share of the population that belongs to the largest ethno-linguistic group, the Netherlands score 99%⁹, while the more or less comparable but bi-lingual Belgians reach to a meagre 57%. Other relevant indicators of ethnic homogeneity, such as race, religion, et cetera, are neglected by this measure.

With use of these (rather questionable) measures of ethnic homogeneity, Zak and Knack (2001) find that ethnic homogeneity does not have a linear relationship with trust, but a quadratic, U-shaped one. Trust is the lowest in societies with a few big ethnic groups. When there are a lot of different small ethnic groups, each one of them is too small to form a ‘threat’ to the others. Regressions on economic growth show that all four indicators of heterogeneity have significant negative effects on economic growth, but that their coefficients are considerably lowered when the WVS trust variable is added to the equation (Zak and Knack 2001). The effects of heterogeneity on economic growth thus seem to arise from their effects

⁹ The score of 99% for the Netherlands is questionably high in itself. Apart from the issue whether the Frisians constitute an own ethno-linguistic group, the influx of foreigners with a different ethno-linguistic background is clearly underestimated in this measure.

on trust. In a study on communities in the US, also Alesina and La Ferrara (2002) provide evidence of a relation between homogeneity and trust. They find that interpersonal trust is lower in communities with higher income inequality and which are more racially heterogeneous.

We conclude that it is hard to find appropriate indicators for norms of civic co-operation and for ethnic homogeneity. The indicators for civic norms that are actually used in the empirical research on economic growth are plagued by methodological problems and are mere indicators of trust; they do not seem to provide substantial additional information to our analysis of social capital.

2.5 Religion – structural and moral elements of social capital

In most research of social capital, the religiosity of people is not taken into account.¹⁰ This is a missed opportunity, because there are several reasons why an examination of religiosity is interesting from the perspective of social capital. First, religiosity and social capital have a similar character and similar effects. They are both a sort of intangible societal asset, consisting of structural and moral elements, with assumed large-scale external effects. Due to these similarities, religion is closely connected to the idea of social capital and probably part of it. Second, there are many indications that religiosity and the level of social capital are closely related. According to Putnam (2000), religious people are very active social capitalists. If we want to measure social capital or if we want to form an opinion on the danger of declining social capital, religiosity might be an important factor to look at. Third, religiosity combines the structural and the moral element of social capital. Religious groups are structured in closely connected networks with frequent face-to-face contacts, and spreading ethical values and norms is their core competence. The study of religious behaviour may provide an opportunity to learn more about the relative importance and causality of the structural element and the moral element of social capital.

For these three reasons, we devote this section to religiosity. In order to make sure that we talk about an issue that is still relevant in the 21st century, we first look at the relevance of religious behaviour in the Netherlands and other Western countries. Thereafter, we examine the direct economic effects of religion from both a macro and a micro perspective, followed by an empirical investigation of the relations between religiosity and elements of social capital. In this latter subsection, we especially pay attention to the question whether the structural or the moral element of religions is important with respect to social capital.

2.5.1 Relevance of religion

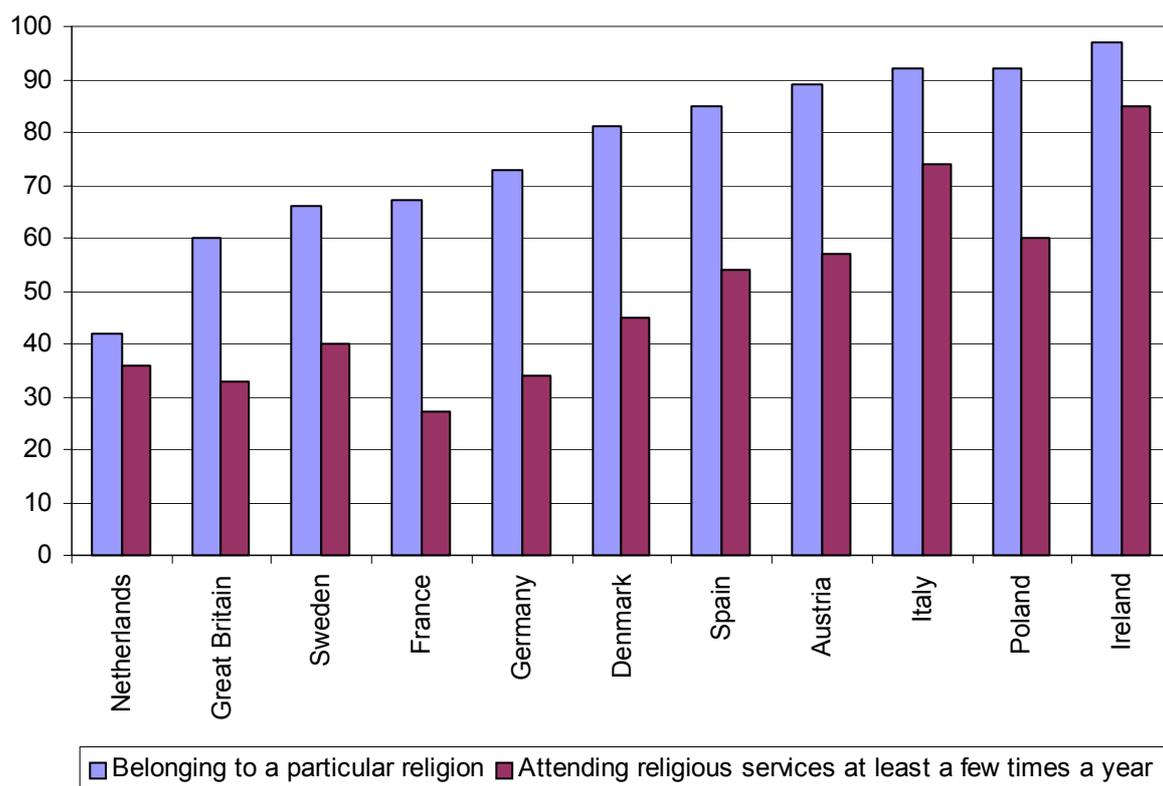
Are religions still a relevant factor in the social (and economic) life of the modern Western world? The Western countries share a high level of economic development, which, according to the secularisation hypothesis, causes their citizens to become less religious and downplays the role of religion in political, social and legal processes (Inglehart 1997). Nevertheless, two arguments buttress an affirmative reply to the relevance question. The first is that, although the highly developed Western societies cannot hide the marks left by the trends of (post)modernisation, individualisation and globalisation, the cultures of these societies are still entrenched by the influence of the religions that dominated life for centuries. Therefore, the values, norms, and trusting behaviour in regions that used to be Protestant may still

¹⁰ Religion is “any shared set of beliefs, activities, and institutions premised upon faith in supernatural forces” (Iannaccone 1998: 1466).

considerably vary from those in regions with a mainly Catholic history, even although most of the current inhabitants of these regions respond ‘not affiliated to any religion’ in surveys.

The second argument is that the secularisation hypothesis is wrong, at least for some parts in the Western world. Iannaccone (1998) reports for the United States that the levels of church membership, clergy employment, church attendance, religious beliefs, and church contributions (as percentage of GDP) have increased or at least been stable over the last century. Also US scientists’ belief in a god who answers prayers has not diminished since 1916, with a clear exception for scientists active in the field of social sciences.

Figure 2.5.1. Belonging to a religion and attending religious services, 1998



Source: EuroBarometer 50.0 1998.

In order to check whether the US are an outlier in this perspective or that religiosity is also still important in other Western countries, we provide an overview of levels of religious affiliation and attendance for 11 countries in Figure 2.5.1. The proportion of people that say to belong to a particular religion varies from about 40 percent in the Netherlands to 90 percent and higher in Ireland, Poland, and Italy. The percentage of regular churchgoers varies from about 30 percent in France and Great Britain to around 80 percent in Ireland and Italy. Attendance is also relatively low in the Netherlands, but the difference between belonging and attending is relatively small. Apparently, the Dutch do not consider themselves member of a church if they do not regularly attend its religious services. This is different in countries with a state church (e.g. the Lutheran church in Scandinavian countries). Belonging is more or less automatic in these countries. It is for this reason not an appropriate measure of religious commitment, as can also be seen from the huge discrepancy with attendance rates (De Hart and Dekker 2002). From these two measures, we conclude that religion is still a relevant factor. The majority of the people in Western countries belong to a particular religion, and on average about 40 to 50 percent of all people attend religious services at least a few times a

year. The trend of secularisation seems to be the strongest in the Netherlands. There is a clear downward trend in church membership and the attendance of religious services over the period 1958-1999 (Becker and De Wit 2000). This means a decline in the ‘structural element’ of religiosity. Remarkable is that there seems to be an increase in the moral element during the 1990s. Over the period 1991-1998, the proportions of Dutch who say to believe in a life after death, in heaven, in hell, and in religious miracles all soared with about seven percent points (Becker and De Wit 2000).¹¹ So, even in the secularised Low Countries, religion affects many people and remains a relevant factor.

2.5.2 Religion: empirical investigations of the economic effects

Macroeconomic effects of religion

When studying the relationship between religion, social capital and societal performance, we cannot but start with Weber’s (1905/1930) claim about the positive relationship between Protestantism and economic progress. His argument is that the Protestant Ethic encourages certain virtues and personal traits that foster economic prosperity, like thrift,¹² honesty and saving, a rejection of idleness and consumption, and a willingness to work hard.¹³ This last characteristic is related to the Protestant conviction that God already ‘rewards’ his loved ones in their life on earth. Private wealth is therefore an indication that one is ‘chosen’. According to the Weber theory, this Protestant Ethic caused the fast economic development of the Protestant regions in Europe, while the Catholic regions lagged behind.

These ideas have received a lot of criticism. “The most noteworthy feature of the Protestant Ethic is its absence of empirical support” writes Iannaccone (1998: 1474, also see Samuelsson 1993). One of the arguments raised is that Weber distinguishes several ‘typically Protestant’ capitalist institutions that favoured economic growth, but that all these institutions already existed before the Protestant Reformation took place. Although the mechanisms proposed by Weber are probably predated, this does, of course, not rule out the possibility that Protestantism has beneficial effects on the economy through other channels.

Putnam (1993) proposes such a channel.¹⁴ He argues that hierarchical religions (like Catholicism, Orthodox Christianity and Islam) are intertwined with hierarchical cultures. In these cultures, networks tend to be vertically organised instead of horizontally organised. As mentioned before, in horizontal networks information spreads more easily and norms of generalised reciprocity are sooner developed than in vertical networks. Societies with a non-hierarchical dominant religion (like Protestantism) will therefore have a relative abundance of horizontal networks, leading to a relatively high trust and more developed norms of civic co-operation, which contributes to their economic performance. Landes (1998) points at the

¹¹ Between 1991 and 1998, belief in afterlife increased from 53 to 60%, belief in heaven from 49 to 55%, belief in hell from 18 to 26%, and belief in miracles from 32 to 40% (Becker and De Wit 2000: 41).

¹² Although just a few classical economists would deny that thrift is good for the economy, it is remarkable to see that in the last 15 years economic growth collapsed in very thrifty Japan, while the carelessly spending Americans (both government and consumers) have seen their wealth substantially increased.

¹³ To refrain from action is sometimes regarded as a virtue in the ‘fatalistic’ religions Hinduism and Buddhism (Paldam 2001).

¹⁴ Paldam (2001) presents empirical evidence on the relation between corruption and religions in poor countries. Protestantism and tribal religions lower corruption, while other religions, such as Catholicism, Orthodox Christianity and Islam, increase corruption. If corruption is an important factor explaining long-term growth, this would form another channel through which Protestantism causes economic prosperity. Proofs for this assumption are weak however.

culture of intolerance that is (was) inherent to the Catholic Church (remember the Catholic Inquisition) and that hampered economic growth in Catholic countries.

What are the results of the macroeconomic empirical research with respect to religion? To start with the secularisation hypothesis, economic development of countries is indeed associated with less religiosity, measured by church attendance or religious beliefs (Barro and McCleary 2003). As stated above, Iannaccone (1998) concludes that there is no evidence for the economic effects of the Protestant Ethic. However, the research of Grier (1997) provides evidence that there is a positive relation between Protestantism and economic growth.

Influences of religions (in general) on economic performance are found by Barro and McCleary (2003). They formalise these influences by distinguishing between the costs and benefits of religions. Church attendance is considered to be on the input side (i.e., attendance is a measure for the resources used by the religious system), while the extent of religious beliefs are regarded as the main output. In line with this theory, they find that economic growth is negatively related to church attendance and positively related to the extent of religious beliefs, notably those in hell and heaven. They conclude that “growth depends on the extent of believing relative to belonging” (Barro and McCleary 2003). As an explanation for these results, they suggest that religious beliefs influence individual traits that increase economic well-being.

These macroeconomic findings are not convincing. The findings on the Weber thesis are contrasting and the authors have a tendency to explain their findings by looking at micro level processes. Moreover, the results of this type of research are doubtful from a methodological perspective. The number of countries (which determines the number of observations) is relatively small in comparison with the many institutional differences between countries. The resulting lack in control of country fixed effects makes the regressions vulnerable for wrongly associating religiousness instead of national institutional particularities with economic performance. This implies that we have to be very careful in interpreting these results, at least, and that we would do even better by neglecting them altogether and turning our attention to the microeconomic empirical research.

Microeconomic effects of religion

An economic analysis of individual religious behaviour starts with the argument that the consumers of religion, i.e. the (potential) believers, weigh the costs and benefits of beliefs, just like consumers of ordinary goods. This simple starting-point already offers an explanation for the fact that high-educated people visit church more regularly than the low-educated. The benefits of group participation (including church services) accrue more to high-educated than to low-educated people (Iannaccone 1998, Sacerdote and Glaeser 2001, Barro and McCleary 2003). On the other hand, when the costs of belonging to a certain religion become obtrusive for personal growth, the high educated drop out. Most of the members of sects and other theologically conservative or fundamental denominations are relatively poor, low-educated, or from minority groups (Iannaccone 1998). The high-educated are mainly attracted by more liberal religions, which do not restrict access to secular high-paying jobs and high-status social networks. Another part of the explanation could be that education decreases religious beliefs (Sacerdote and Glaeser 2001).

Micro level research reports a list of positive social-economic effects of religion for individuals. Member of religious groups are, in comparison with non-religious people, healthier, less criminal, more satisfied with their lives, experiencing longer lasting marriages and less divorces, et cetera (see Iannaccone 1998 for an overview). The effects on health may originate from religious regulations that prohibit the consumption of drugs and alcohol (e.g.

by the Islam), or that promote soberness (e.g., gluttony is one of the seven deadly sins in Christianity), but may also result from group benefits (e.g., social support and help from friends in times of need) that suppress stress. However, we have to be careful in interpreting these results. It is possible that there is no direct link between religion and these positive effects. There could be a third, underlying factor that influences religious behaviour and ‘good’ behaviour at the same time. Persons with a rebellious character may prefer not to go to church *and* not to go to school *and* to experiment with drugs (Freeman 1986). This ‘self-selection’ problem can lead to spurious results.

Guiso, Sapienza and Zingales (2002) study the relations between religiousness and ‘good’ economic attitudes, where ‘good’ is defined as “conducive to higher per capita income and growth”. They find that religious people have a higher tendency to trust other people, the government and the legal system, show more restraints on breaking the law, and have a stronger belief that markets’ outcomes are fair. On average, people affiliated to Christian religions are the most pro-market, while Muslims are the least related to good economic attitudes. It is not clear whether Protestants or Catholics rank highest. The former have a higher tendency to trust and favour incentives more, while the latter are thrifter and more supportive of private property and competition. These results are somewhat in contrast with the findings reported by Iannaccone (1998), namely that there is *no* influence of religiosity on attitudes concerning capitalism, socialism, income redistribution, private property, free trade, and government regulation.

We conclude that there seem to be some direct, positive relationships between religion and economic performance, but these findings are not convincing in all aspects. Researchers find mixed and sometimes contrasting effects, and there are several methodological problems, such as self-selection and lack of observations, that blur the empirical results. Possibly, the relations are not direct and one-dimensional, but can be better studied through their effects on (other forms of) social capital.

2.5.3 Religion: empirical investigations of the relations with social capital

Above, we concluded that it is hard to find a robust, direct relationship between religion and economic outcomes. It is possible that the effects of religion on economic performance – if there are any – occur through intermediate mechanisms. This might happen in two ways. First, religion might influence the attitudes of religious people that lead to economic prosperity: a normative influence, e.g. the development of altruism, solidarity, honesty et cetera. Second, churchgoers (and society) may benefit from the network effects of participating in religious groups: a structural influence (Bekkers 2000). For example, churches generate social commitment among their members, because they meet each other regularly, learn to trust each other, stimulate social responsibility, and acquire civic skills by participating in church activities that are helpful for successful participation in other social domains (Verba et al. 1995, Wuthnow 1996). According to Putnam (2000: 66), American “churchgoers are substantially more likely to be involved in secular organizations, to vote and participate politically in other ways, and to have deeper informal social connections”. They are very active social capitalists, caused by their frequent interaction with other churchgoers during church services and other church related activities. New forms of religion that go without these regular church meetings may attract a lot of members these days, but miss the network generated benefits of the ‘classical’ religions.

We therefore analyse the relations between religiousness and the different elements of social capital. We examine the relation with trust, with social and political participation, and with norms of civic co-operation. In this analysis, we pay special attention to the distinction between the structural and moral elements of religion, and to the Dutch situation.

Religion and social capital: trust

A commonly found idea in the literature is that the level of interpersonal trust of religious people depends on the specific denomination to which they belong. Putnam (1993) argues that hierarchical religions are inimical to horizontal networks and trust. Also Inglehart (1990) and Fukuyama (1995a) share the vision that Protestants are more trusting than followers of hierarchical religions. Country level research corroborates this claim. LaPorta et al. (1997) find a significant negative relation between trust and the percentage of population that belongs to a hierarchical religion (Catholicism, Orthodox Christianity, Islam). Knack and Keefer (1997) report that a five percentage point rise in the proportion of Protestants in a country is associated with a one point increase in trust. Percentage of Catholics and percentage of Muslims in a society are significantly and negatively related to levels of generalised trust (Knack and Keefer 1997, Zak and Knack 2001).

These findings are somewhat contrasted by empirical research of trust on the scale of European regions. Beugelsdijk and Van Schaik (2003) show that various traditional Catholic regions, e.g. in the south of the Netherlands, in Flanders, around Madrid and in the north of Italy, are among the group of regions with the highest scores on trust. So it is not by definition that Catholicism impedes the emergence of generalised trust. Of course, we already knew this from Putnam (1993), who draws attention to the huge differences in social capital in the different regions of Italy, which have all been dominated by the Catholic church for centuries (and still are albeit to a lesser extent). The specific religion to which people belong is just one of the many factors that influence their tendency to trust. A whole list of characteristics, like income, wealth, education, happiness, gender, marital status, age, institutional environment et cetera, is more or less related to people's tendency to trust. It is difficult to control for all these specific influences at country or region levels, but some controls are possible at the individual level, to which we turn now.

First, we take a closer look at the relationship between 'tend to trust' and several religious indicators based on the World Values Survey. Table 2.5.1 reports the frequencies. The analysis focuses on the Netherlands, two neighbour countries, and a representative group of ten Western countries. For this latter group of ten countries, we find the expected, general result that Protestants respond 'tend to trust strangers' instead of 'cannot be too careful' more often than non-religious people or Catholics do. However, also two remarkable results appear. First, Orthodox Christians are the most trusting religious people in our dataset. Second, when we turn to the Netherlands, Catholics appear to be more trusting than Protestants. Its cause seems not to be centred in the high trust of Dutch Catholics,¹⁵ but more in the fact that Dutch Protestants appear to be relatively low trusting. Their tendency to trust is even lower than that of non-religious people. An explanation for this result could be that the Dutch Protestants are on average more 'orthodox' or 'fundamental' than Protestants worldwide, which might invoke Dutch Protestants to distrust people who do not belong to their church. Their within-group trust and bonding social capital is probably very high, but at the expense of their between-group trust and bridging social capital.

This finding confirms the theory that the relationship between religious participation and generalised trust might have an inverted U-shape (Smidt 1999). Increasing religiousness is related to increasing trust as a consequence of network effects, but after a certain point, this

¹⁵ Inglehart (1997: 95) notes that "[h]istorically, the Netherlands has been shaped by Protestantism; even the Dutch Catholics today are remarkably Calvinist". This is corroborated by our finding that the trust of the Dutch Catholics is at the same level as the average trust of Protestants in our benchmark of ten countries.

relationship is reversed. More religious participation leads to a more orthodox and strict vision on religious matters, which raises distrust in people with other opinions and/or to an increasing pessimism in human nature itself (Dekker and De Hart 2001). Although our empirical results corroborate this theory, Dekker and De Hart (2001), who use another data source that is more specialised to the Dutch situation, find that Dutch Protestants are more trusting than non-religious and Catholic people, and do not find evidence for the inverted U-curve.

Table 2.5.1. Religion and generalised trust, in percentages^a

	Netherlands	W Germany	Belgium	10 countries
<i>Religious denomination</i>				
None	50	36	27	39
Catholic	48	33	33	35
Protestant	42	38	.	47
Orthodox	58	.	.	53
Other	55	.	31	38
<i>Member of church</i>				
Active	64	49	47	52
Passive	48	35	44	45
Don't belong	47	35	31	36
<i>Attends church</i>				
Less than once a month	48	35	29	37
Once a month or more	51	38	38	41
<i>Is respondent religious</i>				
Religious	48	36	34	39
Not religious	51	36	30	39
Atheist	54	42	28	39
<i>Belief in hell</i>				
Yes	45	36	31	39
No	50	36	33	39
<i>Belief in heaven</i>				
Yes	46	35	34	39
No	51	35	32	39
<i>Belief in God</i>				
Yes	47	36	33	38
No	52	33	32	40

^a Values denote proportion of respondents that “tend to trust strangers” instead of “cannot be too careful” in percentages. ‘.’ denotes less than 50 observations.

Source: World Values Survey 1981 and 1990.

Our second indicator of religiosity is whether people are an active member (i.e. doing voluntary work), a passive member or no member of a church. Active members (volunteers) dispose of a far higher tendency to trust than inactive and non-members. This is an indication that trust is created by active network behaviour (the structural component of religion) instead of by learned values and norms (the moral component) (cf. Bekkers 2000, Dekker and De Hart 2001). This argument is enforced by the results of the other measures of religiosity. In

general, church attendance (structural component) is associated to more trust, while the moral components (the respondent is religious and beliefs in hell, heaven, or God) have no influence on trust. In the Netherlands it is even the case that atheists and people who do not believe in hell, heaven and God are more trusting than do-believers. This result correlates of course with the earlier finding that the (strongly) religious Dutch Protestants exhibit lower trust than other people in the Netherlands. Apart from this, the finding that Dutch atheists have a higher tendency to trust than religious people is not as strange as it may sound. Guiso, Sapienza and Zingales (2002) find the same result for a sample of 56 countries, also using the World Values Survey.

We take a closer look at these figures by using a logit regression model, which allows us to control for gender, age, income and education, see Table 2.5.2. The findings of the previous table are confirmed by these regression results. Being a Protestant, being an active or passive member of a church and attending church regularly are associated with a higher tendency to trust. The striking result that Catholics are more trusting than Protestants in the Netherlands is confirmed by the estimated odds ratio. Due to a limited number of observations, this result is not statistically significant however. Active members of a church in the Netherlands, West Germany, Belgium and in the group of ten countries appear to be far more likely to trust a stranger than people who are not a member. This makes active membership of a church the most influential religious indicator for trust.

Table 2.5.2. Explaining ‘tendency to trust’ with measures of religiosity: odds ratios^a

	Netherlands	W Germany	Belgium	10 countries
<i>Religious denomination (compared to Protestantism)</i>				
None	1.1	0.8	.	0.8*
Catholicism	1.2	0.8*	.	0.7*
Orthodox	1.5	.	.	1.2
Other	1.7	.	.	0.7*
<i>Member of church (compared to non-members)</i>				
Active	2.1*	2.1*	2.0*	1.6*
Passive	1.2	1.1	2.0*	1.3*
<i>Church attendance (compared to at least monthly)</i>				
Less than once a month	0.8*	0.7*	0.7*	0.8*

^a Dependent variable: tendency to trust. Method: multinomial logit regression. Values are odds ratios. Not reported: controls for gender, age (6 age groups), income (10 income groups) and education (age when finished school). * flags significance at the 0.10 level, ‘.’ denotes less than 50 observations.

Source: World Values Survey 1981 and 1990.

Religion and social capital: networks and political participation

In this subsection, we first look at the relation between religious behaviour and network activity, thereafter we continue with an examination of religiosity and political participation. With regard to associational activity, we restrict our attention to the most active form, i.e. volunteer work, see Table 2.5.3. Volunteering in political activities is the least popular among types of volunteering in all countries. The level of volunteering is highest in the Netherlands, France and the United States.¹⁶ The level of volunteering is relatively low in Spain, Italy,

¹⁶ The relatively high level of volunteering in the United States puts the Putnam statements about the ‘dramatic decline’ of US social capital in a broader perspective.

Portugal and Denmark. Religious denomination influences the level of volunteering. In countries with substantial numbers of both non-religious, Catholic and Protestant people, volunteering is higher among Protestants than among Catholics and non-religious people. In countries without a substantial number of Protestant respondents, it depends on the specific country whether Catholics or non-religious people tend to do more volunteer work.

The most substantial deviations with regard to volunteering activity result from the frequency of church attendance and not from the specific denomination. People who are attending religious services at least once a month are doing more voluntary activities than other people. De Hart and Dekker (2002) add to this, that the variable ‘religious volunteering’ has an even better explanatory power than denomination and attendance. They conclude that “volunteering in a religious setting is an important stepping stone between being a member of a religious community and political involvement” (De Hart and Dekker 2002: 11). We can combine these findings with those of Bekkers (2000) who also investigates the relations between religiosity and voluntary behaviour for the Netherlands. Bekkers points at the importance of altruistic values for the propensity to volunteer. Although he finds that altruistic attitudes indeed have the expected positive association with volunteering activity, there seems to be no relation between religiosity and altruistic values. He concludes that the higher participation of religious people in volunteering activities results from the contacts with other church members and volunteers and not from stronger moral attitudes.

We conclude that it is, again, the structural component instead of the moral component of religiosity that forms the link between religion and (other forms of) social capital.

Table 2.5.3. Effects of religious affiliation and attendance on volunteering, 1998, in percentages^a

	Nl	Sw	Dk	Ge	Au	GB	Ie	Fr	It	Sp	Po	US
<i>Volunteering activities:</i>												
- Political activities (helping political parties, political movements, election campaigns, etc.)	4	4	4	5	8	4	4	8	4	4	4	10
- Charitable activities (helping the sick, elderly, poor, etc.)	31	27	11	9	8	24	23	34	11	13	15	39
- Religious and church-related activities (helping churches and religious groups)	15	11	7	11	10	12	11	16	10	6	14	20
- Any other kind of voluntary activities	34	35	22	17	17	19	18	40	9	10	9	38
Any of these	51	49	33	27	29	37	34	58	24	22	27	59
<i>Deviations from national average:</i>												
- Non-religious	-6	-6	-1	-7	-4	-10	-7	-7	-2	1	11	-11
- Catholics	5	.	.	3	1	9	1	6	2	0	-1	-7
- Protestants	13	2	0	2	.	11	.	.	.	.	.	7
- Attends church less than monthly	-6	-3	-2	-5	-2	-8	-15	-6	-8	-4	-9	-16
- Attends once a month or more	19	36	20	14	5	29	6	29	9	6	12	17

^a “Have you done any voluntary activity in the past 12 months in any of the following areas? Voluntary activity is unpaid work, not just belonging to an organisation or group. It should be of service or benefit to other people or the community and not only to one’s family or personal friends.” Values are in percentages. ‘.’ denotes categories with less than 50 observations. Nl = the Netherlands, Sw = Sweden, Dk = Denmark, Ge = Germany, Au = Austria, GB = Great Britain, Ie = Ireland, Fr = France, Sp = Spain, Po = Portugal and US = United States. Source: De Hart and Dekker 2002, table 4. (They base their table on data from the International Social Survey Project 1998.)

We now turn our attention to the link between religion and political participation. Table 2.5.4 shows three measures of political activity: (i) discussion of politics with friends, (ii) interest in politics, and (iii) political protest. These are related to five indicators of religiosity for the set of ten countries and for the Netherlands.

We examine ‘discussion of politics’ and ‘interest in politics’ together, because they are closely related indicators of a general positive interest in political matters. Regarding religious denomination, we see that Protestants and Orthodox Christians discuss politics more frequently and have a higher interest in politics than Catholics and non-religious people, although the Protestants in the Netherlands discuss politics at the same frequency as Catholics. This is in line with the Putnam argument that non-hierarchical religions are related to horizontal networks and a higher general interest in political affairs.

The effects of church attendance are mixed. For the group of ten countries, a higher church attendance is associated with less discussion and with less political interest, while this is the reverse in the Netherlands. The effects of church membership are clearer. Active church members are substantially more discussing politics and show a greater interest in politics than passive members and non-members. This forms an indication that active participation (the structural component) is the main channel through which religiosity leads to political participation. The strength of internalised beliefs (moral component) is less important; we even find that beliefs in heaven and hell are associated with less political interest and discussion.

We now turn to a measure of more active political participation: political protest. This is measured by taking the average of three indicators of active political protest: (i) signing petitions, (ii) joining in boycotts, and (iii) attending demonstrations. Although these three types of political actions are lawful forms of political protest, Protestants and especially Catholics seem to hesitate to partake in them compared to people who do not belong to a religious denomination. For the Catholics, the hierarchical argument could apply. In hierarchically based cultures, it is less common and less socially accepted to protest against the output of the political hierarchy. More general, religious people may be more used to the idea of obeying the rulings of a higher authority. This is confirmed by all other measures of religiosity. The people who attend church relatively often, who are (active) member of a church, who believe in heaven, and who believe in hell have a lower tendency to protest than other people. The findings for the ten countries are comparable to those for the Netherlands.

We conclude that active participants in any religion are more involved in politics than other people. They discuss politics with friends more frequently, they are more interested in politics and they are more often member of a political party. This fits nicely with the finding of Guiso, Sapienza and Zingales (2002) that active church members of any religion (except Buddhism) place more trust in the government than non-religious people. On the other side, religious people who believe in heaven and hell are on all fronts less active in politics. They exhibit lower levels of political protest, discuss less and are less interested in politics. So again, it is the active participation aspect of religiosity, instead of the moral element, that links religion to higher social capital.

Table 2.5.4. Religion and political participation, frequencies^a

	The Netherlands			10 countries		
	Discussion	Interest	Protest	Discussion	Interest	Protest
<i>Religious denomination</i>						
None	76	44	30	67	45	35
Catholic	73	48	16	59	35	21
Protestant	73	49	16	74	50	27
Orthodox	78	52	22	68	49	29
Other	74	.	.	69	54	34
<i>Church attendance</i>						
Less than monthly	72	52	25	66	42	28
Monthly or more	76	40	18	62	39	25
<i>Member of church</i>						
Active	84	58	27	75	53	31
Passive	78	55	18	68	50	26
None	72	49	25	63	38	25
<i>Belief in heaven</i>						
Yes	72	48	17	59	38	22
No	76	54	28	70	44	30
<i>Belief in hell</i>						
Yes	74	49	17	60	39	23
No	75	53	24	67	43	28

^a Discussion: percentage of respondents answering “frequently” or “occasionally” to the question “When you get together with your friends, would you say you discuss political matters frequently, occasionally or never?”. Interest: percentage of respondents answering “very interested or somewhat interested” to the question “How interested would you say you are in politics?”. Protest: average percentage of respondents that answers “have done” to the question “I’m going to read out some different forms of political action that people can take, and I’d like you to tell me, for each one, whether you have actually done any of these things, whether you might do it or would never, under any circumstances, do it: (a) signing a petition; (b) joining in boycotts; and (c) attending lawful demonstrations”. ‘.’ denotes less than 50 observations.

Source: World Values Study 1981 and 1990.

Religion and social capital: norms of civic co-operation

The last part of our analysis of the social capital aspects of religiosity concerns the norms of civic co-operation. We create a measure of civic norms, which is based on the following three World Values Survey questions: “Please tell me for each of the following statements whether you think it can always be justified, never be justified, or something in between: (a) Claiming government benefits to which you are not entitled; (b) Avoiding a fare on public transport; and (c) Cheating on taxes if you have a chance”.¹⁷ The answers are on 1-10 point scale. We sum the outcomes of the three questions and then classify the results in three, equally large groups, representing a high, middle and low score on civic norms.¹⁸ We relate this indicator of civic virtue to different measures of religiosity, see Table 2.5.5.

Even when taking the previously discerned methodological problems into account, the results are very clear. On all indicators of religiosity and for all countries, religiousness is

¹⁷ This measure is inspired by the civic norms indicator used by Knack and Keefer (1997).

¹⁸ For the ten countries: the high, middle and low group contain respectively 39%, 35% and 26% of all observations.

positively associated with norms of civic co-operation. Protestants and Orthodox Christians tend to have higher developed civic norms than Catholic people, but religious people from all denominations have substantially higher civic attitudes than non-religious people.

Table 2.5.5. Religiosity and civic norms, frequencies^a

	Netherlands			West Germany			Belgium			10 Countries		
	Low	middle	high	low	middle	high	low	middle	high	low	middle	high
<i>Religious denomination</i>												
None	32	40	27	39	41	21	48	33	19	38	36	26
Catholic	22	47	31	25	43	32	34	36	29	26	24	40
Protestant	.	43	42	23	41	36	.	.	.	18	36	46
Orthodox	.	45	42	.	.	.	.	.	.	11	36	53
Other	.	.	.	.	.	.	.	.	.	33	32	36
<i>Church attendance</i>												
Less than monthly	30	42	28	31	42	27	43	35	22	31	36	34
Monthly or more	14	45	41	14	41	45	29	36	35	19	34	47
<i>Member of church</i>												
Active	14	49	37	.	39	50	25	38	38	14	33	53
Passive	17	45	38	.	45	38	27	36	38	19	35	46
None	28	41	30	27	42	31	39	35	25	28	35	37
<i>Belief in heaven</i>												
Yes	17	44	40	16	39	45	32	36	33	21	33	46
No	29	43	28	32	41	27	41	35	24	32	36	32
<i>Belief in hell</i>												
Yes	.	41	45	16	38	45	31	33	36	19	32	49
No	26	43	31	27	42	31	40	35	25	29	36	35

^a Percentage of respondents that are in the group with a low, middle or high score of civic norms. Civic norms is based on the questions: "Please tell me for each of the following statements whether you think it can always be justified, never be justified, or something in between: (a) Claiming government benefits to which you are not entitled; (b) Avoiding a fare on public transport; and (c) Cheating on taxes if you have a chance". '.' denotes less than 50 observations.

Source: World Values Study 1981 and 1990.

2.6 Conclusion

Two goals were set at the beginning of this chapter. The first goal was to explore the concept social capital. Because social capital is a somewhat diffuse amalgam, we chose to examine three of its main components (trust, networks, and norms) and its relation with religion. The second goal was to measure the level of social capital in the Netherlands. We summarise our results below.

2.6.1 Summarising conclusions with regard to trust, networks, norms, and religion

The first general conclusions apply to *trust*. There are some empirical indications that the level of interpersonal trust in a country is positively related to higher economic performance, but these empirical results seem to hinge disproportionately on the inclusion of poor countries

in the analysis. In developed countries, the economic effects seem to be smaller than the effects on happiness.

The level of generalised trust in a country is not stable. Russia and other former socialist countries experienced a strong decline in trust after the collapse of the socialist political supremacy, but also politically stable and economically developed countries as the United States and the United Kingdom saw their trust levels dip. Directly after the traumatic events of 9/11 Putnam notes a sharp rise in trust, civic involvement and political participation in the US. These are major indications that the level of social capital is not something that can be taken for granted. It refutes the idea social capital is formed in processes that take centuries to develop, that social capital should be considered as part of a region's culture and, thus, that is a highly constant factor.

On the level of countries, trust and (perceived) trustworthiness are closely related. The trust of a particular country in the inhabitants of other countries is almost equal to the average trust of other countries in this particular country. However, the citizens of a country have a considerably higher tendency to trust their compatriots than to trust the inhabitants of other countries. Also on the scale of nations, within-group trust is much stronger than between-group trust.

On the level of individuals, we found the familiar results that age and education are important explanatory variables for trust of individuals. The relation between trust and age has an inverted U-shape: trust rises with age, but declines when the age becomes higher than 54. Trust unequivocally rises with education.

It is hard to find a clear relation between *network* activity and economic performance. Networks seem to generate positive 'Putnam' and negative 'Olson' externalities at the same time. Macroeconomic research finds no relations or small negative relations between associational activity and economic performance. When group memberships are divided between Putnam and Olson groups, the Olson type groups seem to have no effects on economic performance, while the Putnam type groups have a small negative effect on investments.

When we examine the relation between associational activity and trust on the micro level for ten countries, we find a positive relationship between membership and trust. Members of associations always have a higher tendency to trust than non-members. Moreover, active members are more trusting than passive members, except in the case of political parties, environmental organisations and professional organisations. This last result might be an indication of an Olson type, perverse effect. We conclude that both Putnam and Olson effects on trust may appear from membership of organisations, depending on the type of the organisation. These contrasting effects may explain the fact that there is no relation found between associational activity and economic performance in macroeconomic research.

Using leisure activities as a (Putnam) measure of voluntary associational activity, we find no indications of a decline in civic involvement in European countries. The general trend is upward, also for the younger generations.

With regard to *norms*, we conclude that it is very problematic to find appropriate indicators for norms of civic co-operation and generalised reciprocity. The measures that are suggested in the empirical literature have two problems. First, they are hardly distinguishable from (norms) of trust(worthiness) and therefore do not provide additional information to the analysis of social capital. Second, they are highly susceptible to the tendency of respondents to provide socially accepted answers and to factual contextual differences between countries and over time. Results received with use of this type of indicators should therefore be regarded with extended caution.

With regard to *religion*, the empirical literature shows a potpourri of contrasting findings of the direct links with economic performance. Among them is the study of Barro and McLeary (2003) that claims to have found a direct, positive relation between the extent of religious beliefs and economic growth, and a negative relation between church attendance and economic growth. Our research that is based on examining the links between religiosity and other forms of social capital strongly contrasts their findings. We confirm Putnam's idea (2000: 67) that "connectedness, not merely faith, is responsible for the beneficence of church people". According to our results, people who believe in heaven or hell are less trusting, less discussing politics, have less political interests and exhibit lower levels of political protest than non-believers. The only positive link we find between beliefs and other forms of social capital is with regard to the measure of norms of civic co-operation (which is a questionable measure after all). The indicators for religious connectedness (being an (active) member of a church and attending church regularly) are positively related to trust, civic involvement, volunteering, political participation and civic virtues. So it is the structural component of religiosity (and not the moral component) that is most closely associated with other forms of social capital.

Further, our findings confirm the idea of a 'Protestant Ethic' with beneficial consequences for societal performance. For a group of ten Western countries, we find that, on average, Protestants have a higher tendency to trust, do more volunteer work, have a higher political participation, and have higher norms of civic co-operation than Catholics and non-religious people.

We conclude that, although the precise relationships between religiosity, economic performance, and other forms of social capital are still a little mixed, there are various indications that religiosity has positive external benefits for society and could in this light be seen as a part of the social capital of a country.

2.6.2 Summarising conclusions with regard to the measurement of the Dutch social capital

There is no reason to fear a dramatic decline in social capital in the Netherlands. On the contrary, the Netherlands dispose of a 'stock' of social capital, which is very high (i) in an international context and (ii) with regard to most of its separate elements, and that (iii) shows no sign of decline.

The first element of social capital we examined was *trust*. In an international perspective, the level of interpersonal trust is very high in the Netherlands. Only the citizens of the Scandinavian countries exhibit a higher trust in strangers. The inhabitants of other European countries also regard the Dutch as among the most trustworthy people in Europe.

There is no sign of a decline in trust. According to World Values Study data, interpersonal trust in the Netherlands rose between 1981 and 1990. This is confirmed by EuroBarometer data, which show a pattern of a stable level of trust between 1976 and 1986, a steep rise in trust between 1986 and 1990, and stabilisation until 1996. Over this period 1976-1996, the trust of the Dutch in the Dutch has somewhat increased, while the trust of foreigners in the Dutch remained stable. Highs and lows in the economic tide correspond remarkably well to the ups and downs in perceived trustworthiness.

The level of institutional trust is remarkably high in the Netherlands compared with other European countries. Trust in all features of government (government, parliament, civil service, and political parties) is the highest in the Netherlands. In this international comparison, the Dutch people also dispose of the highest trust in all forms of the news media

(television, radio and written press). Strikingly, also the Dutch social partners, who are closely attached to the Dutch government through their participation in the preparation (and implementation) of social-economic policies in the Social Economic Council, are also considered to be the most trustworthy of all European countries.

Finally, we examined the number of lawyers as an indicator of distrust. The number of lawyers as a proportion of the population strongly increases after 1970. The larger part of this increase however stems from a general trend of increasing labour volume in commercial services. When we correct for this, there appears to be a surge in lawyers over the period 1970-1980, but the number of lawyers is more or less stable after 1980.

The second element we considered was *civic involvement*. An international comparison shows a very high rate of associational activity in the Netherlands. The Netherlands appear to have the highest membership rates in 9 out of 16 types of voluntary organisations, varying from religious and cultural organisations to environmental and sports associations. We reach the same conclusion when we limit our scope to the amount of civic involvement in leisure activities (the ‘pure’ Putnam organisations).

There is no sign of a decline of associational activity between 1980 and 2000. The younger generations exhibit equal or even higher rates of associational activity than older generations. The trend in membership rates is upward over the period 1980-2000, while the number of volunteers and time spent by volunteers is stable over this period. Also fundraising has risen.

Although the general trend is upward, some organisations lost a substantial number of members and supporters during this period, especially the political parties, women rights groups and religious associations. Consumers associations and organisations in the field of health, international solidarity and environment and nature experienced a very strong growth in membership rates. This is an indication that people switch from face-to-face organisations to check-and-mail organisations.

This switch is especially pregnant in the field of political participation. Membership of political parties, attending meetings of political parties, and voter turnout at elections have gone down, but there is no general trend of increased indifference in politics. Especially the single issue organisations welcomed many new members in the last decade. This does not necessarily mean that social capital is in decline; it is an indication that the younger generations use other ways to express their political involvement.

We found mixed results with regard to the effects of associational activity on trust. In the Netherlands, the tendency to trust is lower for active members than for passive members in most types of organisations, while the trust of active members of political parties and professional associations is even lower than the trust of non-members. These are indications of an ‘Olsonian’ detrimental effect on trust, which arises from active membership of ‘distributional coalitions’. However, we also note that for some types of associations, the assumed positive Putnam relationship between associational activity and mutual trust holds. Passive membership is always associated with higher trust than non-membership and also the active members of church and religious organisations and art, music and educational organisations have a far higher tendency to trust than non-members. So, for the Netherlands, especially religious and cultural organisations seem to enhance trust, while the active involvement in labour unions, professional associations, environmental organisations and political parties is associated with lower trust.

The third element we investigated was *norms of civic co-operation*. Measures of ethnic homogeneity and civic norms showed respectively a high and moderate score of the Netherlands in an international perspective, but both measures appeared to be highly questionable.

The last element we considered was *religion*. The Netherlands are one of the most secularised countries in the world in terms of belonging to a church and regularly attending religious services. However, more than 40 percent of the Dutch still belong to a church and more than 35 percent regularly attends religious services. That is a considerable part of the Dutch population.

The trend is negative, however. Church membership and the attendance of religious services have substantially decreased over the period 1958-1999. Remarkably, during the 1990s there seemed to be an increase in the proportion of the Dutch people who believe in an afterlife, in heaven, in hell, and in miracles. This is an indication of a possible recovery of the moral element of religiosity, but the decline in the structural element weighs heavier, because the positive external effects of religiosity are mostly associated with attendance and active membership.

The general relations between religiosity and other forms of social capital also apply to the Netherlands, with the exception of one remarkable finding. The only deviant result, in comparison with other countries, is that Dutch Protestants have a smaller tendency to trust than Catholics and non-religious people. Its cause does not seem to lie in the high trust of Dutch Catholics, but more in the relatively low trusting attitude of the Dutch Protestants. This is probably related to the existence of a few orthodox Protestant groups in the Netherlands, of which the members share a lot of bonding but somewhat less bridging social capital.

We conclude that the Netherlands are a leading country with regard to social capital. This may be one of the main reasons that the Netherlands belong, together with the Nordic countries and Switzerland, to the group of the happiest people in the world (Bjørnskov 2003).

2.6.3 Final remarks

In this chapter, we tried to measure and understand social capital. We only looked at three elements and one related issue (religion). Nevertheless, it took us 70 pages to get a basic understanding of how these elements are related to economic performance, how they are related to each other, and how they relate to the concept social capital. Still, this is a very modest approach. For example in the field of networks, we largely disregarded several forms of network activity that have become more important recently (e.g. work related contacts) or that are relatively new (e.g. Internet based contacts). And there are many more ways to empirically investigate social capital. Putnam (1993) used 17 indicators for civiness and 33 for institutional performance. Before the real boom in social capital research occurred, Grootaert (1998) already published a list of 51 different indicators of social capital that had been used in empirical studies. The World Bank now proposes a questionnaire that consists of 95 questions to measure social capital (Grootaert et al. 2004).

We do not think that it is fruitful to add more and more features to social capital. The causal arrows among trust, networks, and norms are already “tangled as well-tossed spaghetti” and adding more components only aggravates the confusion about which components are part of social capital, and which components are “epiphenomenal, arising as a result of social capital but not constituting social capital itself” (Fukuyama 2001: 7). We agree with Dasgupta (1999: 327) that the research on social capital is in danger of trying to “amalgamate incommensurable objects”. Of course, that is also why we did not try to construct an overall index of social capital in the Netherlands, but used a range of indicators in order to get a feeling about the Dutch level of social capital.

The two most important conclusions that emerge from our exploration of social capital are, first, that trust seems to be the most plausible link between social capital and economic

performance, although even this link is not completely unambiguous; and, second, that the ‘structural element’ of social capital, i.e. the personal contacts in network structures, has a beneficial influence on the creation of trust. This confirms our intuition that trust is an important lubricant of economic co-operation and that human interaction in social networks is the key to the explanation of the creation of trust. We deepen these issues in the next chapters.

2.7 Data sources

Rabier, J.R.

Commission of the European Communities * Brussels, Belgium
Eurobarometer 06 1976 [computer file]
Amsterdam, Steinmetz-archieff (P0365)

Rabier, J.R.

Commission of the European Communities * Brussels, Belgium
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Amsterdam, Steinmetz-archieff (P0385)

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Commission of the European Communities * Brussels, Belgium
Eurobarometer 25 1986 [computer file]
Amsterdam, Steinmetz-archieff (P0863)

Reif, K.

Melich, A.

Commission of the European Communities * Brussels, Belgium
Eurobarometer 33 1990 [computer file]
Amsterdam, Steinmetz-archieff (P1029)

Reif, K.

Melich, A.

Commission of the European Communities * Brussels, Belgium
Eurobarometer 39.0 1993 [computer file]
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Eurobarometer 41.1 1994 [computer file]
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Melich, A.

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Eurobarometer 46.0 1996 [computer file]
Amsterdam, Steinmetz-archieff (P1337)

Inglehart, Ronald, et al.

World Values Surveys 1990-1993 and 1995-1997 [computer file]
Amsterdam, Steinmetz-archieff

Chapter 3

Trust – a typology

Trust is a complex and slippery notion.
Nootboom (2002: 1)

3.1 Introduction

The economic and social sciences use trust as an object of analysis for describing and explaining a wide range of inter-human relations and interactions.¹ See for example chapter 6 of this thesis which argues that trust forms an important ingredient for international trade, because it lowers of transaction costs between (potential) transaction partners. In this type of research, trust is regarded as an independent variable that is capable of explaining, for example, part of the bilateral trade flows. However, trust can also be regarded as a product of interactions and relations between the traders. In this meaning, trust is a dependent variable that is itself a resultant of diverse effects and circumstances.

This chapter aims to deepen the concept of trust by sketching a picture of the complex influences that surround the emergence and maintenance of trust. We start with an overview of the mechanisms that play a role in the creation of trust. We define these ‘trust mechanisms’ as the frequently appearing causal patterns that form a plausible explanation for the creation and continuance of trust in contingent bilateral and collective inter-human relationships (cf. Hemerijck 2002). The search for and classification of trust mechanisms are problematic, because of the huge diversity of views that exist on this topic in the scientific literature (Levi and Braithwaite 1998). These differences in opinion have led to an enormous expansion of overlapping and contrasting definitions and aspects of trust. Although most of these studies are valuable in themselves, they only form single pieces of the complete puzzle that pictures the creation of trust. Selecting the relevant pieces of the puzzle and defining their interrelationships are crucial to obtain a more sophisticated view on the factors that influence the creation of trust in various situations and relations. In order to address this problem, this chapter develops a trust typology that pays attention to the various influences on the creation of trust and the corresponding trust mechanisms. This typology makes it possible to deconstruct the empirical factors in a balanced way, such as to provide a coherent explanation for the way in which trust develops in specific situations or relations. While constructing this typology, we use the following questions as a guideline. Which trust mechanisms are distinguished in the trust literature? What is the connection between these mechanisms?

We use a multi-disciplinary approach to answer these questions, in which we make use of insights from the scientific disciplines of economics, business administration, (social)

¹ This chapter is largely based on Mosch and Verhoeven (2003a). Some ideas have been published before in Mosch and Verhoeven (2003b).

psychology, sociology and political sciences. International trade practices function as an empirical point of reference. Nevertheless, we formulate the concepts in such a way that they are also applicable to other types of interactions and relations. Our approach fits in the tradition of Karl Polanyi, who states that all types of relations constitute each other (see Krippner 2001), and is further inspired by Nooteboom (2002), who distinguishes trust in its sources and process aspects.

Finally, this mainly theoretical exercise results in a proposal for a contingency approach of trust mechanisms, which combines the individual and institutional dimensions responsible for trust creation. This contingency approach constitutes an analytical framework that provides a more complete insight in the creation and maintenance of trust in various situations and relationships.

The set-up of this chapter is the following. In section 2 we present an overview of the single pieces of the puzzle by ordering the most important perspectives of the various scientific disciplines and the therein distinguished trust mechanisms. We combine these perspectives in a trust typology, in which we show the relations between the various trust mechanisms with use of empirical results, in section 3. This forms the basis for our contingency approach of trust, which is presented in section 4.

3.2 *Four perspectives on trust mechanisms*

3.2.1 Definition of trust

Most of the definitions given in the literature relate trust to the expectation of the future behaviour of others. Sobel (2002: 148) defines trust as “the willingness to permit the decisions of others to influence your welfare”. We use his definition as a point of departure. Especially the element of uncertainty is important in this definition. There will only be a willingness to let other people influence your welfare, when there is the expectation that these other people will not harm your welfare. However, the behaviour of other people in the future is inherently uncertain. When people place trust in other people, they act like they know the future. Trust thus transforms uncertainty in risk (Luhmann 1979). Trustors take the risks that accompany the unpredictable behaviour of other people for granted. This risk is two-sided: the ‘bet’ can have a negative and a positive payoff. Trust situations are characterised by the fact that trust that is responded by trustworthiness generates a higher payoff than not placing trust at all: a positive risk. Abused trust, however, causes a loss that is larger than the profits generated by responded trust: a negative risk. So, to take the bet to trust another person means that one accepts the vulnerability to the possible opportunistic behaviour of other people.

In relations between individuals, trust can be schematised as: A trusts B to do X (cf. Blackburn 1998, Hardin 1998, Levi 1998, Harré 1999, Sztompka 1999). In most cases, trust is not ‘general’ but related to a certain X. Because X is varying, trust has to be regarded as something relative. For example, an Indian data administrator (B) is for example trusted by a Dutch clerical office (A) to process a certain amount of data in time and with a certain consistence (X_1), but is not trusted to guide the office’s initial public offering (X_2) and is also not trusted to administer the bank account (X_3). It is also possible that A trusts B irrespective of a specific X. If A and B know each other very well, we can expect that A will trust his friend B in a variety of situations ($X_1 - X_n$). Finally, A can trust B in all situations X, for example when he thinks that B, who might be a guru, acts in complete wisdom (Blackburn 1998). So, the extent and character of trust are determined by the actors and their mutual expectations and obligations in a specific context. Essential in this context are the intentions

and competencies of the persons involved and the external conditions in which they are formed (cf. Nooteboom 2002).

Competencies – and the corresponding ‘competence trust’ – refer to the skills or capabilities of the actors to keep their promises. In the example of above, B might be specialised in data processing (X_1), but has no experience with investment banking (X_2). Intentional trust refers to the intentions or good will of the actors to keep the promise. B might be capable of administering the bank account (X_3), but A would be wise not to set the fox to watch the geese. To behave according to the agreement (keeping your promises) is the least one can expect from a trusted partner. Trust often goes further than that. It is not only the letter but also the spirit of the agreement that counts in the co-operation. Lyons and Mehta (1997) distinguish between two types of behavioural risk. The first type is the contractual risk: the risk that the contract will be breached. The second type is the goodwill risk. This is the risk that the contract partner will only act in his own interest, instead of acting in the common interest of both parties, in the occurrence of unanticipated circumstances. There is no breach of contract in this case, because the relevant developments were not, *ex ante*, foreseen in the contract. In the words of Elster (1989: 275), goodwill trust indicates that “people may feel bound by the agreement they would have reached had the unanticipated development been foreseen”.

Both competencies and intentions are factors that mainly play a role with regard to the emergence of trust at the bilateral level between individuals. Both elements, however, are influenced by external conditions which apply to the specific context of acting. We can think of the formal and informal institutions that limit the (uncertain) behaviour, but also of (unexpected) developments that might occur. Therefore, the competencies and intentions of the actors have to be analysed together with the external conditions in which they operate.

It is unusual for people to trust someone without proper reason. In order to get more certainty about someone’s competencies and intentions, people form expectations about the trustworthiness of the other party. In general, trust only emerges, when the trustworthiness of the other party is considered to be positive. According to Sztompka (1999), trustworthiness can be distinguished in primary and secondary elements that are connected with personal and contextual factors (also see WRR 2003a). With regard to personal factors (primary trustworthiness in Sztompka’s terminology), three indicators are important, namely reputation, performance and appearance. Reputation refers to known past performances, based on consistent behaviour. Performance refers to the acts themselves, the current behaviour and their results. Appearance relates to personality, identity and status. With regard to the secondary factors (secondary trustworthiness), it is the information flow from the external environment about the person or organisation that counts. In this respect we look at indicators in the fields of accountability, pre-commitment and trust-inducing situations. Accountability means that trustworthiness can be enforced, for example by organisations that monitor the behaviour of people and punish them in the case of opportunistic behaviour, such as consumer protection agencies, the police, stock exchange commissions, the ombudsman, the courts *et cetera*. Pre-commitment refers to the situation that an actor changes the context of his behaviour in the sense that he willingly decreases his options for opportunistic behaviour, thus increasing the credibility of his trustworthiness. With regard to trust-inducing situations, we can think of small communities in which people personally know each other and in which people also know whom to trust or distrust.

The definition of trust, the reasoning about competencies, intentions, external conditions and the different aspects of trustworthiness only provide a general insight in the ways how trust

develops and how trust relations function. In order to gain a deeper insight, we search the literature for the most important trust mechanisms that have been distinguished in the various scientific disciplines. We do this in the next section by looking at trust from a rational choice perspective, a relational perspective, an institutional perspective and a social-cultural perspective.

3.2.2 The rational choice perspective on trust mechanisms

As mentioned above, trust means that one accepts the risks involved with the unpredictability of the future behaviour of others. The rational choice perspective enables us to model the interactions between (economic) actors, whose interests are partly conflicting and partly corresponding, with help of game theory. According to this perspective, trust is determined by instrumental rational behaviour and is described as ‘calculative’ (Williamson 1985) or ‘self-interested’ (Lyons and Mehta 1997) trust. Trust is the carefully calculated answer to behavioural risks in (economic) transactions. The potential profits and losses of trustworthiness and trust are assumed to be measurable and are compared with each other within the limits of the relation or of the game. In game theoretical terms, trust can only exist when it is the Nash equilibrium outcome – the outcome that results from a combination of actor strategies such that no actor can obtain a higher payoff by changing to another strategy under the assumption that the other actors do not change their strategies (Nash 1951). The economic actors only have an eye for the outcomes of the game, not for how they have arrived there. Therefore, this kind of trust is inherently future oriented. Actors are only trusting or trustworthy when they expect that this behaviour will bring them direct economic payoffs in the future.

Coleman (1990) presents a model of how actors make their calculations about whether they should place trust or not. First, the actors need knowledge about the chance p that the other is trustworthy, the profit G that results when trust is rewarded and the loss L that results when the other behaves opportunistically. An actor will place trust if the expected outcome of this strategy is positive: $p * G > (1-p) * L$; with $0 \leq p \leq 1$. In short, an actor will be more trusting, the more the other party is considered to be trustworthy, the higher the potential profits and the lower the potential loss.

The question that arises with regard to this analysis of Coleman is how one can determine the chance that the other party is trustworthy. In order to answer this question, we have to analyse the situation more carefully. In rational choice inspired analyses, the situation is often portrayed as a co-ordination problem of the prisoners’ dilemma type. See Figure 3.2.1 for such a situation, in which {a, b, c, d} denote the payoffs of the behavioural options of actors A and B.

Figure 3.2.1. Prisoners’ dilemma

	Trustworthy / co-operation	Untrustworthy / defection
Trustworthy / co-operation	b, b (2, 2)	d, a (-1, 3)
Untrustworthy / defection	a, d (3, -1)	c, c (1, 1)

A prisoners’ dilemma is characterised by a payoff scheme in which $(a > b > c > d)$ and $(a + d < 2b)$. For clarification, we added a numerical example in the figure. If A and B do not cheat on each other, but act co-operatively, both earn 2. A could deceive B, for example by doing an advance payment, but not paying the rest of the agreed transaction sum after B has delivered his job. This would mean extra profits for A (3) but a loss for B (-1). B could cheat

on A by fiddling with the quality of his work. When both behave non-co-operatively at the same time, both receive a minor gain. The Nash equilibrium is the bottom-right situation with both actors defecting, which is a sub-optimal societal solution in comparison with the Pareto optimal top-left solution, in which both actors choose the trustworthy strategy. However, from an individual perspective, the strategy of defection is strictly dominating the strategy of co-operation, independent of what the other player does. This involves that the chance p that the other player will behave trustworthily is 0. In this single play situation with rational choice behaviour, trust will never emerge. If an actor ever chooses to place trust, he will be exploited by the other actor and will receive a negative payoff.

Thus, in the rational choice perspective on trust, the trustworthiness p of the other actor is the central theme. This trustworthiness is determined by the calculation of whether it is profitable for the actor to behave trustworthily. When the dominant strategy is defection, the perceived trustworthiness is 0. When the dominant strategy involves co-operation, there is no social dilemma such as in Figure 3.2.1. Trustworthy, co-operative behaviour then generates higher payoffs than untrustworthy behaviour; in terms of Figure 3.2.1: $b > \{a, c, d\}$. Without social dilemma or co-ordination problem there is of course also no trust problem ($p = 1$). This is the argument of Williamson (1993), who states that trust is a concept that is useless for economic analysis. Problematic about this approach, however, is that the ‘bet’ and uncertainty that are at the foundations of trust seem to lack in this situation. We think that this one hundred percent certainty is an illusion. The outcomes of the games are still dependent on the free will of the actors, which is inherently uncertain (Nooteboom 2002), and the circumstances of the game may change rapidly and unexpectedly.

The actor may also deliberately try to change the game in such a way that trustworthy behaviour becomes more credible. For example, actors may use hostages or offer guarantees. When these hostages are valuable enough, they form credible incentives to prevent opportunistic behaviour. This could, however, set in motion a string of new trust problems. The hostage taker might appreciate the hostage so much, that he refrains from returning it although the hostage giver has fulfilled his part of the agreement. This second trust problem can be mitigated by choosing a hostage that is valuable for the hostage giver but not for the hostage taker. An example is a hostage that has a high emotional value to the hostage giver, but a low material value. Instead of using (self-imposed) sanctions to deter untrustworthy behaviour (with help of hostages, guarantees and sureties), it is also possible to use rewards for trustworthy behaviour (bonuses). Both sanctions and rewards enhance the credibility of the actors to behave co-operatively in the future. They are examples of performance mechanisms that foster trustworthiness.

Another method of increasing trust is by allowing external parties to influence the payoffs. An intermediary can take away the individual risks, by providing security, by performing independent checks on quality and progress of the work (e.g. certification, hallmarks) or by facilitating payment and delivery (e.g. letters of credit). These examples are forms of pre-commitment mechanisms. A part of the freedom to act is voluntarily transferred to an external identity in order to enhance the trustworthiness of one’s behaviour. This solution implies the emergence of a new trust problem: the usefulness of this solution is completely dependent on the trustworthiness of the intermediary. A second form of pre-commitment considers specific investments. Specific investments are investments that are only valuable in a specific relationship and thus form an incentive to continue that relationship. When actors make specific investments, they lock themselves in the relationship, because these investments raise their switching costs (see also Axelrod 1984).

When the game is repeated, both parties gain more from co-ordinating on the high equilibrium (with payoff 2) instead of on the low equilibrium (with payoff 1). This Pareto optimal solution can be ‘enforced’ when both parties can credibly communicate that they will follow the trigger strategy known as the grim norm. The grim norm implies that co-operative behaviour is reciprocated by co-operative behaviour, but that untrustworthy behaviour of the other actor will lead to a definitive fallback in the suboptimal Nash-equilibrium. This strategy is a credible enforcer of trustworthy behaviour when the total payoffs of continuously staying in the high equilibrium are higher than the one-time high payoff of cheating followed by the continuous payoffs of the low equilibrium. A prerequisite is that the game must be played an infinite or an unknown number of times (Folk Theorem). Otherwise it would always be beneficial to cheat in the last round, and knowing that the other party will cheat in the last round, it is always beneficial to cheat in the round before, and so forth, back to the first round.

A small calculation example may illustrate the point. Given that time is not discounted, that there is a constant chance δ that the transaction will be repeated and that both parties follow the grim norm strategy, trust will develop as long as δ is at least $\frac{1}{2}$.² If the chance of repeated business is lower than half, then the short term profit of opportunism more than compensates the expected value of future losses. So, as long as the future is valuable enough, repetition allows for the emergence of ‘rational choice-trust. Note that both parties do not get fooled about the true motives of the other. Both know that the other is only motivated by his self-interest. However, this does not hinder the mutual trust that the other will keep his promises. In this situation, the reputation mechanism is responsible for the emergence of trust, even though it only reflects on the behaviour in the previous round and in a bilateral sphere. The mechanism of this ‘known past performance’ is still powerful enough to generate trust through the connected promise of high rewards and the threat of low payoffs.

We see that the rational choice perspective provides a clear framework that explains when and how trust is created. Performances (hostage, bail, and bonus), pre-commitment via intermediaries (certification, hallmarks, and letters of credit) or specific investments, and reputations (in repeated plays) are the active trust mechanisms. Nevertheless, the application and validity of this perspective are confronted with two problems. The first problem is that it only deals with contractual risks and not with goodwill risks. The analysed trust mechanisms make sure that parties can mutually trust each other to keep their promises (contractual risk), but are irrelevant for intentional trust that goes further than stated agreements (goodwill risk). The rational choice perspective thus sheds no light on a considerable part of trust problems.

The second problem is that the rational choice approach assumes that trust problems can be solved by collecting evidence on the trustworthiness of the other party. This assumption is not plausible. If evidence could solve the trust problem in co-ordination dilemmas, this would imply that there would be no trust problem at all (Gambetta 1988). The problems surrounding the collection of ‘waterproof’ evidence are the following:

“(a) People are imperfectly informed, both about other people’s preferences and about their assessment of probabilities; (b) Limitation (a) itself may be imperfectly understood; (c) The acquisition of such knowledge may be variously impossible, expensive, and so on. One particular difficulty is that any actual process of inquiry may itself change preferences, destroy information, raise more questions, and generally confuse the issue; (d) There is a very significant limit, for social as well as

² The payoffs in our example of continuously co-operative behaviour are: $\pi_{\text{co-operative}} = 2 + \delta 2 + \delta^2 2 \dots = 2/(1 - \delta)$; the payoffs of untrustworthy behaviour after which co-operation definitely ends are: $\pi_{\text{non-co-operative}} = 3 + \delta 1 + \delta^2 1 \dots = 2 + 1/(1 - \delta)$. $\pi_{\text{co-operative}} > \pi_{\text{non-co-operative}}$ then and only then when $\delta > \frac{1}{2}$.

cognitive reasons, on the recursive complexity of possible calculations” (Williams 1988: 4-5).

In other words, the information about the trustworthiness of another party is in general far from complete. People have to cope with incomplete information, fundamental uncertainty and bounded rationality.³ This implies that the evidence of trustworthiness of another party is also incomplete, which means that the calculations, as proposed by Coleman, are hard to realise in practice. The holes in the available information form an indication that trust is not solely based on ‘hard’ evidence about somebody’s trustworthiness. Other factors are also involved. Explanations based on the rational choice perspective therefore are not sufficient to receive a full understanding of trust problems.

3.2.3 The relational perspective on trust mechanisms

The problems of incomplete information, fundamental uncertainty and bounded rationality are less troublesome, if we consider them from a relational perspective. In mutual relationships people develop a wide diversity of trust mechanisms that meet these problems. The main focus of the relational perspective lies on people’s personalities and identifications with other people (Sztompka 1999). In this section, we first examine the personal inclination to trust, thereafter we look at identifications with other people.

The personal inclination to trust (basic trust)

As we saw in the previous section, problems of fundamental uncertainty appear in all transaction situations. Still people find ways to deal with them. How people actually handle these problems depends on the specific person and is related to his personality structure. A dominant factor is what the sociologist Giddens (1991) calls ‘ontological security’, a general feeling of how one fares in life. The feeling of ontological security is closely associated with the natural inclination to trust, which is called “basic trust” (Giddens 1991), “capacity for trust” (Hardin 1993), “trusting impulse” (Sztompka 1999), “propensity to trust” (Mayer, Davis and Schoorman 1995) or “innate sociability” (Fukuyama 1995). According to Giddens, the inclination to trust is formed in the subconscious of people in their early childhoods, when they develop an emotional-cognitive orientation to other individuals, their environment, and their self-image. This orientation functions as a mechanism of protection against risks and dangers in interactions (Giddens 1991). The early experiences with placing and receiving trust determine the extent to which a person develops a personal inclination to trust. The level of ‘basic trust’ plausibly strongly differs between individuals. People have different childhood experiences, and therefore some people are better capable of handling uncertainties and placing trust than others. Although the level of basic trust may strongly vary between individuals, it forms an important trust facilitating mechanism in situations of incomplete information and bounded rationality.

Identification with other people

When actors are considering the possibility to start a co-operative relationship with each other, we may assume that they dispose of a certain ‘stock’ of basic trust and that they are, therefore, used to manage uncertainty to a certain extent. It is possible that they negotiate an agreement with each other, just on this basis of basic trust, even though they do not know each other very well. Especially the problem of incomplete information is pregnant in the case

³ Furthermore, Nooteboom (2002: 99) points at problems of language interpretation which he calls the ‘inscrutability of reference’, following Quine (1960).

of a first transaction. Both actors lack the information to make a one hundred percent waterproof estimation of the other's trustworthiness. Several psychological mechanisms have been suggested in the social-psychological literature of how people deal with this problem. One of the most well-known is the 'satisficing' mechanism, which is the psychological mechanism in which people collect and process information until a certain level of aspiration is satisfied (Simon 1986).

Another proposed solution for the problem of incomplete information is that the actors trust each other at the basis of their personal 'trust heuristic'. A trust heuristic is a series of attitudes that enables people to deal with trust problems (Scholz 1998). These attitudes form a constructed summary of information about trustworthiness and trust in more or less comparable situations. Actor A has, for example, done business with Indian business partners before and has collected positive memories about these experiences. A has kept a 'diary' in his subconsciousness in which he reported the averages of the relevant information about these experiences. These averages now direct his attitudes about trust in other Indian business partners. This positive trust heuristic enables A to negotiate an agreement with the Indian businessman B.

This idea of summarising attitudes is closely connected to Blackburn's (1998) idea of 'typecasting'. Typecasting refers to a trust mechanism that classifies people on the basis of what they are doing and how well they are doing this. Again, information is reduced by classifying, which eases the placing of trust. People avoid the problems of incomplete information and bounded rationality when entering a new relation by developing a trust heuristic or with use of typecasting. Both mechanisms can be considered to be specifications of the satisficing mechanism, because both mechanisms lead to a reduction of the aspired level of information.

When the first transaction between two actors encounters no problems, it is plausible that they enter into more transactions and that they build a co-operative relationship. In this way, the actors get to know each other better and better. As a consequence they develop mutual identifications and mutual social bonds. This means that they identify with each other's needs, and that they think and act in the common interest instead of in their individual interests. A situation of mutual identification enables the actors to trust each other on the basis of 'habituation', which diminishes the problem of incomplete information. This routine induced trusting behaviour forms a rational solution for the problem of bounded rationality (Nooteboom 2002, Schlicht 1998). Routinised behaviour allows people to concentrate their restricted brain capacity to developments that have a high priority. According to Nooteboom (2002), trust becomes a 'default'. The actors will assume trustworthiness and will continue placing trust (and expecting trustworthiness), until the opposite is proven. The reasoning behind this is that trust is connected to certain tolerance limits for deviant behaviour. This tolerance mechanism eases the mutual rules of behaviour, because small deviations are tolerated and are not immediately interpreted as a breach of trust. This routine character of trusting disappears however, when the tolerance limits are crossed. From that moment on, the attention of the actors on formal control criteria and available information is reactivated, because deviant behaviour outside the limits needs correction. As a consequence the tolerance limits are narrowed, because the actors will judge the minimal criteria for (perceived) trustworthiness more strictly, or because they will lower the perceived limit of maximal trustworthiness of the other person (Nooteboom 2002).

When the actors mutually co-operate for a longer time, the personal relation becomes closer and the actors develop mutual identifications. The social-psychological research of Tyler (1998) shows, that strong identification and social bonds between actors contribute to the

situation that these persons start to judge the trustworthiness of the other in terms of benevolence and goodness.⁴ Do the actors take care of each other's interests? Do they have an open ear for each other's arguments? Are they fair to each other? This type of considerations only involves, in principle, personal motivations, which are unrelated to the rational choice calculations of risks. The continuance of the mutual trust is determined by the social and emotional relationship, in which obligations and convictions with an ethical and moral character have a central place. Trustworthy behaviour is related to informal rules and codes of benevolence and goodness, and the corresponding tolerance limits for deviant behaviour. In this situation, we can speak of a mechanism of informalisation, because the formal criteria of trustworthiness and the related problems of incomplete information, fundamental uncertainty and bounded rationality disappear in the background.

At the moment that the informal criteria of trustworthiness start to dominate the economic co-operation between the actors, the danger of 'blind trust' is looming (Williamson 1993). If actor A is strongly convinced of the goodwill of actor B, he might ignore strong deviations from the informal rules and codes by B. This implies that A's perception of reality is being distorted. A concrete example of a distortion mechanism is cognitive dissonance. Cognitive dissonance is an unpleasant feeling that arises because you are aware of inconsistencies in the things you believe and/or do (see e.g. Smith and Mackie 1995). A usual reaction is to try and reduce this dissonance by reasoning away the inconsistencies. For example, actor A notices flaws in actor B's work, which dissonates with his belief that B is a trustworthy business partner. A concludes that he gave unclear instructions to B of how to do the job. The emotional tie hinders A in acknowledging B's untrustworthiness (cf. Nooteboom 2002).

Conclusion

Economic relationships are embedded in social relationships. It is therefore necessary to study the social bonds and the related informal rules and codes in order to get a better understanding of trust relationships. An important prerequisite for the emergence of trust is the level of basic trust of the persons involved. Mechanisms of satisficing, such as the use of trust heuristics and typecasting, form a social-psychological answer to the problems of incomplete information and bounded rationality at the start of new co-operative relationships. When the relation develops and repeated interactions have taken place, these problems are dealt with by considering trust as a default within certain limits for behaviour (tolerance mechanisms). The emergence of strong identifications and social bonds between transaction partners creates space for informal aspects of trustworthiness, which are related to goodwill and goodness (informalisation mechanisms). These 'soft' criteria can be as effective as formal performance criteria, but allow for less 'hard' information in the control procedure. However, when the sustenance of trust is exclusively tied to these informal criteria, the danger of blind trust appears, for example as a result of cognitive dissonance (distortion mechanism).

The relational perspective and the rational choice perspective on trust relationships provide insight in the creation and maintenance of trust between individuals. Both perspectives are focused to the intentions and competencies of the *individual* actors. We now turn to the perspectives which take care of the external conditions that influence the emergence of trust.

⁴ This can also be related to the idea of "framing", see e.g. Lindenberg 1988, 2000. Some entities are in the foreground (in the "frame") and others are in the background of people's attention. This leads to a selectivity of information processing. Most attention is paid to events in the foreground, and information is analysed in terms of what is in the foreground. During the development of a relationship, the appropriate frame might change from a "loss frame" or a "gain frame" – in which the goal is to avert losses and subtract a gain, implying strict formal monitoring and instrumental reasoning – to a "normative frame" – in which the goal is to act appropriately, implying mutual goodwill (Lindenberg 2000).

First, we examine the institutional perspective, thereafter we pay attention to the social-cultural perspective.

3.2.4 The institutional perspective on trust mechanisms

The institutional perspective on trust points at the importance of organisations and rules that ease the emergence and continuance of trust in individual relations. The legal system of a country is the best-known example, but networks have the same function.

Legal system

The legal system forms a standard solution to trust problems between business partners. The solution works in both a direct and an indirect way. The indirect way refers to the way in which the questions of corporate governance and bankruptcy are solved by legislation and jurisprudence. Well-developed legislation on corporate governance contributes to the trustworthy and transparent accounting by the management of its policies and actions to the shareholders, the employees, and the other stakeholders. This reduces the probability of mismanagement, fraud, and opportunistic behaviour by the management. Legislation on bankruptcy should prescribe clear procedures of what to do when firms run into insolvency problems. This reduces the vulnerability of creditors and business partners.

The direct way in which the legal system mitigates trust problems is that it functions as a framework that enables parties to write down their agreements in official contracts and to enforce these contracts through legal procedures. The legal system generates incentives for parties to uphold the contract in the form of fines, recognizances and imprisonment. A well-functioning legal system refers to the ‘accountability’ of Sztompka’s (1999) trilogy of secondary trustworthiness.

We use the word ‘confidence’ instead of ‘trust’ with regard to the legal system (Luhmann 1988). We prefer to speak of ‘trust’ when we talk about the horizontal relationships between individuals or organisations. When the relationship is vertical, for example between an individual and a governmental institution, we speak of ‘confidence’. ‘Trust’ and ‘confidence’ are related to Sztompka’s (1999) use of the terms ‘primary trust’ and ‘secondary trust’. In principle, a higher ‘vertical’ confidence in the functioning of institution leads to a higher ‘horizontal’ trust in other individuals. The interaction between ‘trust in individuals’ and ‘confidence in institutions’ has a paradoxical character. Both in the situation that the confidence in the legal institutions is strong and in the situation that it is weak, people will refrain from using it. If the legal apparatus is weakly developed, e.g. legal procedures cost a lot of time and money while the verdict is arbitrary and unpredictable, people refrain from bringing cases to court, because they do not *want* use it. If it works very efficiently, nobody *has* to use it, because of the deterrent effect on potential contract breachers. If the legal system works moderately fine, e.g. legal procedures are expensive but lead to righteous outcomes, only disputes with large financial consequences will be brought to court.

One might feel tempted to argue that the institutional perspective has an eye for contractual risks only and neglects goodwill risks, just like the rational choice perspective does. This is not true. A well-functioning legal system may have an internal focus on guarding against contractual risks, but this does not rule out the possibility that legal systems also protect against goodwill risks. This depends on the specific character of the legal system. The Anglo-Saxon type of legal systems is based on the premise of contractual freedom and, therefore, protects mainly against contractual risks. The German type of legal systems (the legal systems in e.g. Germany, Austria, and the Netherlands belong to this type) takes care of general rules

of conduct, like ‘good faith’ or ‘reasonableness and fairness’, which always apply independent of the contractual agreements (cf. Bachmann 2001). These general rules of conduct offer the judge the possibility to modify the contractual obligations and even to ignore ‘unreasonable and unfair’ contractual agreements.

However, solving trust problems by means of formal contracting is not without practical problems. This solution works best, when parties write down complete and legally binding contracts. This is impossible to achieve. Incomplete information and bounded rationality lead to inherently incomplete contracts. Moreover, legal procedures tend to be expensive and protracted, while the verdict of the court is troubled by verification problems. Although the involved parties may be able to determine whether a certain transaction has taken place according to the agreement, this verification is not possible for external parties, like judges, because they lack the necessary insider knowledge and tacit information.

If the legal dispute has an international character, the problems multiply. Language problems, unfamiliarity with the foreign legal system, overlapping rules and holes between the two legal systems, endless legal procedures, and the potential prejudice of the judge against foreigners hinder an efficient handling of the case. This is corroborated by our findings presented in chapter 6, which show that the volume of bilateral trade between countries with a similar type of legal system is about 50 percent higher than between countries with a different type of legal system. Apparently, similarity of legal systems is an important mitigator of trust problems.

These practical problems involved with legal procedures raise questions about the relevance of legal contracting as a trust mechanism. There is even a strand of research in the literature that has clear doubts about the importance of legal systems. These doubts are confirmed by research that indicates that business relations are merely influenced by juridical rules and that contracts play a marginal role in daily business life (Macaulay 1963, Beale and Dugdale 1975). We leave the discussion about the question whether formal rules are necessary for trust or whether they are responsible for its disappearance to section 3 of this chapter, in which we put the substitution and complementary approach against each other. Here we conclude with the remark, that a well-functioning legal system is important to generate trust between the parties in the early stages of their relationship. This role diminishes however when parties get to know each other and other (informal) trust aspects will play an increasing role.

Networks

A second field of attention of the institutional perspective relates to networks. A network is a group of connected people and/or organisations. Networks contribute to the creation of trust by enhancing the effects of the reputation mechanism. In section 2 about the rational choice perspective, we already mentioned the grim norm. Trustworthy behaviour is responded by trustworthy behaviour, but a one-off act of untrustworthy behaviour leads to a definitive breakdown of co-operation. This threat can be strong enough to deter opportunism. Trustworthy behaviour in the past thus forms an economic value for the future. It is an incentive to build a reputation of trustworthiness and to be careful not to spoil it by non-co-operative behaviour.

Networks make the reputation mechanism even more important than in bilateral situations. Buskens (1999) distinguishes two types of effects on the behaviour of the trustor, learning and control. “Learning indicates the extent to which a trustor can modify her expectations about characteristics of a trustee from observing his behaviour in past transactions. Control indicates the extent to which the trustor can influence the trustee’s behavior via sanctions anticipated by the trustee” (Buskens, 1999: 11). The trustees might, for example, consider applying the grim

norm in dealing with untrustworthy actors. This makes a good reputation very valuable for the individual actors, because reputations spread fast through the network to all its members. A reputation of untrustworthiness decreases the willingness of other people to trade.

The reputation mechanism functions better when the frequency of interaction between the network members is higher. A common history of interactions and behaviour evolves out of sustained co-operation. Therefore, trust grows provided that the performances are good (Hirschmann 1984, Gambetta 1988). The social-psychological mechanisms that are active at the bilateral level and that we discussed in the previous section are also relevant with regard to networks. Especially in the case of dense networks, the main difference with respect to the bilateral situation lies in the scale of the effects. So, trust becomes routinised when the members of a network have gathered positive experiences while transacting with each other. As we have seen before, this is a result of the fact that people are incapable of giving their full attention to all information available (bounded rationality). As long as the performances are good during the repeated co-operation (performance and reputation mechanisms), there is no reason to distrust the other party. The 'rational' side of trusting narrows to the primary trustworthiness measured by performance (tolerance mechanisms). This is a sustainable solution, because the co-operation partners develop their own system of informal rules and codes about trustworthiness and trust (informalisation mechanism). Lorenz (1988) provides empirical evidence for the claim that norms emerge between business partners. These norms make clear which behaviour is acceptable and which behaviour implies a non-acceptable violation of trust. If trust is not violated, reputations of trustworthiness and personal bonds gradually develop. Trust as routine, based on informal rules and codes that determine trustworthy behaviour, starts to regulate the economic interactions.

In this context of networks, Hirschman (1970) mentions the functions between 'voice', 'exit' and 'loyalty' mechanisms in networks. Voice refers to the use of networks as a communication channel, which enables people to learn about the trustworthiness of other people (cf. 'learning' effect). Exit relates to the possibility to switch to other partners (cf. 'control' effect). Loyalty means that people do not use their exit possibilities, but use voice and stay loyal to the network, also in times of trouble. Loyalty "holds exit at bay" and enforces voice (Hirschman 1970: 82). With more possibilities for voice and exit, or learning and control effects, the network becomes more powerful in creating trust. Loyalty may be a result of this generated trust. It is the willingness to continue a relationship for its own sake, instead of only for the material benefits that may arise from it (Hemerijck 2002).

An important advantage of the voice and exit mechanisms in networks is that they enable the reputation mechanism to substitute for complete and legally binding contracts. The reputation mechanism allows for working with implicit contracts. Contrary to explicit formal contracts, implicit contracts can be based on non-verifiable information. This implies a decrease in transaction costs. The implicit contracts may be self-enforcing – they do not need external interference to be enforced – because the actors have an incentive to act in line with the contract in order not to risk their valuable reputations of trustworthiness.

In line with this, companies and political parties can be seen as 'reputation carriers'. In comparison with individuals it is more important for these organisations to have a good name, because their lifespan is (potentially) longer, because they are easier to identify due to their brand names, because they are involved in more transactions and because they are better able to transpose their reputation.

This analysis is especially relevant for trading networks, which evolve from the common goal to improve the efficiency of business transactions. However, the informal rules and codes (implicit contracts) that foster the co-operation inside networks are often a reflection of the

cultural trust norms that are active in larger communities. They form the central theme of the social-cultural perspective of the next section.

3.2.5 The social-cultural perspective on trust mechanisms

The social-cultural perspective focuses the attention on the communities in which people work, live, spend their leisure time, and grow up, and the way in which these communities contribute to the creation and maintenance of trust (cf. Putnam 1993, 2000). The term communities refers to organisations, villages, cities, but also to countries, and networks. In these communities, informal trust rules develop which are commonly shared and which are considered, by most members of the community, to be externally given (Sztompka 1999). Community based trust rules are informal cultural norms that are more widely shared than the informal rules and codes in bilateral relationships. These cultural trust norms can be seen as culture elements.

A culture element is a common influence from cultural descent that influences certain behaviour, and is the source of commands (sanctions) and possibilities (stimuli) for behaviour (Goudsblom 1960). The actual sanctioning or stimulating effect of culture elements is not easily recognisable in daily life. An explanation comes from Hofstede (2001), who states that our thinking, feeling, and acting are, for a large part, determined by values, rituals, heroes, and symbols, but these values, rituals, heroes and symbols only become meaningful by the way actual mutual behaviour is interpreted by group members. The same reasoning applies to trust norms. Every trust norm can be regarded as a culture element that originates in a past influenced by values, rituals, heroes and symbols. Together they can be seen as a trust culture that sanctions or stimulates the behaviour in a group. This argument comes close to the definition of a trust culture by Sztompka:

“Trust culture (...) is a system of rules – norms and values – regulating granting trust and meeting, returning, and reciprocating trust; in short, rules about trust and trustworthiness. Trust culture accumulates and codifies into rules those prevailing, lasting experiences with various types of trust” (Sztompka 1999: 99).

An important element of this definition is that a trust culture provides rules for both trustworthiness and trust (cf. Braithwaite 1998). This reveals an analogy with the earlier reasoning about informal criteria for trustworthiness and tolerance limits for trust that sanction or stimulate behaviour in bilateral relations. If we extend this analogy, we could expect that there are also culturally determined criteria for trustworthiness and culturally determined tolerance limits for trust. Cultural norms of trustworthiness may then refer, for example, to criteria in the fields of regularity, reasonableness, efficiency, predictability, tidiness, discipline, decency, responsibility, kindness, authenticity, fairness, righteousness, respect, caritas, generosity and other forms of unselfishness (cf. Sztompka 1999, Braithwaite 1998). The cultural tolerance limits determine the extent to which specific criteria of trustworthiness that are dominant in a community can be breached without this being followed by social sanctions. The criteria and tolerance limits function as the shared informal external behaviour regulators that are engraved in the collective memory, the social conscience, or the moral conscience of a family, group, organisation, network or country.

Where do cultural trust norms come from? The ‘production’ of cultural trust norms can be seen as a constant interaction between values, rituals and symbols and the underlying social relations that give meaning to their existence. Social relation patterns generate a specific view on the world, and such a vision legitimises and sanctions a certain way of communal life

(Thompson et al. 1990). Commonly shared values and beliefs on the one hand and social relations on the other hand form each other's essential prerequisite: they are mutually reinforcing. It is hard to determine unambiguously how trust norms are produced in these mutual relations, because it is impossible to determine a causal priority in the underlying interaction (cf. Thompson et al. 1990). However, it is possible to discern a feedback mechanism (Sztompka 1999). We take the cultural trust norms in a country as the starting point for the analysis. The cultural trust norms influence the personal attitudes to trustworthiness and the personal tolerance boundaries for trust through socialisation processes in various communities such as the family, associations, village et cetera. An adjustment process of personal experiences and attitudes among all individuals in their communities modifies the underlying values about trustworthiness and, in this way, will also modify the cultural trust norms. These adjusted norms find their way back to the personal attitudes through socialisation processes and a next circle of feedback is started. This feedback mechanism provides a general explanation for the creation of cultural trust norms. Nevertheless, not all communities dispose of a broadly shared set of cultural trust norms. Sicily may be an example of a region in which distrust rules as a result of mafia influences. So the sphere of influence and strength, i.e. the reach, of cultural trust norms may vary widely between different communities.

Fukuyama (1995) relates the reach of cultural trust norms to their production in respectively families and voluntary associations. His argument goes as follows. In countries in which the family dominates as means of association, like in Taiwan, Hong Kong, China, France and the southern regions of Italy, voluntary associations are relatively weakly developed. People have relatively little interaction with non-family members, because they focus on their family. As a consequence, these societies gather relatively little (bridging) social capital (see chapter 2) and as a consequence, cultural trust norms that exceed the family communities develop relatively slowly. In countries in which voluntary associations blossom, like in Japan, Germany and the United States, people are interacting with a much broader network of people. Through the interaction in voluntary associations, people learn to trust strangers and to reciprocate given trust (Putnam 1993). As a consequence people will also more easily place trust in other strangers, who do not have any family or associational connection with them. This linking with strangers is called bridging social capital (Putnam 2000). The logic behind this phenomenon is that individuals learn in associations that co-operation is a profitable behavioural strategy, which induces them to trust strangers in other situations, even when information is scarce (Levi 1998).

This process is enforced by cultural mechanisms originating from religion, tradition and political culture (Fukuyama 1995). These factors can, however, also lead to the opposite effect. For example, Fukuyama argues that the Chinese Confucianism and the South-Italian absolute monarchy emphasised the family as the dominant form of association to the detriment of voluntary associations. As a result, the above mentioned feedback mechanisms operated at a low level and widely shared cultural trust norms could hardly develop. This pattern is also present in developing countries (Galjart 2003). Because the people in these countries know that personal relations work best, people only place trust in relatives and friends, and distrust the intentions of other people. This leads to 'barriers of distrust', which not only restrict the development of more widely shared cultural trust norms, but also restrict the capability to co-operate with strangers. This parallels the effects of bonding social capital (Putnam 2000). Social experiments indeed show that the resistance to do business is strongly determined by cultural orientations (Buchan et al. 2002). People from individualistic cultures (like Europe or North America) have less trouble in co-operating with persons with a different cultural background than people from collectivistic cultures. The collectivistic people limit

their trust to relatives and close friends, while the individualistic people have a higher tendency to trust in general and a higher tendency to trust people with other backgrounds.

The differences in the reach of cultural trust norms show that the underlying adjustment processes have a limited strength. Moreover, wide variations exist in the extent to which trust cultures influence actual behaviour. We give two explanations for this variation.

The first explanation relates to the fact that the influence of cultural trust norms on individual behaviour is dependent on the extent to which effective social control is possible in a specific community. If there are no sanctions or stimuli involved with upholding informal norms, people feel less restricted in their behaviour. On the contrary, cultural trust norms are highly effective in the presence of strong social control and sanction mechanisms. In such a situation, cultural trust norms can be regarded as a form of ‘normative power’ on which one can count if one enters into a co-operative relationship (Galjart 2003). Untrustworthy behaviour is deterred by the threat of social sanctions like exclusion from the community. These highly effective norms are only present in dense, closed networks, such as traditional village communities or inward faced families.

A famous example are the Jewish diamond merchants in New York and Antwerp (Wechsberg 1966). Strong social control and social sanction mechanisms enable the merchants to rely for their economic co-operation on trust norms. The trading network of the Maghribi traders in the 11th century around the Mediterranean is an example of normative power in which the network compensates for the lack of well-functioning legal system (Greif 1989, 1993, 1994, 2000). Maghribi merchants seated in all harbour cities and operated like a closed network. In principle, they only did business with other network members. A remarkable feature is that they used the grim norm. If a trader cheated on another trader, he became vulnerable to a collective punishment, which often meant an attack on both his economic and social status. Another example of normative power in networks is formed by the overseas, closed Chinese trading networks (Rauch 2001). Also in these networks a kind of grim norm or normative power is functional. If a member is found guilty of cheating, the whole Chinese network refrains from doing any further business with the cheater. This way of managing co-operation is seen as much more effective than the threat of a legal procedure (see also Weidenbaum and Hughes 1996).

The second explanation for the wide variance in the influence of cultural trust norms on individual behaviour refers to the individual sensitivity for status considerations. Cultural trust norms can have a sanctioning or stimulating effect on behaviour through individual status mechanisms like feelings of pride for a certain community and the respect a person receives in a certain community (Tyler 1998). The extent to which people are guided by considerations of pride and respect influences the extent to which they conform to group rules. Pride and respect thus function as status mechanisms that also influence the extent to which a person conforms to cultural trust norms.

We have to be careful not to overstate the effect of social control on individual behaviour. Many interactions between people take place in large anonymous labour organisations, in relatively open networks and in anonymous cities in which effective social control is hardly possible.

Moreover, the above mentioned examples of closed trading networks with high social control are not exemplary for most trading networks. This type of closed networks has a major disadvantage in the sense that closure leads to rigidity. The traders have too little contact with traders from outside the network and as a result profitable business opportunities are missed. In the terminology of Putnam (2000), these closed networks lead to too much bonding social capital and to too little bridging social capital. A second danger that looms for

closed networks is that the system slackens institutional development. If the system seems to function well, there is no urgency for a change. Meanwhile, one may miss important institutional innovations. The Genovese competitors of the Maghribi trading network, for example, were used to trade with merchants who were not related to the Genovese trading network. This strategy implied a larger potential stock of business opportunities, but also induced larger trust problems, because this diminished the monitoring and controlling power of social networks. In order to mitigate this trust problem, the Genovese invented an advanced method of bookkeeping, which enabled them to monitor the behaviour of their business partners in an objective, formal way (Greif 1994). This invention enhanced their possibilities to trade with outsider merchants, but also proved to be advantageous for planning future business.

So, one has to find the optimal mix of trust mechanisms that results in an efficiently functioning network in both the short and long term. An illustration for this mix-seeking comes from Schmitz (1999). He looks at the development of trust in two industrial clusters that are based in developing countries but that export most of their products to North America and Europe. The main conclusion of this research is that trust was based, in first instance, on the social-cultural ties between the firms in the network (“ascribed trust”), but rational elements of trust (“earned trust”) became more important over time as a consequence of deliberate investments in transactions between firms. Nevertheless, this did not impede the role of social-cultural trust elements, which remained essential for maintaining the network.

3.3 A typology of the complex influences on trust

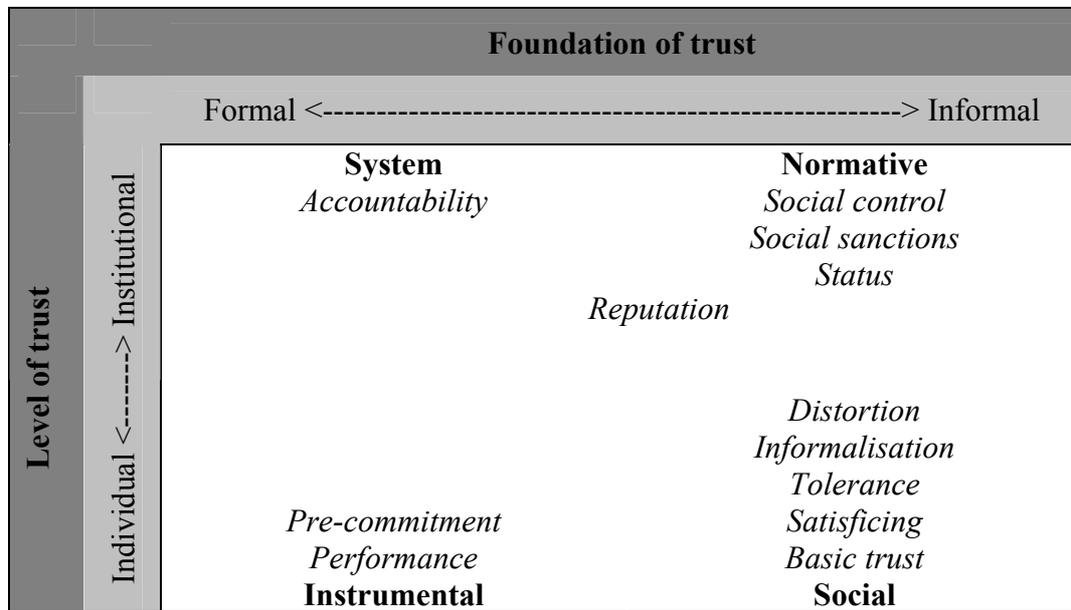
The various perspectives on trust of the previous section show that the creation of trust is a complex phenomenon in both a conceptual and an analytical sense. A picture of trust between individuals emerges as a product of relational and rational considerations, but which is not an exclusive result of complete calculation. Furthermore, the creation of trust seems to be linked to the formal and informal institutions that influence the behaviour of individuals and vice versa. In order to get a better understanding of the complexity behind these linkages, we develop a trust typology that orders the various perspectives. Further, we analyse the cohesion between the elements of this typology with use of empirical research results.

3.3.1 Influences on trust and trust mechanisms: a typology

In order to bring order in the many various factors that influence the emergence of trust, we have to work with a multidimensional trust typology that combines the various perspectives that were examined in the previous section. To work with multiple dimensions is not new. It has been used before in, for example, the business administration and organisation science literature, see Braithwaite 1998 for a short overview. Nevertheless, in most research articles we see that one dimension is used, namely the foundation of trust, which is distinguished in two aspects. This leads to conceptual trust dichotomies like for example “fragile trust” versus “resilient trust” (Ring 1997), or “calculative trust” versus “moral trust” (WRR 2003a). However, the use of this kind of dichotomies restricts the complexity about the emergence of trust too much, because it does not identify the different levels on which this process of trust creation occurs. Inspired by Nooteboom (2002) and Williams (1988), we therefore construct a typology that exists of two dimensions: the level of trust and the foundation of trust; see Figure 3.3.1. These two dimensions are, in their turn, subdivided in the individual, personal level and the institutional, suprapersonal level (cf. Cohen 1999, Nooteboom 2002), and in a formal foundation and informal foundation (see also chapter 6). By connecting the levels and foundations with each other, we create a trust typology that identifies four types of influences

on the creation of trust and their underlying trust mechanisms. These are respectively the instrumental, social, system and normative influences. Every type of influence and the corresponding trust mechanisms are related, sometimes with use of another name, to the various perspectives on trust mechanisms of section 2.

Figure 3.3.1. Typology of influences on trust and corresponding trust mechanisms^a



^a The four types of trust influences are pictured in **bold**, the trust mechanisms in *italic*.

3.3.2 The individual level

On the individual level, the emergence of trust is especially related to the intentions and competencies of individuals. It refers to the development of trust in a person and to the expectations, the personal criteria for trustworthiness and the tolerance boundaries of trust, which together influence the creation of trust. On this level, trust is a relational product that emerges out of a mix of formal and informal trust mechanisms. Both instrumental and social influences play a role in this process. We take a closer look at each of them.

Instrumental influences on trust are active on the individual level and have a formal foundation. Rational calculations give rise to expectations about gains and losses. Instrumental influences function better when there is more ‘hard’ information available about the potential consequences of placing trust in someone. The expectations about reciprocal behaviour of the other party determine the extent to which instrumental considerations influence the creation of trust. Empirical research shows that instrumental considerations form an important aspect of the personal decision making process of whom to trust (Tyler 1998, 2001). On the basis of these findings, it is plausible to assume that the instrumental trust mechanisms have a formal foundation. These can be sanction based performance mechanisms (hostage, guarantee, surety), reward based performance mechanisms (bonus), and pre-commitment mechanisms (intermediaries: certification, hallmarks, letters of credit; or specific investments), see section 2.2.

Social influences on the creation of trust are also active on the individual level, but have an informal foundation. They are especially important at the moment that individuals know each

other personally or have developed a close relationship over time. Therefore, social trust is a relational product of which empathy, love, friendship, mutual identifications and routine form the main ingredients (Putnam 1993, Patterson 1999, Nooteboom 2002). ‘Hard’ information plays no substantial role in social considerations. The research of Tyler (1998, 2001) shows that also social considerations are an undeniable aspect in the decision making process of people about whom to trust. The social influence on trust is related to informal trust mechanisms, like basic trust, satisficing (trust heuristic, typecasting), tolerance mechanisms, informalisation mechanisms and distortion mechanisms (cognitive dissonance), see section 2.3.

3.3.3 The institutional level

On the institutional level the sources of trust are more abstract than on the individual level. They do not refer to considerations about trust in a person, but, for example, about considerations about the functioning of a formal institution, like the legal system (Nooteboom 2002). If these considerations turn out to be positive, it generates confidence in the institution and its sanctioning capabilities with regard to individual behaviour. The same applies to informal institutions, like cultural trust norms. The confidence in formal and informal institutions originates from the assumption of people that other people will also rely on the corresponding norms and will behave in line with these norms. Confidence in institutions can thus be seen as an intervening variable on the individual level. With regard to this definition of confidence, we distinguish between system and normative influences on the creation of trust between individuals.

System influences on the creation of trust relate to the formal external conditions that lead people to have positive expectations about the future behaviour of other people (Luhmann 1979, Giddens 1990, Bachmann 2001). A well-functioning system of contract law and efficient enforcement by the judicial power offers additional material incentives to rationally operating actors, because they imply that a breach of contract will be followed by legal sanctions. Formal accountability mechanisms (fines, recognisance, and imprisonment) contribute to a positive expectation of the trustworthiness of business partners. Also networks are characterised by their system influences on the creation of trust, because the network-related reputation mechanisms provide a supporting, material incentive for trustworthy behaviour, see section 2.4. The reputation mechanism is placed in the centre of Figure 3.3.1, because networks are a type of structure that floats somewhere between the institutional and individual level, and that combines formal and informal trust mechanisms.

Normative influences on trust are related to cultural trust norms and the communities from which they originate. They refer to cultural norms for trustworthy behaviour and to the tolerance limits that indicate the extent to which one is allowed to deviate. Individuals see these norms as externally given. Trust emerges on the basis of shared values, norms, habitudes and identities that individuals build with each other over time as a consequence of socialisation in the family, school and other organisations in the ‘civil society’ (Putnam 1993, 2000, Cohen 1999, Fukuyama 1995). The reach of these norms may vary widely between communities, depending on, for example, the density of voluntary associations in the community. Furthermore, the reach of these norms varies, depending on the effectiveness of social control mechanisms, of social sanction mechanisms (e.g. social exclusion), and of status mechanisms (e.g. pride and respect), see section 2.5.

3.3.4 Coherence between trust mechanisms

The typology of Figure 3.3.1 can be seen as an analytical framework that combines and orders the various trust mechanisms. In practice, these mechanisms are closely interrelated. This is indicated in Figure 3.3.1 by presenting the foundations and levels of trust on continuous instead of on dichotomous scales. Thus, the analytical perspective of Figure 3.3.1 provides landmarks for further research of trust mechanisms and their mutual interactions. Below, we present several examples of concrete links between these mechanisms and we pay some attention to process aspects of the emergence of trust.

Empirical examples of the coherence between trust mechanisms

We start with the interactions between the formal and informal trust mechanisms. On the individual level, the research of Tyler (1998, 2001) about the influence of trust on respect for authority shows that considerations with both an instrumental and a social character play a role in the creation of trust between individuals. Both forms of trust are empirically distinguishable, but do not exclude each other. Tyler (2001) even concludes, on basis of his research, that an analysis of trust is not able to offer an adequate explanation of the dynamics of trust – characterised by the attitudes, motives and the behaviour of individuals with regard to authority – if it limits itself to one of both approaches. Nevertheless, the extent to which instrumental and social considerations play a role is strongly varying. Social considerations are especially relevant in existing relationships, while instrumental considerations dominate in situations with strangers (Tyler 1998).

Also on the institutional level the formal and informal influences are related to each other. Legal systems and forms of normative power appear to be closely connected to each other. The way in which legal systems are dealing with (the autonomy of) contracts determines the trust that emerges on the individual level between actors to a large extent. Substantial differences exist between the British and German legal system. Under British law, the contract that has been negotiated between two parties is ‘sacred’ (Bachmann 2001). The basis principle of the ‘law’ is that it exists to protect the individual against collective powers (the state). The judge therefore gives a high priority to the autonomy of the contracting parties and bases his verdict in case of a conflict, in principle, only on the text of the contract. This stance of high deregulation of the British system implies that co-ordination must take place at the personal level, because there will be, in principle, no institutional interference. This has as a result that the individual contracting parties mainly have to rely on their mutual agreement as basis of their trust. Thus, the trust of the Britons originates from social trust mechanisms and from pre-commitment and performance mechanisms (Bachmann 2001).

This contrasts with the German (and Dutch) legal system, which is more formally organised, because in these countries collective co-ordination mechanisms are strongly developed. Collective and individual interests are weighed against each other in legal procedures, with as a consequence that especially the collective guarantees of the legal system contribute to the emergence of trust (also see Lane and Bachmann 1997). “German businessmen trust each other as representatives of their organizations which are embedded in highly regulated socio-economic systems, rather than as more or less sympathetic and potentially dangerously idiosyncratic individuals who merely by accident represent firm A instead of firm B” as is the case in the United Kingdom (Bachmann 2001: 353). The German legal system has an eye for the contractual arrangements but also for general principles of justice such as good faith, reasonableness and fairness (Arrighetti et al. 1997). In these systems, contract law is not created for the protection of individuals who only try to serve their own interests. If the contract includes clauses that are contrasting with the general principles of justice, the German judge may conclude that the contracting parties could not

have come to such a clause in all reasonableness. The judge may even ignore the clause and put a general principle of justice in its place. In contrast to the British legal system, it is possible in the German system that the negotiated agreements between parties do not receive the highest priority. In a situation in which A is more powerful than B and this has enabled A to negotiate a contract that is highly favourable to A, the British judge will be inclined to enforce this clause, while his German colleague might propose renegotiations between A and B that would rebalance their individual interests. The German legal system enhances the trust of German business people in co-operations with other firms and thereby impedes opportunistic behaviour. Therefore, Germans mainly base their trust on accountability mechanisms (Bachmann 2001).

This strongly developed system trust in Germany may be not advantageous in all situations. People who are used to do business in a context dominated by institutional habits and rules are confronted with large adjustment problems when they come into a situation in which those habits and rules do not apply (Bachmann 2001). Therefore, the Britons may have an advantage in doing international business, because they are 'trained' to build trust relationships without strong formal institutional influences.

The previous example also already indicates how close the personal and (formal) institutional influences are related to each other. We continue with the linkages between informal institutional influences and the emergence of trust on the individual level. Here lies a clear parallel with the influence of formal institutions as described by Bachmann. Putnam (1993, 2000) argues that people who live in small, closed communities and who are guided by the norms of those communities will have trouble in developing trust in strangers: they have mainly acquired bonding social capital. In contrast, people who live in more loosely connected communities with less dominating group norms are more open to other people: they possess bridging social capital. It is easier for them to trust strangers, because they are not hindered by oppressive forms of normative power that may dominate closed communities and networks.

Micro-economic behavioural game experiments show that players exhibit behaviour that is in sharp contrast with purely instrumental motives. Instead of choosing the instrumental strategy with the highest expected material payoff, players often choose the co-operative strategy that makes them vulnerable to non-co-operative behaviour of other players. The behaviour of the players appears to be influenced by social norms as fairness, reciprocity and equality, which lead to positive expectations of trustworthiness and, thus, to trusting behaviour. These results have been proven to be very stable in situations with high stakes, across different cultures, without reputation effects et cetera (see Berg, Dickhaut en McCabe 1995, Camerer en Thaler 1995, Cameron 1999, Fehr en Gächter 2000, Ostrom 2000, and the overview of Camerer 2003). It is plausible to expect that these norms influence individuals to a different extent depending on the extent to which they are confronted in daily life to normative trust mechanisms like social control, social sanctions and status mechanisms.

Together, the empirical examples yield strong indications that interactions of trust mechanisms on different levels influence the creation and sustenance of trust. This occurs in interaction processes.

Process aspects of the emergence of trust

In the fields of economics, economic sociology and business administration, a lot of attention is paid to the way in which trust develops between traders or firms that start to collaborate. Commonly found is a complementary approach of trust. Co-operative relationships start with instrumental trust and social trust aspects only develop after some time (see e.g. Lindenberg

2000). Without instrumental trust there can be no social trust, or in Lindenberg's words: without removing 'legitimate mistrust' there is no place for 'genuine trust'. Lyons and Mehta (1997: 242) state that "goodwill trust presupposes contractual trust". Note that the term complementarity has a somewhat restricted meaning in this case. Instrumental trust is needed to develop social trust, but social trust is not needed for instrumental trust. In the complementary approach, we often see a three step process in which social trust aspects become more influential on the creation of trust. The first stage is characterised by formal control and lack of social trust, the second stage by the creation of tolerance boundaries of trust, and the third stage by identification and broadening of the tolerance boundaries (Nooteboom 2002).

An illustration of these three stages can be found in Ratnasingam (2001), who studies the emergence of trust between firms in the field of business-to-business e-commerce. She distinguishes between the following three phases. In the first stage, parties mainly focus on instrumental behaviour mechanisms. Much time and effort is put in the competency of the other party to implement the technology in such a way that the intended economic and organisational results will be achieved (performance mechanisms). Parties use strict and demanding quality standards and procedures in order to diminish implementation failures of the technology and external security risks. Instrumental behaviour mechanisms also dominate the second phase, but their character becomes routine like. The partners focus at the consistence and competency of the performances (reputation mechanism). Continuously good performances lead to mutual expectations of credibility and trustworthiness. The communication becomes more open and the willingness to share information increases. Furthermore, the focus of the parties changes to the routine aspects of behaviour like honesty and predictability (tolerance and satisficing mechanisms). The development of trust becomes even more influenced by social and cultural trust mechanisms in the third phase. Mutual benevolence and obligingness characterise trust in this phase. This leads to joint investments, to an increase in e-commerce transactions, and to a relaxation of formal rules like strictly keeping to deadlines (informalisation mechanism). The long-term strategic payoffs of the co-operation become most important. In this phase, the partners develop a joint business 'culture' with corresponding social control and sanction mechanisms based on mutual identifications.

Comparable phases of trust development between firms are also shown in the research by Cooray and Ratnatunga (2001), who study collaboration between a Japanese firm and an Australian firm, and in studies of network creation (Casson 1997, Ebers 1997, Ring 1997).

The three stages do not always occur, because the process may stop prematurely. Nooteboom (2002) concludes that the process of trust development is a chaotic process with an unpredictable course, which may substantially differ from the one described by the three step complementary approach. Formal and informal aspects may act as substitutes instead of complementary elements. Substitution of informal influences by instrumental and system influences occurs when the strong emphasis on instrumental and system co-ordination mechanisms (for example by negotiating detailed contracts and subsequent intensive monitoring and enforcing) leads to redundancy of the social aspects of trust creation.

Detailed contracts may decrease social trust in three ways. First, they have the effect that parties concentrate on a narrow interpretation of the text instead of handling in the spirit of agreement when they implement the contract. Second, writing down all possible eventualities in the contract lessens the opportunity for spontaneous gifts in the occurrence of an unforeseen event. Mutual gift exchange or reciprocal behaviour is a source of social trust (Putnam 1993). Third, explicit accounting for all forms of opportunistic behaviour may lead to doubts about the trustworthiness of the transaction partner. "Why do we need all these contractual arrangements? Doesn't he trust me?" In this way, an emphasis on formal trust

mechanisms crowds-out informal trust aspects. Intrinsic motivations for trustworthy co-operation may thus be undermined by instrumental trust mechanisms (see Tyler 1998, Ostrom 2000, Frey and Jegen 2001).

There is even a strand of literature that doubts the importance of courts and contracts (Macaulay 1963, Beale and Dugdale 1975). According to these authors, a business relationship often starts with the signing of a contract on headlines of the agreement, but when this first contract is signed, nobody looks after it anymore. The contract is rarely updated and is only taken from the archive, when it already too late. This happens not only for the above mentioned practical reasons, but also because going to court means the definitive end of the co-operative relationship and the mutual trust.

Another strand of the literature, however, considers a well-functioning legal system as a very important mechanism to reduce transaction risks, which enhances mutual trust (Luhmann 1979). This argument is also used by Humphrey and Schmitz (1998: 45) who note that the “law supports trust by reducing uncertainty. The smaller the leap into the unknown, the easier it is to make”. Moreover, Bachmann argues in line with Luhmann (1979), that “legal norms do not fulfil their social function by actually being mobilized”, but do their job in a latent manner by directing “the expectations of social actors to certain routes of behaviour, long before sanctions are seriously considered by those who feel betrayed and might want to take recourse to legal action” (Bachmann 2001: 343). This implies that legal rules are more or less the same as social norms for co-ordinating behaviour. If the legal rules and the social norms point in the same direction, this will lead to mutually enforcement instead of crowding-out. A last argument in favour of the complementary approach comes from the idea that writing a contract can be seen as a way of dealing with ‘legitimate mistrust’ (Lindenberg 2000). Legitimate mistrust refers to the situation that there is good reason to assume that a promise will not be kept, because it is “blatantly against well-understood self-interest” (Lindenberg 2000: 12). In this situation, both parties understand that it is reasonable to build-in some safeguards. Contracting (or posing hostages or using intermediaries) then forms no burden for the relationship, but aligns incentives on which the development of informal aspects of trust can be based.

In the end, of course, also the specific social context matters. Sako and Helper (1998) investigate the determinants of trust in supplier relations in the automotive industry in Japan and the United States. One of their main findings, besides that they conclude that Japanese suppliers are more trusting than U.S. suppliers, is that written contracts appear to be very important to back up customers’ informal commitment into the future in the U.S., while written contracts lower trust in Japan, “lending support to the view that they institutionalise suspicion” (Sako and Helper 1998: 406). The contextual dependency also appears from Bachmann’s (2001) study of the British and German legal system. Detailed written contracts are seen as sign of distrust in Britain, because they are the result of a “battle of contracts” in which both parties try to insert clauses that are the most favourable for them individually (Sako 1992). In Germany, normative elements, like the notion of good faith, are an integral part of the legal code, which implies that there is no discrepancy between trust and contracts. They share the same normative background. The writing of detailed contracts just reassures the underlying legal and normative principles, and in this way enhances trust.

Substitution of formal trust aspects by social and normative influences occurs when the social influences on trust between the parties are strong enough to do without formal guarantees. This situation can arise in prolonged co-operative relationships or in closed and dense networks. We gave examples of the Jewish merchant and Chinese trading networks in section 2.5. The network of the Maghribi’s forms an example of social and normative influences that compensate for the lack of well-functioning legal system.

3.3.5 Conclusion

The empirical examples that show the coherence between the trust mechanisms and their influences on the creation of trust, are connected to the process aspects of the creation of trust. In other words, the coherence between types of mechanisms and influences is determined by the process in which trust is generated and the system and the social-cultural contexts in which this process occurs. Attention for the contextual influences illuminates the discussion when doing concrete empirical research on the creation of trust. In this line, we plead for a contingency approach of trust.

3.4 Concluding remarks – towards a contingency approach of trust

The two previous sections show the different perspectives on trust mechanisms, their interactions and coherence. The interaction processes of the development of collaborative relations in which trust is created seem to determine the form of cohesion between the trust mechanisms. At the same time, it is not only the development of a relation that determines the cohesion between the mechanisms, but also the institutional context in which the relation develops. When this context has an one-sided character in which either formal or informal institutions dominate, this will lead to dominance of either instrumental or social aspects in individual relations. In most of the times however, there will be no one-sided contextual influences on the creation of trust, but there will be plural influences in which formal and informal institutions interact in stimulating and sanctioning individual behaviour.

Given the large number of mechanisms that influence the creation of trust and the even larger combination of interactions that may occur, we propose to come to a contingency approach of trust. This approach takes the complexity of influences on the creation of trust as the point of departure. The approach assumes that the precise interaction between the influences on the creation of trust cannot be stated as a ‘general law’, because all sorts of personal and institutional factors are determining the extent to which particular trust mechanisms stimulate or impede the creation of trust. When we look at the relationship between people, it is impossible to say how much hard information and guarantees these people require and how much social trust mechanisms will be used to cope with the problems of incomplete information and bounded rationality. Moreover, it is impossible to state which influence system and normative trust aspects will have on these considerations, because the formal and informal institutional context in which these people behave can fluctuate strongly.

Therefore, the number of factors has to be made ‘manageable’ per research object or per research context by excluding trust mechanisms or even excluding entire influence spheres in a reasoned way. This can be done by, for example, first examining the context in which the research object resides. If the research object happens to be the role of trust in trading relations in Medieval Mediterranean countries, then one should first check whether there is a well-functioning legal system present, before focusing on the normative influences that regulate the creation and maintenance of trust between trading partners. In this example, this check may lead to the exclusion of a complete influence sphere from the analysis. More often it is plausible that both instrumental, social, system and normative influences are active. In that case only an exclusion of specific trust mechanisms is possible. Some contexts for example do not allow for informalisation or tolerance mechanisms. This may happen if there are no possibilities to develop a prolonged personal relationship. A customer who buys a product at the Internet will focus on the quality of the product and the satisfaction of other

customers about the performances of the seller. Personal bonds and mutual identifications will not develop.

Taking account of the object of research and the context in which this object resides enables a careful deconstruction of the relevant influences on the creation of trust. On the basis of this deconstruction, one can examine the coherence between the concepts, perspectives and mechanisms that dominate the creation of trust in the specific context and in the specific relationship. In this way one can achieve a better understanding of the chaotic processes in which trust emerges, without minimising the risk of reducing the underlying complexity so much that an one-sided view of reality results. The added value of this contingency approach lies in the fact that it relates the insights of different scientific disciplines more closely to each other, which contributes to a more realistic understanding of the emergence and continuance of trust.

This contingency approach does not only apply to international trade relationships, but also provides clues for the analysis of trust in other types of relations. As an illustration we end this chapter with two examples of how the contingency approach can be used to analyse the trust relation between (i) citizens and the government, and (ii) employers and employees.

Example 1: trust between citizens and government

The relations between citizens and government change. Compared to the past, nowadays more citizens have to be convinced of the legitimacy of government actions by continuous efforts of that government (WRR 2002). Citizens only trust the government when they are sufficiently convinced about its trustworthiness.⁵ The active creation of citizens' trust in the government is important for the functioning of the government, because perceived trustworthiness provides room for the government to set its own tasks and perform these tasks to its own insights (Schuyt and Verhoeven 2003). The creation of citizen trust is an empirical puzzle, just like the emergence of trust in economic co-operation relationships. The proposed contingency approach offers clues how to analyse this puzzle.

Using our analytical distinction, we could examine trust between citizens and government by considering the performances of government institutions (performance mechanism) and their reputation. Further we have to ask ourselves to what extent the performances contribute to the emergence of trust, because all sort of social mechanisms may lead to a lesser need of information (satisficing mechanism) or to lack of attention for actual performances (tolerance, informalisation and distortion mechanisms). Moreover, citizens appear to use either exchange based or on social identification based trust norms with regard to the government (Braithwaite 1998). The normative aspects of trust determine the reference framework, which forms the base on which the government is judged, and the extent of trust the government is able to generate. For example, citizens that judge the government on the basis of mainly exchange based norms (e.g. regularity, reasonableness, efficiency, predictability) derive part of their status from a government that abides by these norms. However, citizens that judge the government on the basis of mainly on social identification based norms (e.g. equality, social fairness, honesty) derive their status from entirely different expectations of government behaviour. So citizens can identify with the government as the collective representant of their community on completely different grounds, which determine their trust bond with the government. Also system elements influence trust in the government, because a government

⁵ Note that we talk about 'trust' in the government instead of 'confidence' in the government, because the citizen-government trust relationship examined here involves a direct 'horizontal' trust relation between citizens and government, while 'confidence' in the government must be seen an intervening variable in (horizontal) trust relationships between individuals.

that is subject to law, order, and transparent procedures (which is the case in democratic societies) can be brought for court if its actions seem to be unrightful (accountability mechanism).

Example 2: trust between employees and employers

A mutual trust problem exists between employees and employers at the labour market. In a sound labour relationship an employee can trust his employer to pay him a reasonable wage (no underpaying) and the employer can trust his employee to exert sufficient effort (no shirking). Both trust the other that the relationship will not suddenly be ended. This enables employees and employers to make long-term investments in the relationship that raise the labour productivity. This is beneficial for both of them.

In order to get a deeper understanding of this trust relationship, we have to pay attention to all sorts of influence on the emergence of trust. The instrumental perspective points at the mechanisms of performances (the employee arrives at time every day and rarely reports sick; the employers pays the salary on time and pays extra for overtime) and pre-commitment (the employee buys a house close to his work; the employer invests in education of his employees). Social mechanisms also play a role. The employee may start to identify with the firm he works for, which increases his loyalty, while the employer may develop a growing feeling of responsibility for his employees. Routine slips in the relation and less (formal) monitoring takes place, e.g. without use of time-clocks, to guide the relation (satisficing, tolerance, informalisation).

Furthermore, the relation is influenced by societal norms about work ethics and how employers and employees should treat each other. Inside firms, forms of social control and social sanction develop that regulate, in informal ways, the behaviour of both employees and employers. The identifications of both parties with the firm moreover offer incentives to abide by these informal behavioural rules through status mechanisms. Besides this, some behavioural norms can also be found in legal rules (system mechanisms), for example with regard to legal terms of notice for ending the relationship and the legal minimum wage. On the institutional level in the Netherlands, there is also the framework of discussion between social partners and the resulting collective labour agreements. These agreements form a 'summary' of what is considered 'righteous' in society in the field of labour standards. If the employer implements the provisions of his industry collective labour agreement, he shows to be a trustworthy employer who, in principle, does not have to fear for labour disruptions. Another advantage of these higher level discussions about the yearly wage rise is that they prevent that employers and employees have to 'fight' with each other about this issue at the bilateral level every year (also see chapter 4). However, this requires a sufficient level of trust of employers and employees in their respective representants in employer organisations and labour unions.

Chapter 4

The Dutch Miracle – institutions, networks and trust

I am a polderman, but in the polder it takes three to tango.
De Waal, chairman of union federation FNV (De Telegraaf 2004)

4.1 Introduction

Between 1982 and 2000, the Netherlands experienced a remarkable economic recovery.¹ Some people even speak of a ‘Dutch miracle’ and hold the so-called ‘polder model’ responsible. Highlights are the increase of labour participation from a by international standards relatively low 52 percent to the European average of 65 percent, and the decrease in unemployment from a high of 12 percent in 1983 to a low of 2 percent in 2001. Furthermore, government finances turned from a 9 percent deficit to a small surplus and the social security system was drastically reorganised.

Several explanations have been given for this miraculous recovery. This chapter focuses on the role of the specific Dutch institutional framework of social-economic policy preparation as a driving force of the recovery. The Dutch culture of consensus finding, in combination with the institutional consultation structure in which government, unions, employer organisations, central bank and advisory bodies frequently meet each other in formal and informal atmospheres, produced an environment of mutual trust and co-operation that was capable of effectively dealing with the problems of the economy.

We elaborate this proposition in a two-step approach. The first step explains the way in which the polder model has been able to produce collectivised trust. The second step investigates the specific micro-conditions of the Dutch policy and institutional context in which mutual trust contributed to macro-economic growth.

The concept of trust becomes relevant for economic analysis when one drops the standard assumption of perfect and free information and takes care of the notion of bounded rationality. In a situation of imperfect and asymmetric information, which is typical for the policy making process, it is impossible to write complete and legally binding contracts. This offers the possibility for opportunistic behaviour by transaction partners. It means that agents can gain additional benefits at the expense of their transaction partners (Williamson 1985). In these situations, trustworthiness is the characteristic of the party that refrains from

¹ This chapter is largely based on Den Butter and Mosch (2003a). Some ideas have been published in Mosch (2000).

opportunistic behaviour. Trust is the expectation of a party that the other party will behave in a trustworthy manner.

As was discussed in the previous chapters, the literature on social capital overlaps, to a major extent, with the literature on trust and networks. The ability to trust is often seen as an important element of social capital. Networks are regarded as an essential framework for the development of trust and social capital (see e.g. the reviews by Nooteboom 2002, and Sobel 2002). Seminal contributions in this field are Bourdieu (1986), Coleman (1990), the collection of papers in Dasgupta and Serageldin (1999) and Putnam's (1993, 2000) empirical work on social capital in Italy and the United States. Knack and Keefer (1997) and La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997) provide evidence, for several countries, that trust leads to higher aggregate economic activity and better societal performance. Camerer (1997), Fehr and Gächter (2000) and Ostrom (2000) present evidence on the existence of trusting (and reciprocating) behaviour by human beings, based on microeconomic game experiments. They also determine which circumstances are favourable for the development of trust and, above all, establish the link between "more trust" and "higher individual and collective payoffs" that appears in trust games, prisoners' dilemma games and other types of co-ordination games.

The research in this chapter can be positioned somewhere in between these macro and micro strands of empirical research. Knack and Keefer (1997) show the positive effects of trust on macroeconomic variables, but they do not (really) explain how their trust variable, which is measured at the micro level, translates into positive macroeconomic outcomes. The relationship between the input of trust at the micro level and the output in terms of macroeconomic performance remains a black box in their research. The microeconomic research referred to above actually tries to look into this black box, but because this research is severely limited by very strict and formal laboratory conditions, one cannot easily link its outcomes to 'real life' situations. It is even a harder task to link these results to macroeconomic findings. What we try to do in this chapter is to combine the best of both empirical worlds. We want to explain what happens within the black box and relate this to real-life macroeconomic outcomes. The real-life black box we chose to peer in, is the one of macroeconomic policy making in the Netherlands in the period 1980-2000. We use the findings of the microeconomic based research to explain how trust developed between the players in the Dutch institutional framework (which we referred to as step one). After this, we analyse how this trust resulted in better outcomes of collective action problems. These better outcomes can be understood as better macroeconomic policies, which in their turn led to better macroeconomic results (step two).

In this way, we show, in a case study for one specific country and for one specific period, how the institutional framework operates as a mechanism that transforms trust between persons and organisations at the micro level to positive macroeconomic effects. We admit that it is hard to generalise the findings of a case study to a theory on the working of the relationship between trust formation at the micro level and economic performance at the macro level. We do not pretend to do so but we remark that the case considered by us, the Dutch polder model, has obtained ample attention in international policy research.

In our opinion a major reason that collective action problems yield better outcomes when the parties involved share a high level of trust amongst each other is that it mitigates the effects of hold-up problems. Two decades of co-operation between unions and employer federations in the Netherlands have crystallised into a sustained combined strategy of lowering wage costs, increased labour market flexibility and investment in employment. Although this strategy involved twenty years of wage moderation (during which firms restored their profits), social unrest in the form of strike activity has been negligible. Although some observers consider wage moderation in the Netherlands just as the Phillips-curve effect in reaction to high

unemployment, a major argument of this chapter is that this sustained co-operative stance can only be explained in terms of high mutual trust between the negotiating parties of labour standards.

There is also a dark side to the coin of the polder model. In spite of the enhanced labour participation, and in spite of various reforms of the social security system, demand for social security benefits remained high, especially with respect to labour disability. A considerable part of the receivers of benefits is actually unemployed in disguise. Hence, this outcome of the reforms in the social security system shows a remarkable discrepancy between the behaviour of social partners in the wage setting process and their management of social security. The first can be considered highly responsible and praiseworthy, the second is a clear example of rent-seeking behaviour. In an institutional arrangement where on the one hand social partners had to decide about the implementation of the social security system, and on the other hand government had to bear all costs, social partners frustrated the workings of the system by using it as a ‘dump’ for less-productive workers. In that way, they took no interest in the costs for society. This may be a lesson that a co-operative stance in one field of policy does not form a guarantee for joint utility maximising behaviour in other fields. The institutional structure must always be given the shape that internalises all external effects in the decision procedure.

The content of the remainder of the chapter is as follows. Section 2 gives a short overview of the main characteristics of the transition from the Dutch disease to the Dutch miracle. The main institutions and their role in the ‘polder model’ are discussed in section 3. In this discussion, a special emphasis is laid on the trust enhancing aspects of this institutional framework. This section forms step one of our two-step approach by explaining the particular ways in which the polder model is able to produce trust. Section 4 discusses how trust mitigates the hold-up problem in corporatist economies. After the introduction of the theoretical model, we show the appropriateness of the model for the (Dutch) labour market. In section 5, we confront the findings of the earlier sections with the actual outcomes of the policy making process. The Wassenaar agreement and the main policy measures that are held responsible for the economic recovery are analysed in the light of trust and collective action problems. Sections 4 and 5 form step two of our two-step approach, in which we investigate the particular micro-conditions in which trust contributes to macroeconomic growth. Section 6 concludes.

4.2 From Dutch disease to Dutch miracle

The post-war period until 1963 can be characterised by strong GDP growth, full employment and, because of government wage control, modest wage increases. After the period of reconstruction which ended in the mid 1950’s, the Dutch economy was characterised by former Minister Andriessen (1987) as an economic eldorado. It was a period of Keynesian demand management, with hardly any cyclical downturns.

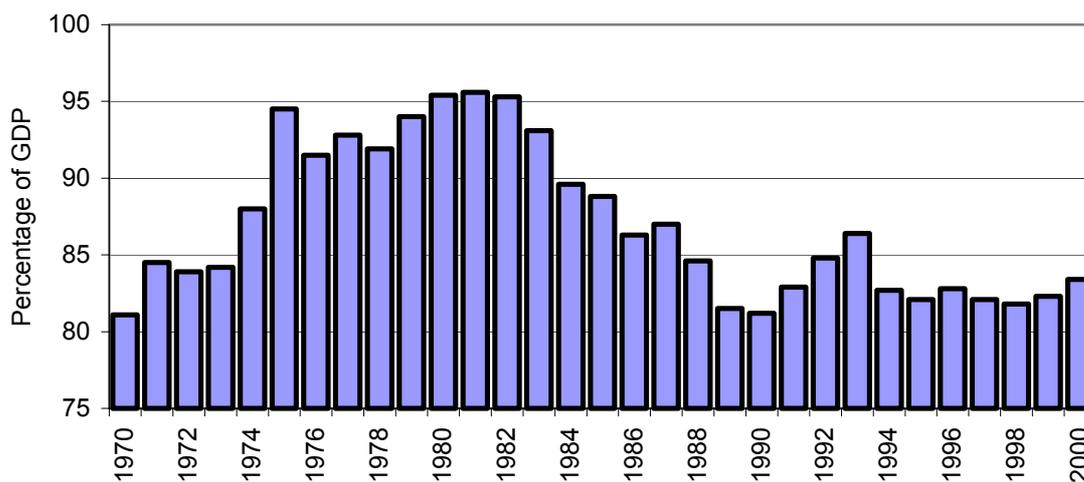
The system of government wage control stops functioning after 1963. This is caused by pressures from the market - where labour shortages lead to ‘black wages’ - and from social partners (labour unions and employer associations) who want to stop the government intervening in ‘their’ labour market. The gradient release of wage setting comes at the same time as the transition to a modern welfare state. This translates into an expansion of the social

security system with a number of provisions which, later, prove to be very generous.² The discovery and exploitation of large stocks of natural gas contribute to the political belief that such a generous and extensive system is sustainable and can be financed.

The oil shock of 1973 marks the end of this period. The shock leads to high energy prices and, through the automatic price compensation, to a proportional rise in wages and benefit levels. The guilder remains strong because of the revenues from the export of gas. This worsens the competitive position, which hinders exports and depresses the exposed sector. The economic problems in this period have become known as the Dutch disease. Prices and wages increase, while profits are shrinking further and further.

Unemployment starts to rise (and nearly does not decline in the period between the oil shocks) and the Keynesian expansion policy of the government leads to rising budget deficits. The second oil shock (1979-1980) worsens the situation even further. The wage share in market sector income – the share of the added value that accrues to the factor of labour and is therefore not available for capital costs – increases to 95 percent (see Figure 4.2.1). Unemployment reaches a high of about 12 percent in the beginning of the eighties. The government tries to enforce wage restraints by intervening with mandates on wages, but these are not very successful in this period.

Figure 4.2.1. Wage income share



Source: CPB 2001.

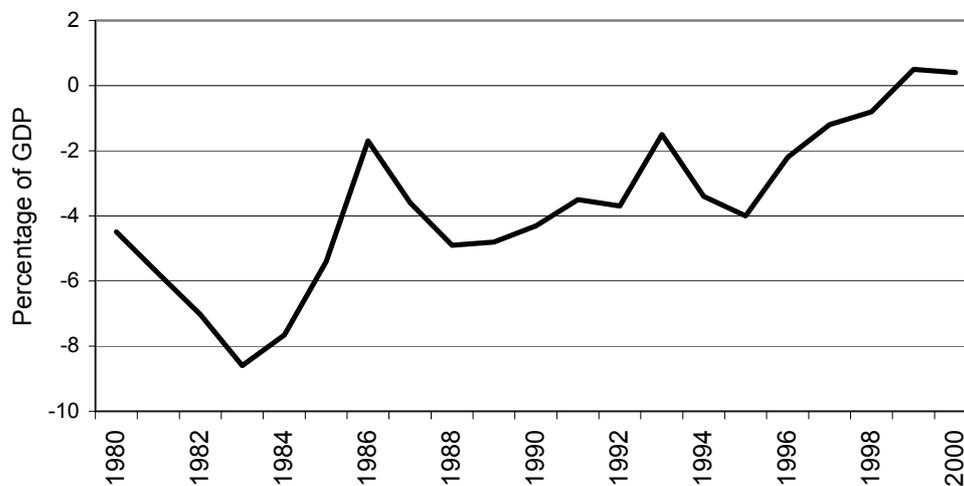
Finally in 1982, labour unions and employer associations reach agreement on a policy of voluntary wage restraint and redistribution of work in the so-called Wassenaar agreement in order to restore profits and fight unemployment. This agreement strengthens and ‘formalises’ a trend of relative wage moderation (e.g. vis-à-vis real wages in Germany) which results in a considerable decrease in the labour-income ratio. In section 5 we discuss further how the agreement acts as a major first step in the transition from the Dutch disease to the Dutch miracle. This switch in policy and its acceptance are partly initiated by insights of the economic profession that Keynesian demand management is no longer an adequate policy

² The social security laws that were enacted in this period took care of old age pension (1957), pension for widows, widowers and orphans (1959), child allowance (1963), medical expenses (1964), social assistance (1965), income loss due to disability (1967) and exceptional medical expenses (1967).

receipt to combat stagflation. It becomes common sense, that the negative supply effects of wage rises are, through lower profits and worsening of the competitive position, stronger than the positive demand effects.

The start of the Lubbers Cabinet in 1982 also marks a switch in fiscal policy. The gradual expansion of the public sector (central government, local government and social insurance) comes to an end and the government budget deficit declines from 8.6% in 1983 to small surpluses in 1999 and 2000 (see Figure 4.2.2). The strict budgetary policy results in a decline of the share of taxes and social security premiums and the share of public expenditures in GDP between 1983 and 2000, namely from 47.4 to 41.4% and 58 to 40.0% (CPB 2001).

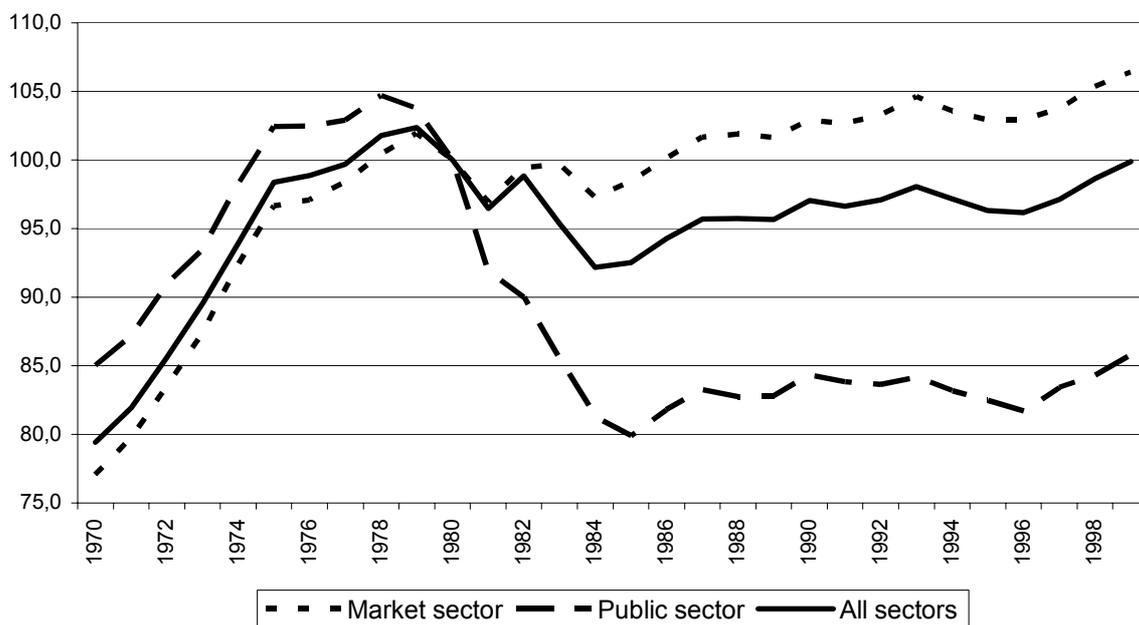
Figure 4.2.2. Government budget



Source: CBS, *Statistical Yearbook*, 1980-2001, SDU publishers, The Hague.

This policy of budget constraint is enforced by two developments. First, employment in the public sector decreases from 15% to 11.7% of total employment, while the wages of civil servants stay largely behind market developments. Putting the index for (nominal) contractual wages at 100 for base year 1980, wages in the private sector rise to 170 in 1999, while workers in the public sector see their income rise to 137.³ In 1999, hourly wages (in real terms) in the public sector are still almost 15 percent below their 1980 level (see Figure 4.2.3). Remarkably, this happens without serious unrest among the government personnel, although union density is relatively high in the public sector. The second source of budget improvement comes from reductions in expenditures on social security – particularly because of lower benefit levels and not so much because of a reduction in the number of benefit receivers.

³ CBS, *Statistical Yearbook*, SDU publishers, The Hague.

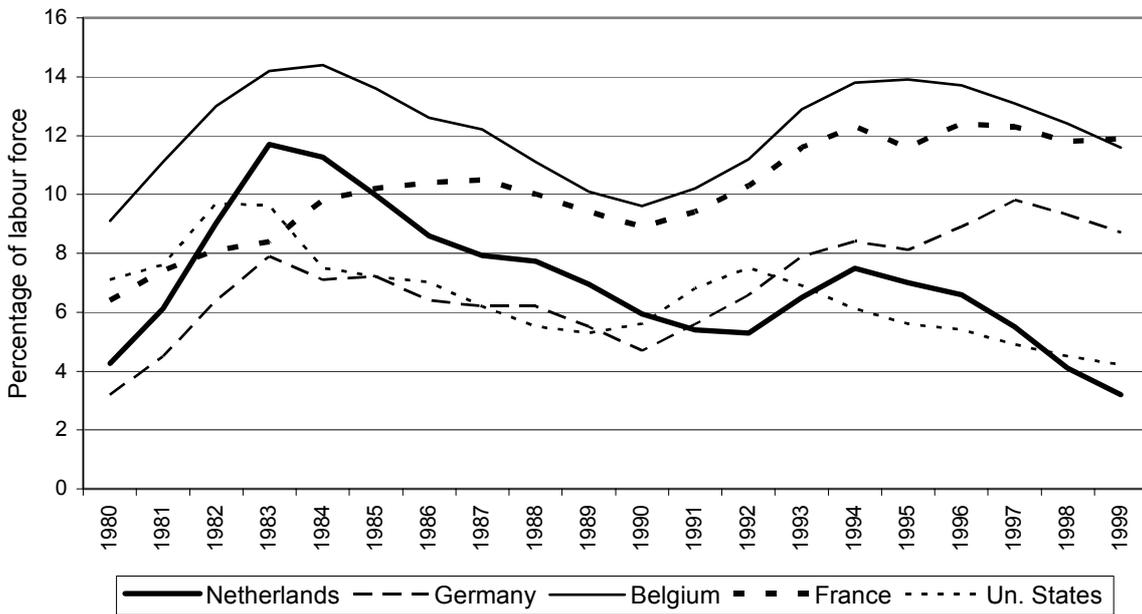
Figure 4.2.3. Real hourly wages (index 1980 = 100)

Source: CBS, *Statistical Yearbook*, 1970-2000, SDU Publishers, The Hague

Yet, the most noticeable change in the Dutch economy is the decline in unemployment from 12.3 percent in June 1983 to 1.9 percent in May 2001 (see Figure 4.2.4). This is especially remarkable, because other European countries that used to experience the same cyclical circumstances as the Netherlands still write double digits for their unemployment performance. However, official unemployment figures are not fully comparable between countries. In the Netherlands, people above 57 years old do not count as registered unemployed, because they are no longer obliged to search actively for a job; this rule is in operation since 1983. Another typical Dutch arrangement is the widespread use of early retirement, which also distracts older workers from the labour force. Above this, the Dutch disability benefit scheme attracts two to three times more people than it does in other countries. Part of these receivers of a disability benefit can be regarded as unemployed in disguise, especially as the disability scheme is more generous than the unemployment scheme (Aarts, Burkhauser and De Jong (1996), Hassink (1997), Lindeboom (1992)). These three options for a comfortable early exit have resulted in a very low participation rate for elderly in the Netherlands.

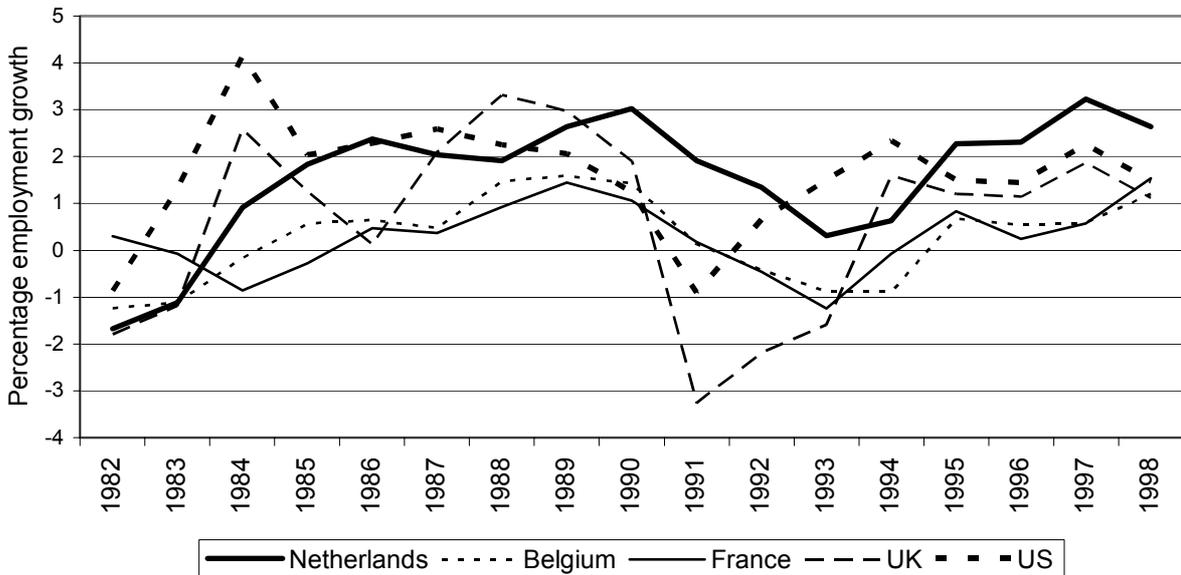
Although the unemployment figures look a little less spectacular given these considerations, the figures about employment are far more conclusive, and again underline the economic miracle. From 1984 on, employment growth is clearly above European average and comparable to the results of the American job machine (see Figure 4.2.5). Labour participation rises from a European low of 52 percent in 1983 to 65 percent, which is about European average.

Figure 4.2.4. Unemployment



Source: ILO Yearbook of Labour Statistics and CBS Statline.

Figure 4.2.5. Annual employment growth



Source: ILO Yearbook of Labour Statistics and CBS Statline.

4.3 Institutions, consultation structure and effects on trust

After the overview of the transition from Dutch disease to Dutch miracle in the previous section, this section elaborates the first step of our analysis, namely the trust enhancing features of the institutional context in which Dutch economic policy preparation takes place. In our opinion this specific Dutch institutional framework contributed substantially to the recovery, described in the previous section. Step two, on the effects of trust on macroeconomic outcomes, is discussed in sections 4 and 5.

The present section considers three aspects of the institutional setting, namely (i) the ‘drive for consensus’ and ‘pillarisation’ (3.1), (ii) the major players in policy preparation and the organisation of the interaction between them (3.2), and (iii) some specific legislation about labour standards negotiations (3.3). Finally section 3.4 analyses how these three aspects of the institutional framework contribute to the formation of trust between the parties involved.

4.3.1 Social characteristics

The drive for consensus is often considered as a dominant social characteristic in the Netherlands. Its origin is often attributed to the Dutch historic context of the struggle against the water. Already in the twelfth century, public boards came into being to organise protection against the sea and initiate land-winning procedures. This common interest forced people to co-operate with each other and to reach a compromise, or preferably a consensual agreement, in order to be able to defend themselves against the danger of floods in all circumstances. Moreover, agreement is needed on the level of the ground water and on good maintenance of the dikes and ditches to make farming in the ‘polders’ possible.

This practice of consensus formation as a dominant social characteristic was, in a portentous way, combined with another peculiarity of the Dutch society, namely its ‘pillarisation’. During the twentieth century until the seventies, the Dutch society was separated into four ‘spheres of influence’, i.e. into four separate ‘pillars’, namely a catholic, a protestant, a socialist and a liberal one. These four pillars had their own schools, newspapers, broadcasting companies, sport clubs, shops and political parties. For a large part, people only communicated with people who belonged to the same pillar. At the level of government, however, the leaders of the different pillars did not hesitate to contact each other and form coalition governments. These coalition governments are a necessity in the Netherlands, where the political parties originally represented the various pillars. It has never happened that a single party obtained a majority in parliament. This system of coalition governments forces the different political streams to work together, reach compromises and, even better, consensus.

This drive for consensus and ‘pillarisation’ constitutes the background for the institutional framework for (economic) policy formation in the Netherlands. An insight in the working of these institutions is crucial for the understanding of how the trust enhancing effects of this institutional framework have contributed to the Dutch miracle.

4.3.2 Organisations involved in the policy making process

Many organisations and stakeholders are involved in the economic policy making process in the Netherlands, either in a formal or in an informal way. Here we focus on the prominent players and elaborate the role of two of them, which we consider most distinctive in the institutional setting of the polder model. The first of the institutions which gets full attention is the Central Planning Bureau (CPB), for two reasons. First, its history illustrates the struggle to find an appropriate way to combine the characteristics of ‘drive for consensus’ and

‘pillarisation’ in a suitable form in order to advise the government on matters of economic policy. Second, the model based and specific quantitative economic analysis of the CPB is still a basis for every discussion on economic policies in the Netherlands. The second institution that merits some deeper analysis is the Social and Economic Council (SER), together with the Labour Foundation. In the SER, social partners and external advisors discuss matters of economic policy. As the social discourse in the SER is often referred to as the “heart of the polder model”, it seems justified to spend a few more lines on this organisation. After the discussion of the CPB and the SER, we pay somewhat less extensive attention to the other important institutions in the field, like the Central Bank, government committees, the Scientific Council for Government Policy and parliament.

Central Planning Bureau

The Dutch Central Planning Bureau (CPB) plays a crucial role in the institutional set-up. It has now renamed itself in English as the CPB Netherlands Bureau for Policy Analysis (CPB), as it does not want to be associated with economic planning in the sense of the socialist economies. Yet, it was originally founded in 1948 as a central planning bureau for economic affairs, with Tinbergen as the first director.

In spite of the fact that the CPB is formally part of the Ministry of Economic Affairs, it fulfils its advisory task independent from government interference. This status of independence is recognised by all parties and stakeholders in the policy making process, which has provided the analyses of the CPB with high reputation and esteem. The two major periodic publications of the CPB are the Central Economic Plan (CEP) and the Macroeconomic Outlook (MEV). The Central Economic Plan is published each year in springtime and contains a survey and analysis of economic developments in the Netherlands and abroad. The CEP also contains economic forecasts for the current year. The MEV is published together with the government budget yearly in September and contains the formal forecasts of the economy in the next year. The government budget is based on these forecasts. Moreover, the MEV gives revised projections for the current year.

In fact, the CPB has two major tasks nowadays. The first is the task of national auditor: it implies economic forecasting and assessment of the effects of policy measures for the government and for other groups involved in the policy making process. The second task of the CPB has remained, up to now, somewhat underexposed. It is that the CPB conducts, in the more general sense, applied economic research (see Don 1996).

CPB’s reputation of independence has been challenged from time to time both in academia and by the press, especially with respect to its task of formal auditor for the government. Here the position of the CPB is in fact that of a monopolist and it is true that the CPB has a special position, as it has access to confidential information on government policy. This position is needed in order to be able to react promptly on questions by policymakers, which mainly regard technical and accounting aspects in policy discussions. Yet, in the institutional framework for policy making in the Netherlands a number of checks and balances have been built in to prevent the CPB from misusing its monopoly position. Such misuse would also immediately destroy much of the reputation that the bureau has built up so carefully. Besides, it is a question of efficiency to have only one institute that is responsible for this kind of macroeconomic forecasting and policy evaluations in a relatively small country as the Netherlands. This task requires many specific investments and hence the institute has to be quite sizeable. It is typical for the institutional set-up of Dutch policy making that there are numerous formal and informal contacts between the staff of the CPB and the economists at ministries, researchers in academia and the staff of the social partners. On the one hand, they

provide relevant information to the CPB, but, on the other hand, they will, if needed, be critical on the work of the CPB.

The CPB does not hold a monopoly position for its second task, namely that of institute of applied economic research. Here, it competes both with other Dutch institutes and with institutes abroad. Nowadays the CPB is asked more frequently than before to give a second opinion on research conduct by other institutes. Moreover, international organisations such as the OECD, the staff of the European Commission and the IMF also publish periodical forecasts for the Dutch economy.

Since the CPB's first director Tinbergen (1936) has built the first econometric policy model it is understandable that model based policy analysis has, from the origin, constituted an important part of the work of the CPB. The CPB's 'model' early acquired a high status in academic circles and has come to be regarded in Dutch society as an objective piece of economic science (Den Butter and Morgan 1998). The analyses of the CPB are widely used as input for social economic policy discussions. However, in the first few years of the CPB there was a fierce internal discussion in the CPB about the way the bureau should give shape to its advices (see Van den Bogaard 1998). On the one side was Van Cleeff, who had the view that the CPB should follow a normative approach, while on the other side Tinbergen supported the idea of disentangling the positive and normative elements of the analyses. Crucial in this controversy was which type of economic policy advice would be the most successful in the 'pillarised' economy. Van Cleeff tried to develop an all-embracing normative theory, which would integrate the ideas of the different pillars. Tinbergen wanted to develop a method that would give the most objective description of reality. The differences between the pillars would then be minimised to their different normative proportions. In other words, he wanted to make a clear distinction between the workings of the economy (model) and the policy goals (welfare functions), and then 'try to agree on the first and compromise on the second issue'. Tinbergen won this battle. Since then, economic policy preparation in the Netherlands is organised in three autonomous parts: data, model and norms. The data and statistics are collected by the Central Bureau for Statistics (CBS), the workings of the economy are described by the models of the CPB and the balancing of the different points of view is done by the government in dialogue with unions, employer organisations and other associations of organised interest. This method of splitting facts and politics seems to be the best in creating consensus in a pillarised society.⁴

A major and unique example of this functioning of the CPB in policy consensus (or rather compromise) formation occurs in years in which general elections for parliament take place. The major political parties then ask the CPB to calculate the effects of their election programmes on economic growth, employment, income distribution and so on. The results for the different political parties are widely spelled out in newspapers and television programmes. Seemingly, it is almost a realisation of Tinbergen's dream to separate the knowledge on the working of the economy, which is contained in the models used by the CPB, and the normative preferences on trade-offs between policy goals, which will differ for each political party (or pillar). In fact, this procedure has proved beneficial in the formation of coalition governments and in drafting the 'coalition agreement' that is signed by the various political parties who co-operate in the coalition government. In the discussions after the elections,

⁴ Also see Bovenberg (2000: 324): "By providing information about the effects of policies, the economist allows the political debate to focus on different political priorities, rather than on differences of opinion about the effects of policies". For a discussion of the role of economists as "facilitators of consensus" or "lawyers of adversarial interests", see Dewatripont and Tirole (1999).

when a new government has to be formed, those policy measures put forward by the various political parties have the best chance to be included in the government agreement that have, according to the calculations of the CPB, the largest favourable effects on the major policy goals.

However, this procedure may bring about some questionable side effects. Firstly, the CPB will not include the various policy proposals by the political parties at face value in their model calculations. Instead, there is ample interaction and discussion between the party officials, who write the economic sections in their political programmes, and the staff of the CPB, who implement the proposals in their models. Therefore, this exercise of the CPB may lead to revisions of the proposals by the political parties before they are published in their final programmes. A second, even more questionable, side effect is that the economists of the political parties have become familiar with the properties of the models of the CPB. Consequently, they will see to it that their policy proposals are effective in terms of the CPB models. In fact, a bad performance in the CPB calculations, especially with respect to employment, can lead to a large loss of votes in the elections. The result is that this procedure makes the policy proposals of the political parties to be very much in line with proposals, which are beneficial according to the models of the CPB. So it has led to a remarkable convergence of policy plans, which contributes to the lack of interest of the Dutch population for general elections – apart from ‘de-pillarisation’ which may be another reason. Moreover, there is a risk that the way the CPB models describe economic reality is not correct, so that all political parties are begging for the wrong horse in the design of their programmes. This would imply an extraordinary example of a political lock-in (see also Den Butter 2002).

Labour Foundation and Social and Economic Council

It is typical for the Dutch polder model that the social partners are at the heart of the consultation structure for economic and social policy. The Labour Foundation (STAR) is the formal platform where employees and employers meet each other on a structural basis. It was founded in 1945 as a private organisation and acts as a bilateral forum of discussion for unions and employer associations in the field of labour standards. The seats are equally divided between the two, and both sides deliver one of the two chairmen. The results of the discussions are stated in so-called ‘central agreements’. This occurs about once in two or three years.

Yet, the major forum for political discussions, which is associated with the Dutch polder model, is the Social and Economic Council of the Netherlands (SER). The SER is the main policy advisory board of the government for social economic matters. Its constellation is tripartite. Labour unions, employer associations and independent ‘members of the crown’ each possess one third of the seats. There are three important labour union federations: the socialist/catholic FNV, the protestant CNV and the MHP for middle and higher ranked personnel/managers. Nation-wide union membership rate is about 27 percent, of which 64 percent belongs to the FNV, 19 percent to the CNV, 11 percent to the MHP and 6 percent to other unions.⁵ There are also three employer federations at the central level. The most important is the VNO-NCW, which acts as a representative for all employers. Members of this federation are both individual firms and lower level employer organisations, often organised by industry. MKB and LTO are the representatives for respectively firms of middle and small size, and firms in the agricultural sector. The “members of the crown” consist of professors in economics or law, politicians, the president of the Dutch Central Bank and the director of the CPB.

⁵ These CBS data relate to January 2001.

It is through these independent members that the policy discussions within the SER benefit from the insights of scientific research. The analyses of the CPB and the Dutch Central Bank carry a large weight in these discussions. Policy advices by the SER are prepared in committees where representatives of the three categories discuss and amend texts drafted by the Secretariat of the SER. Representatives of various ministries attend these meetings of the committees but formally, they are observers. They will not take part in discussions unless they are asked to provide relevant information. Obviously it is important for the impact of the advices of the SER that they are unanimous. It is quite exceptional that the government would disregard a unanimous policy advice of the SER. The independent members of the crown (which, by the way, represent the various pillars in the Dutch society) can be helpful in reaching such a consensus advice in informal discussions. The chairman of the SER, who is also an independent member, and understandably has a crucial position in the institutional set-up of the Dutch polder model, plays a major role in this situation.

The SER has an important function in promoting trust between the various policy makers by acting as a platform of discussion for social partners, government, central bank, CPB and scientists. However, the positive role of the SER has not always been recognised by the government. The legal provision that obliged the government to ask the SER for advice on all proposals in the field of social-economic legislation was abolished in 1995. The feeling had arisen at the government level that this procedure took too much time and caused too much 'stickiness' in the policy preparation procedures. However, instead of weakening the position of the SER in the process of policy preparation, this measure seems to have strengthened it. The measure worked, probably unintended by the government, as a trigger mechanism for the members of the SER to reach consensus in its policy recommendations. Recommendations that are signed unanimously by the three parties involved give a strong signal to the government of societal consensus on specific policy measures, and are therefore much more powerful than recommendations that reflect divided opinions. As mentioned above, the Dutch culture of consensus puts strong pressure on the government to follow unanimous recommendations. The government is, however, not bound to act in the way the SER recommends, although it is obliged to give a formal reaction statement at every published advice.

The SER thus fulfils two main purposes. Firstly, it works as a device for the government to get informed about the points of view of employee and employer organisations about social-economic questions. Especially the unanimous recommendations give clues to the government about which policy measures will be supported by society. Secondly, the SER works as a platform that brings together employee and employer organisations to talk with each other about social-economic matters. The presence of economic and legal scientists makes sure that the discussions are based on solid arguments. In this way, they learn about each motives and objectives for and against certain policy measures. This prevents misunderstandings and forms a basis for the development of mutual trust.

One of the major aspects in the negotiations in the SER, which is related to the idea of trust, is that the main negotiators regularly meet each other in both formal and informal meetings. It is the repeated game aspect of trust formation, which plays an important role here. An example of this attitude can be found in an interview by Klamer (1990) on the occasion of the 40th anniversary of the SER. Klamer posed the following question to Jan Stekelenburg, at that time the chairman of FNV, the largest trade union. 'My impression is that you and Van Lede – chairman of the largest employers organisation – are very much on speaking terms and that you are more friendly to each other than the outside world believes you are.' Stekelenburg's answer is: 'No, no, that is not true! It is certainly not true that we're

constantly fighting with each other, but at the moment of conflict it is clear and apparent and we don't ease the problem when we are together.' Then Klamer asked: 'Did it happen that you were really angry with Van Lede?' Stekelenburg replied: 'Yes, when there is really a large conflict I may be angry. However, it will happen in a way, which does not harm our future relationship, because we are condemned to each other. We need each other in these negotiations on labour relations, so that we should be aware that after a big quarrel we will always be forced to come back to business in a next situation. So the real hard and definite battle will never be fought.'

Other institutions

The Dutch Central Bank (DNB) traditionally plays a major role in macroeconomic policy making. The formal task of DNB in the period 1980-2000 was to conduct monetary policy in order to combat inflation and to keep the value of the money stable, i.e. to protect the internal and external value of the Dutch guilder. DNB has always been quite independent from government intervention so that it can be ranked amongst the world's most independent central banks. On the other hand, the role of DNB in the policy discussions in the Netherlands is not restricted to monetary policy; DNB takes part in the most prominent forums for policy discussion in the Dutch polder model. The advices and policy analyses of DNB are well respected and carry a large weight. Moreover, there is ample informal co-ordination with fiscal policy: the President of DNB has regular lunches with the Minister of Finance and the Treasurer General, who is a highly ranked civil servant at his ministry. The exchange rate policy of DNB also played an important role in the economic recovery. The monetary policy of fixing the value of the Dutch guilder to that of the German Mark can be seen as a major contribution to the success of the policy of wage moderation. In this way, the relative decrease of labour costs in the Netherlands due to the policy of wage restraint was not sterilised by a nominal appreciation of the guilder. Consequently, the Dutch guilder depreciated in real terms, which was beneficial to the international competitive position. The introduction of the euro has 'formalised' this peg to the other European currencies, which has led, in this respect, to a diminution of the direct exchange rate influencing role of DNB. At the same time, it has led to an increased importance of wage restraints, a point that DNB in its role as an economic advisor is stressing constantly.

A further major role in the technocratic process of economic policy preparation is played, albeit somewhat outside the spotlights of attention, by several committees inside the ranks and files of the government. The Council for Economic Affairs (REA) and the Central Economic Committee (CEC) are especially influential in this respect. The CEC consists of highly ranked civil servants from the important ministries involved in economic and social policy. The committee is chaired by the secretary general of the Ministry of Economic Affairs and it is through discussions in this committee that calculations by the CPB have inspired to major changes in economic policy (see Den Butter 1991). Incidentally, when no consensus can be reached about difficult policy problems in the institutional framework sketched above, special committees are established for policy advice on these problems. A recent example (2001) is the committee chaired by Donner, former chairman of the Scientific Council for Government Policy and (at present) Minister of Legal Affairs in the Balkenende Cabinet which came to office after the elections in May 2002. This Donner committee which consisted of members representing various political backgrounds, advised on a new design for the social security arrangements for disabled workers (WAO).

A danger that threatens the close consultation structure as it exists in the Netherlands is that it is susceptible to inertia and even to lock-ins so that radical changes will never be initiated. In

order to get out of such a situation, it sometimes helps if an outsider rings the alarm bell. This has become one of the functions of the Scientific Council for Government Policy (WRR). The WRR was founded in 1972 to provide advice to the government about long-term policies. Though this multidisciplinary Scientific Council is not a really a part of the consultation structure of the Dutch labour market, its reports are among the most influential social-economic analyses.

In the end, after all consultations in the institutions in the polder model have been conducted, it is, of course, in the democratic state of the Netherlands always the parliament that takes the final decision about the policy measures proposed by the government. Yet, the outcome of the consultations will always carry a large weight in the voting behaviour of the members of parliament.

4.3.3 Wage negotiations

Trust between policy makers is not only built up and maintained in the organised meetings in the STAR and SER and other platforms. In addition, the general structure and legal environment of the wage negotiations give incentives to the different parties to co-operate and reach consensus. We first look at these features of the wage negotiations at the central level. After that, we consider negotiations at industry and firm level.

At the central level, two times a year a fixed consultation process between government and social partners takes place. These are called the spring- and autumn-consultations. These consultations can be seen as another two occasions for official meetings between government and social partners, but the process also favours trust within the organisations, as will be clarified below. Starting-point for the spring-consultation is the new plan for the government budget, the autumn-consultation marks the beginning of a new round of wage negotiations. The preparations for the yearly cycles of wage negotiations start in the two largest federations of unions (see also Teulings and Hartog 1998). The biggest federation of trade unions, the FNV, uses the macro-economic forecasts of the CPB to calculate the 'wage bargaining space'. This concept describes the reasonable wage cost increase and is usually calculated as the sum of inflation and change in labour productivity. Note that it is not defined in what definitive form this wage space should be realised (wage increase, labour time reduction, schooling, fringe benefits). Together with other wishes, this is written down in a document and consequently discussed with the chairmen of all member unions. The other big federation (CNV) follows a similar procedure. Apart from this consensus and consultation approach, the central strike fund serves as a way to promote unity in union federations. Only unions that strike in line with federation bargaining positions are entitled to receive support from this central strike fund. In this structure, there are two inherent incentives to preserve unity of policies between the member unions and the federation.

Employer organisations also co-ordinate their bargaining positions for the new wage negotiations. The Committee for the Preparation of Wage Policies prepares the fundamental principles for the negotiations. A general strike fund is open for members that are hit by strikes that deal about fundamental issues discussed by the Committee.

Incentives for co-operation are also present in negotiations at the industry and firm level. To make this clear, we first have to look a little closer at the regulation of collective labour agreements. Two laws regulate the completion of collective labour agreements. First, the Law on the Collective Agreement of 1927 stipulates that the terms of a collective agreement are binding for all workers in the firm, not just the members of the union that signed the

agreement. Second, the Law on Mandatory Extension of 1937 gives the right to the Minister of Social Affairs to extend a collective agreement to the entire industry. To get extension, one of the bargaining parties must send a request to the Minister, who checks some formal criteria. The most important is that the collective agreement must cover a substantial majority of the industry. The maximum duration of an extension is two years.

There are several features in the system of wage bargaining that give incentives to (i) all unions to sign an agreement and (ii) the employers to sign an agreement with all unions (see also Visser and Hemerijck 1997). By making it favourable for all parties to reach an agreement, these incentives stimulate the formation of consensus and trust. Because an agreement can only be reached when the different standpoints have come together, this incentive structure also favours the moderation of demands and wishes of the parties and thereby promotes 'reasonable' outcomes.

An important incentive comes from the fact that employers are free to start negotiations with any union, but are not obliged to do so. Firms are not legally bound to acknowledge any union. The law of 1927 further states that in case an employer signs an agreement with a union, this agreement functions as an agreement for all employees, regardless of their eventual membership of the signing or any other union. So, at any moment, anyone can start a union of his own and any union can try to get in negotiations with the employer. In fact, unions are allowed by court to strike to reach this purpose. This means that unions always run the risk of being excluded from labour negotiations by the employer. This sometimes even occurs to the most important unions, so it is a credible threat. The main reasons why unions want to be involved in the negotiations are threefold. The first reason is of course that they want to reach something for their members. They have no reason of existence if they are not the sparring partner of the employer. The second reason is that only the unions that have signed the agreement are entitled to the rights that come forth out of the agreement. The third reason is that the unions that have signed the agreement receive a fixed amount of money per worker in the firm/industry, to be divided between the different unions in proportion to their respective amount of members. The combination of these three reasons together with the possibility of exclusion gives unions positive incentives to form coalitions with other unions and moderate their claims. They are very well aware that the party with the most extreme claims bears the highest risk to be excluded.

The employers face an incentive to include as many as possible unions in the negotiations. Collective labour agreements usually contain a clause that forbids the unions to organise or support strikes during the period the agreement is valid. Since, of course, only the unions that signed the agreement have to obey this clause, the employers have an incentive to get the agreement signed by as many unions as possible.

4.3.4 Trust evaluation

Looking at the Dutch institutional framework for social-economic policy preparation, we notice that it has several characteristics that favour the formation of trust and co-operation. To begin with, there seems to be a character trait or culture prevalent in the Netherlands that is favourable to co-operation and consensus, possibly descending from a joint fight against the water. With other words, there seems to be a sort of 'trust culture' upon which actual mutual trust can be developed. This can also be related to the idea of the path-dependency of trust (see for example Putnam 1993). Given the fact that most people in a society feel inclined to act in trustworthy ways, it is beneficial for all people to keep to this way of transacting, because it will raise extra benefits for the involved parties by being able to solve co-ordination type of games. However, when most people in a society are used to act in uncooperative ways, every individual must distrust other people in order not to be exploited.

In this way, the level of trust at a given date in a society has its effects for trust in the future. The inherent co-operative stance of the Dutch thus favours the formation of trust.

A second characteristic is that people are aware of an external threat and their own vulnerability. This external threat used to be the water but nowadays seems to be replaced by foreign competition. The inhabitants of small open economies have to find ways to deal with this without the option of protectionism. This demands co-operation of all interests in society.

This is reflected in the way policy preparation is organised. The structure can be regarded as corporatist, in which government and organised interest together search for solutions. “(O)rganised interest does not have to lobby, they are welcome partners in the conference room” (Hartog 1999: 8). The framework of institutionalised contacts between government, social partners, central bank, CBS, CPB and advisory boards thus forms the third characteristic. The representatives of all these groups frequently meet each other, both at formal (meetings of the SER, STAR, spring- and autumn-consultation, CEC, REA) and informal occasions (receptions, farewell parties, et cetera). These frequent contacts culminate into better information exchange and thereby prevent misunderstandings. This network, with a relatively low number of players and a high meeting frequency, is also very favourable for the formation of trust. The Dutch institutional framework seems to correspond almost completely with micro findings on how to build trust-enhancing networks. The group of players is relatively small. As we have seen from the interview by Klamer (1990) there is a lot of repeated contacts between the players. A substantial part of it is face-to-face and informal. Ostrom and Walker (1997) found in their study of public good games, that face-to-face communication leads to substantial increases in co-operation. Furthermore, every player belongs to an organisation, so reputations can be smoothly transferred from the one representative of an organisation to the other. In other words, a reputation of trustworthiness does not disappear when individual persons are replaced. Reputations are important, because policy-making is a dynamic process. Organisations repeatedly meet each other, and know that this will not change in the coming years. Together with the aspect of the small group, this leads to the fact that the possibilities for learning and control are substantial.

For the situation in which repeated interactions between agents take place, Buskens (1999) distinguishes two types of effects on the behaviour of the trusting party. These are learning and control, as we discussed in chapter 3. Learning and control become more powerful, when repeated transactions are not only taking place on a bilateral basis, but are also observed by other agents who act as (potential) transaction partners. Social networks and reputations are important in this situation. In the Dutch framework with small groups and high frequency of contacts, we see that people learn quickly about the behaviour of others. Reputations spread fast. When some party acts against the norms, it can be punished quickly both within the group (news travels fast in small groups with frequent contacts) and in public (with help of the press). In this way, a good reputation becomes valuable for organisations. Once obtained a reputation of trustworthiness, they will be eager to keep it, for it enables them to participate in mutually beneficial transactions in the future.

The fourth characteristic is the specific legislation on collective labour agreements, which, as was analysed above, gives incentives to both employers and employees to behave co-operatively, both at central, industry and single firm levels.

As a last characteristic, we observe a tendency to delegation. Since 1982, the government has withdrawn itself from direct intervention in wage negotiations, thereby placing the first responsibility for a sound wage development in hands of social partners. This forms a trigger mechanism for social partners to co-operate. Both union and employer federations want the government to stay out of ‘their realm’. They know, however, that the government has the power to intervene when they do not succeed in negotiating reasonable labour standards. This

forms another incentive for co-operation. Above this, every time co-operation succeeds, trust grows between the parties, which makes co-operation even more likely in the future.

4.4 Labour market theories and trust

The previous section shows how the specific Dutch institutional framework promotes co-operation and trust between the economic policy makers. We now come to step two of our two-step approach, where we discuss how trust between the main actors (government, labour unions, employer federations, central bank and advice agencies) leads to better macroeconomic policies and performance. However, as mentioned before, our analysis is based on a case study with one case only so that we do not pretend to be able to prove that corporatist and consensus-based policies will lead to better economic performance under all circumstances. Our claim is that the necessary policy measures that were responsible for the change from disease to miracle in the Netherlands have greatly benefited from the high mutual trust among these actors.

We have two main arguments for our proposition that the high trust between economic policy makers led to the Dutch miracle. The first and most obvious one is that more trust leads to more co-operation and better solving of collective action problems. In section 5, we elaborate this argument by analysing the policies that were actually devised. The second argument considers a specific type of co-ordination problems that appears in the wage-setting process and which we consider of major importance in this respect. It is the hold-up problem, which can be analysed by regarding it as a prisoners' dilemma problem. Although it just forms a subtype of the family of co-ordination problems that is regarded in section 5, we devote this entire section 4 to it. Our argument is that it has a severe influence on the workings and outcomes of the labour market. Delegating the authority to decide on the (yearly) rise of the wages to higher, corporatist levels, mitigates the hold-up problems connected to the wage-setting process. However, this delegation is only successful when all parties involved trust each other.

4.4.1 Hold-up problem in the wage-setting process

The hold-up problem can be seen as a result of a combination of bounded rationality, scarcity of information and uncertainty. These three aspects make it impossible to write down complete and legally binding contracts, which opens the way for opportunism: people can gain short-term benefits by cheating. The combination of opportunism and specific investments can lead to hold-up problems (Williamson 1985). Specificity of an investment means that the value of an investment is directly dependent of the continuation of the relationship. An example of a specific investment is a firm investing in the skills of an employee while these skills are only valuable in this particular firm. The effect of this investment is that the labour productivity of the employee in this firm is raised. As long as the employee stays within the firm, the investment leads to extra rents (to be divided between firm and employee). When the employee leaves the firm, these gains are lost. This gives additional bargaining power to the employee, because he can threaten to leave the firm. The lack of complete contracts hinders mutually advantageous investments in this case. Though there are profitable investments to be made, potential investors refrain from doing so, because they are afraid that their transaction partner will hold them up.

A solution for this problem is to allocate ex-post (after the investment has been done) bargaining power to the party that carries out the investment. The obvious way to do so is by internalising the transaction. Labour, however, cannot be internalised (that would mean

slavery). The second best solution seems to be the agreement on a long-term contract. The wage in such a contract should be between the outside options for firm and employee. The outside option for the worker is his fallback position outside the firm. It is the wage, which other firms would want to pay for his services. Since the specific investment raises the productivity of the worker only in this specific firm, this outside wage is usually lower than his inside wage. This outside wage (or marginal productivity of the worker before the investment) forms the lower boundary of the inside wage. The outside option of the firm is equal to the cost to hire a new employee and to train him until he has the same productivity level as the incumbent employee. The cost of a new employee (the marginal productivity after the investment) forms the upper boundary of the wage. As long as the wage is between these outside options, it is efficient for both parties to continue the relationship. This situation is called ‘mutual hold-up’ (Hashimoto 1981). Both parties are not credible in their threats to leave the relationship when the wage is in this corridor between the outside options. It is efficient for both parties to continue the relationship.

A solution for the hold-up problem is that parties write nominal contracts on the distribution of the returns a priori. With other words, parties fix in a contract the nominal wage level in the corridor between the outside options (MacLeod and Malcomson 1993). To prevent the appearance of hold-up problems, it is stipulated that there will be no renegotiations about the wage level in first instance. There will be only renegotiations, when one of the outside options becomes binding. In this way, inefficient separations are prevented while the hold-up problem is suppressed.

A problem with this model is that it relies on the assumption that both parties know each respective outside options. Although the model is restricted by this unrealistic assumption, there is some evidence that the model describes reality to some extent. Beaudry and DiNardo (1991) show that the lowest unemployment rate since the start of a job has a strongly significant upward effect on the current wage. This effect is considerably larger than the effects of the current employment rate, and the unemployment rate at the start of a job. The lowest unemployment rate can be considered as the period with the most valuable outside options for the workers, which, according to the model, should result in upward adjustment of the wage to prevent incumbent workers from leaving the firm.

The problems involved with the ‘shaky’ assumption that both parties know each outside options grow, when the economy is hit by unexpected aggregate shocks. It could be assumed that parties know how to handle with idiosyncratic shocks, but it seems less likely that this is also the case for aggregate shocks. Two unfavourable situations can occur. First, there will be renegotiations of the contract and the employer is held-up. Second, the employer refuses to renegotiate in fear of being held-up and inefficient separation takes place. Both possible situations lead to a lower than efficient investment level. The micro level thus seems not to be the right place to adjust nominal contracts to aggregate shocks.

A solution for this problem is to delegate the task of adjusting contracts to aggregate shocks to corporatist organisations. By delegating the wage negotiations to a higher level, the link between bargaining power because of specific investments and the level of specific investments is broken. Negotiators at the higher level are less prone to opportunism. They bargain over wage changes for whole industries, while the specific investments vary per firm and employee. Above that, unions do not want to put their relationship with the employer associations at stake. Furthermore, we can say that “(a)ctive corporatist intervention is superior to mechanical adjustment rules, as these rules can never anticipate all contingencies. Rules require shocks to be contractible, while for corporatist institutions shocks need only be observable” (Teulings and Hartog 1998: 5). It is too costly to arrange a contract that includes

all eventualities and their remedies, *ex ante*, but it is always possible to adjust the contract after some particular shock occurred.

4.4.2 Two types of labour unions

This way of contract adjustment by delegation to organisations at a higher level involves that both unions and employer organisations are trying to maximise the joint surplus of both sides. In the standard neo-classical models of union behaviour, unions only try to maximise the utility of their members. This may describe the situation in decentralised economies very well, but certainly not in economies with a corporatist design (Teulings and Hartog 1998). In decentralised economies in which no bargaining at a central level takes place, unions have an incentive to operate in antagonistic ways. They strive to get the highest possible wages for their members. On the short term, this fulfils best the wishes of their members. Membership of a union is thus interesting for workers. This kind of unions has an incentive to raise their membership level in firms in which they are already active, since this increases their bargaining power. Threats of strikes or other obstructions of the work process become more credible with higher rates of membership. Firms will react in hostile ways to this union behaviour and do everything to prevent unions from getting a solid base in their enterprise. This leads to a scattered presence of unions among firms. In some firms, they are very powerful and this makes it attractive for employees to become and stay member, in other firms, they have hardly any members and the management of these firms prevents them from growing.

In more corporatist societies with centralised wage bargaining, the strategy of unions is different. They have an incentive to maximise the joint surplus by bargaining in ways as to prevent hold-up problems. Because these negotiations lead to higher efficiency of the economy, employers carry a benevolent attitude towards these co-operative unions. The labour unions can demand a portion of the extra rents that result from the increased efficiency in the form of higher wages. Economies that are characterised by co-operative unions show a diffusion of union members over all industries, but with low average union density. Free-rider problems are involved with this. To prevent hold-up problems, the results of the negotiations apply to all employees, so that union membership does not offer the “carrot” of a higher wage.

A second source of different incentives for these two types of unions comes from the problem of insider power. Co-operative unions feel the pressure of their members to start promising the employers a co-operative strategy. However, after the specific investments have been made, they are inclined to use their increased bargaining power to demand a larger fraction of the extra rents, which would mean a switch to antagonistic practices. This ‘insider power’ can be kept under control, when membership is spread over various industries, as is usually the case in corporatist societies. Union members that are working in different industries are then confronted with different idiosyncratic shocks, which leads to a minority of members that wishes wage increases. This minority will be ruled out by a majority of members that wants to save their reputation and keep on with maximising joint surpluses. This makes unions in corporatist societies credible (and unions in decentralised countries incredible) in their co-operative stance.

4.4.3 Trust involved

The mechanism by which hold-up problems are prevented in corporatist economies requires a substantial amount of trust between the bargaining parties. Both parties, employer and

employee organisations, can feel the incentive to cheat. This problem can be seen as a prisoners' dilemma problem. The social optimum would be to co-operate, but there are short-term incentives to defect. Why would parties trust each other? A first reason can be found in the value of a reputation of trustworthiness for a party. Having such a reputation creates value, because it stimulates other parties to engage in mutual beneficial trust-related transactions. The higher the frequency of these transactions and the easier it is to recognise the trustworthiness of the players, the more valuable the reputation becomes. Players will thus be very careful not to waste their reputation.

A second reason for mutual trust comes from social norms. These can help to solve these co-ordination problems by providing a focal point in the (re)negotiations about future wages (see also Teulings and Hartog 1998). The norms ensure that the beliefs about the out-of-equilibrium behaviour of others are in place, and the others will stick to the implicit contract during the renegotiations process. Social norms also have an important function in making the individual firms and workers accept the centrally bargained agreement as being a focal point. The individual members must trust their representatives at the central negotiations to have bargained the best possible agreement for them. The representatives must trust that the individual members will support their bargained outcome. Without this mutual trust, the system does not work. There is no sense in bargaining at a central level if the individual employees and employers are not willing to accept the results.

A specific norm that could offer such a focal point is fairness. The literature on microeconomic experiments shows that unfair behaviour is usually reciprocated by severe punishments, even when this creates some costs for the punishers themselves (see for example Güth, Schmittberger and Schwarze (1982) and Camerer and Thaler (1995) for findings of negative reciprocity in ultimatum games, and Ostrom (2000) for a short overview of findings in public good experiments). Therefore, the bargained labour conditions will have to be considered as fair.

The source of the norms of fairness differs between decentralised and corporatist economies. In decentralised economies, the focus is entirely put on what happens at the level of the firm, since information about shocks that occur at the aggregate level is not or insufficiently known. So, the focal point will be perceived at the level of the firm and rent sharing at this level becomes the norm. In corporatist societies, the focal point is at the macro level where corporatist organisations bargain over their "central agreements". With this focal point of fairness, it is very difficult for firms to deviate and set their own standards without facing the risk of retaliation.

The findings of Gordon (1994) can be related to this. He provides some evidence that antagonistic labour relations can be associated with decentralised economies, and co-operative relations with corporatist societies. In decentralised economies, the supervision intensity is substantially higher than in corporatist economies. In the former, the bargaining power of individual employees is probably put in check by supervision measures, whereas in corporatist societies social norms and the delegation of power to higher levels fulfil this task.

4.4.4 The hold-up problem once again; why is it important?

The proposition of this section is that trust can mitigate hold-up problems. Of course this argument is only meaningful when hold-up problems really exist (in general), when they are substantially large and when they are relevant for the Dutch case in particular. We admit that it is rather difficult to show in general that the main necessary condition for hold-up problems, asset specificity, holds. There is, however, ample empirical literature which suggests that hold-up problems do exist in practice. We first shortly discuss these evidences, and then show how the Dutch institutional framework is related to the implications of the hold-up model.

A major reason why we consider the hold-up problem related to trust formation is that corporatist wage-setting is better able to deal with unexpected price shocks than decentralised wage-setting because of underlying hold-up problems. The results of Holmlund and Zetterberg (1991) confirm this. Their study of real wage growth, for several countries and several industries, reveals that unexpected inflation has only a significant influence on real wages in the two most decentralised countries, Canada and the United States.

A second prediction of the hold-up model is that the length of individual contracts will be longer in decentralised economies. In this way, the contracting parties try to avoid the hold-up problem by contracting it away for several years. In corporatist economies, contracts can be adjusted to changing circumstances by higher level organisations without the danger of hold-up problems. Therefore, there is no need to use long term contracts. Short term contracts have the advantage of keeping in touch with external developments and are therefore preferred. Layard, Nickel and Jackman (1991) present some evidence that contracts of three years or longer are prominent in the United States and less prominent in corporatist European countries.

Third, the hold-up model implies that job-to-job mobility will be lower in corporatist societies. This corresponds with the findings of Abraham and Houseman (1993) who compare adjustments in the employment of production workers in the United States and Germany. In the short run, the more decentralised United States has higher adjustments in employment than the more corporatist Germany. Teulings and Hartog (1998) show on basis of OECD figures about distribution of tenure for different countries, that the proportion of long job duration is higher in corporatist countries, while short tenures are more common in decentralised economies. (However, of the twelve countries considered in this research, only the tenure distribution in the Netherlands does not fit well in the expected relationship. The authors do not explain this outlier.)

A fourth consequence of hold-up problems is that specific investments, in human capital or physical capital, will be lower in more decentralised societies. There are much data measurement and comparison problems with these issues involved. However, Teulings and Hartog (1998: 100) see “strong indications that the incidence of training is low in the United States as compared with other OECD countries”. Lynch (1994) finds that workers in American plants receive 30 hours of training, while workers in Japanese plants receive 80 hours. With respect to investment in physical capital and R&D, Hirsch (1992) finds a strong negative relation with unionisation for several industries in the United States.

These four fields of evidence, together with the research of Beaudry and DiNardo and Gordon mentioned above, provide a clear indication that hold-up problems are a real phenomenon indeed.

The next question is more specific. Given that hold-up problems exist, can the Dutch institutional context be linked to the hold-up model? Here the way in which wages are adjusted every year yields some evidence. The structure of the yearly wage increases in the Netherlands fits very neatly in the MacLeod and Malcomson contract model (see also Teulings and Hartog 1998). A first corresponding aspect is that the contracts are written in nominal terms.

The second resemblance is the decomposition of the wage increases in three parts. The first part concerns the contractual experience and tenure profile. Usually, every employee gets a yearly wage rise, because every additional year of tenure rises him one step at a specified fixed-wage scale. This part of the wage increase can be seen as the contracted wage increase in period 1 for period 2 when no shocks occur. The second component of the wage increase is negotiated by the corporatist organisations and consists of a fixed percentage increase for all wage scales. This is called the contractual initial increase, and can be seen in the model as an

adjustment to aggregate shocks that can be better handled by corporatist organisations than by negotiations at the firm level. The last part of the wage increase concerns the incidental increases (part of wage drift), which is the set of increases not explained by components one and two. These changes are negotiated at the micro level. Notice that this component is zero for two thirds of all workers, which is in line with the implications of the hold-up model.

The fact that employers are free to set wages for new hires also adds to the evidence for the relevance of the hold-up model. Wages for new hires are almost never set at the lowest possible wage scales specified by collective labour agreements, but based on the subjective interpretation of the capacities of the new hire by the employer. When the new employee is settled in a specific wage scale, he follows the yearly increases as is contracted by the corporatist organisations on the industry level. In terms of the model, the micro level is best suited to value someone's particular capacities, a higher level is best suited to determine the appropriate wage increases as reaction to aggregate shocks.

Other aspects of the model that are similar to the Dutch practice are the long-term collective labour agreements and extensions, which are very common in the Netherlands. They form an institutional structure in which employer and employee organisations can make long-term agreements on the development of wage costs. In the discussion of specific investments, we have seen that it facilitates mutually advantageous trade, if ex-post bargaining power is allocated to the party that carries out important non-contractible investments. Applying this to the literature of search models, in which specific investments occur in the creation of vacancies and searching for jobs, the Hosios condition tells us when the search intensity of workers and welfare of society are maximised (Hosios 1990, Boone and Bovenberg 2000). This process hinges on the relative bargaining power of workers and employers, which results in the relative distribution of the rents. Too low bargaining power for workers implies low search activity because of low wages, while too high bargaining power discourages employees from looking for a job because the probability of finding one diminishes when wages rise. Stating the division of rent in long-term contracts prevents the employers and employees from enlarging their bargaining power. Such a change in bargaining power would mean that the ex-post level of bargaining power would differ from the ex-ante optimal level of bargaining power with consequently a disturbance of the optimal distribution of rents.

4.5 Trust and the Dutch practice

After the extensive attention to the hold-up problem in the previous section, this section 5 continues with step 2 of our two-step approach, explaining how trust resulted in sound macroeconomic policies. The previous section argued that the hold-up problem can, in the wage setting process, be seen as a prisoners' dilemma problem, which could be more easily solved when trust is around. Whereas the discussion on the benefits of trust in the previous section took a rather theoretical perspective, the present section concentrates on the concrete measures that were taken by the policy makers and that contributed to the transition to the Dutch miracle. These measures can be understood as the (sound) outcomes of collective action problems. As trust leads to the better solving of this kind of problems, this strongly suggests that trust was an important condition for these measures to be taken and their positive effects on macroeconomic variables. Although we believe that, on balance, the institutional, trust enhancing set-up of the polder model has been beneficial to macroeconomic performance, the model also has its drawbacks. Therefore this section ends with a short discussion of the criticisms that the polder model received.

4.5.1 Wassenaar Agreement

The most famous agreement that is produced by the STAR is the central agreement of Wassenaar in 1982. This agreement, which couples wage moderation to labour time reduction, is seen as a starting point in the turn from the Dutch disease to the Dutch miracle. It marks the moment that unions and employer associations started realising that they had to cooperate in order to find a way out of the economic crisis. Although the Wassenaar agreement was maybe nothing more than a beacon of change, after it mutual trust developed quickly and the agreement was followed by a string of other central agreements. It marked the beginning of an “ideological pacification” between social partners (Van Bottenburg 1995: 199).

How did the agreement come into being? As we saw before, the economic situation in the beginning of the 1980s was unsustainable. The unions were not in a favourable position. They were losing members in a fast way and the government was threatening to use wage measures to get rid of the automatic price compensation rule (Van Bottenburg 1995). Especially the threat of the government to intervene seems to have functioned as a trigger mechanism for social partners to reach an agreement. The unions reasoned that they would gain nothing if the government intervened, but that they could expect something in exchange if they would reach an agreement with the employers. The compensation the unions sought (and got in the end) was a redistribution of work. This redistribution, given shape as labour time reduction, had as a purpose to fight unemployment.

It is noticeable that not only the unions had an incentive to prevent government intervention in the wage development. Also the employer associations wanted to keep the government out of the realm of labour market negotiations, although they had a different motivation. The employers were wary about the level of ambition the government would attain to lower unemployment. They feared that the government would copy policy measures implemented in France and Belgium, where governments announced collective job plans and obligatory working time reduction (see also Visser and Hemerijck 1997).

Notice, however, that the central agreements, signed by the chairmen of the employer and employee federations, are not binding for member unions and associations, nor for individual members. They just function as a focal point for negotiations about labour standards at lower levels. This is reflected in the names given to the central agreements. They vary from ‘central recommendations’ (1982), to ‘common policy framework’ (1989), ‘social-economic policy orientations’ (1992) and ‘agenda for the discussion on collective labour agreements’ (1992).

Although these central agreements of the STAR just put moral pressure on negotiating parties at industry or firm levels, this moral pressure has proved to be strong enough to change the outcomes of labour negotiations to a large extent. The agreement of Wassenaar of 1982 is illustrative. The Wassenaar agreement stated the importance of restoring firm profitability through wage moderation. Together with labour time reduction, this should encourage investments in employment. The agreement was very short, written in vague terms and not legally binding. The results, however, were impressive. In reaction to the Wassenaar agreement, the government enacted a law that made it possible to open all existing collective labour agreements and to postpone the automatic price compensation. In one year, about two thirds of all collective labour agreements had been renegotiated. On average, the price compensation was postponed for two years and the average working time declined with five percent. Between 1983 and 1985, the average wage decreased in real terms by nine percent (Visser and Hemerijck 1997). The labour income ratio decreased from 95.3 percent in 1982 to 81.5 percent in 1989.

An additional stimulus to the instrument of wage moderation came from the CPB. As what can be seen as a coincidence, the CPB based its economic policy analyses at the end of 1970s on a vintage model in which the favourable effects of wage moderation on employment were

much stronger than the negative income effects (Den Butter 1991). According to the model, lower labour costs would have a strong positive effect on the economy, because it increased the return on capital and would therefore postpone the replacement of machinery by more labour-extensive ones. Therefore, in accordance to the model, the CPB already had ‘instructed’ social partners and government for some years, that wage moderation would be the most appropriate measure to revive the economy. It marked the end of Keynesian demand policy.

A third important result of the agreement of Wassenaar, besides the stimulus to further co-operation between social partners and the start of a policy of wage moderation and work redistribution, was the retreat of government from the realm of labour market negotiations. This implied a drastic break with the past. Before 1982, the government intervened often and in a direct manner. In the nine years before the Wassenaar agreement, the government directly intervened with wage measures in six respective years. In the period after 1982, the government abstained from interference. It always followed the developments in labour standards closely, but used the possibility of wage measures only as a trigger mechanism to make sure that social partners would reach reasonable negotiation results by themselves.⁶ Although the government did not intervene anymore in a direct way in the field of labour standards, it still influenced and supported developments that it considered favourable for the economy. For example, the government supported the policy of wage moderation that social partners had agreed on, by lowering taxes and premiums for social security, especially after 1994. In this way, the decline in purchase power of families was softened, which made the agreement more acceptable for workers. Another example is that when social partners agreed on redistribution of work and ongoing liberalisation of the labour market, the government responded with a law on flexibility in labour relations, thereby adapting the law to the changing preferences for flexible working hours.

A background for the creation of the Wassenaar agreement can be found in the ‘sense of urgency’-feelings that arose in the beginnings of the eighties. The WRR and several committees wrote alarming reports about the state of the economy. A contributing factor to these “sense of urgency”-feelings is the fact that policy makers know that the Netherlands are a small open economy and therefore rather vulnerable in an international economic context (see Katzenstein 1985). The policy makers are aware of the fact that they do not have the possibility of protectionism to guard their industries. The Netherlands are too small to have an impact on the world economy, so it is the Dutch who will have to change when the economic environment changes. This forms another element that forced the Dutch to develop problem solving ways of decision making and inter organisational co-operation between government and social partners in order to reach consensus about adjusting to changing economic environments in flexible ways.

4.5.2 Policy measures

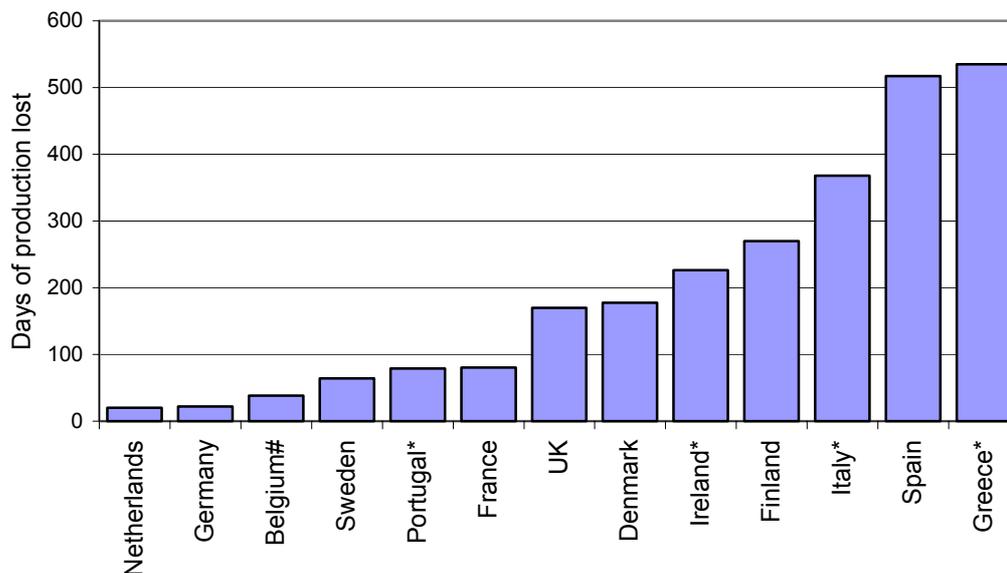
It is interesting to see how the theoretical considerations regarding the model of the labour market of section 4 relate to the three main policy measures that are held responsible for the Dutch miracle. Firstly, the most important, as stated before, was the policy of wage moderation in combination with the promise of employers to invest in employment. This can be seen as the clearest example of a long-term view of social partners and of a situation in which bargaining power has not been used to disturb the distribution of rents. The fact that

⁶ Since 1982 the government still has the right to proclaim a ceiling on wage rises, but the law only allows for these wage interventions in case the interests of the national economy require intervention because of sudden external shocks to the economy.

social unrest, in the form of strikes, was extremely low by international standards (see Figure 4.5.1), can be seen as a proof that labour relations were healthy even after two decades of sustained wage moderation.

The attempts to make the labour market more flexible are considered as the second beneficial policy measure. Like the consent on wage moderation, this measure also found support or maybe even originated in the Wassenaar agreement. Trade unions used to oppose flexible work, because they were afraid that other than full-time jobs would diminish the rights of employees. However, during the eighties and nineties, the Dutch unions reached agreement with the employer organisations on how to organise the rights and duties of ‘flex workers’. In 1999, a law on ‘Flexibility and security’ came into force, which provides a legal protection for flex workers. This attitude of willingness to adapt to a changing environment is one of the reasons that flex work took a high flight in the Netherlands. Between 1970 and 1996, the number of part-time jobs increased with 1.2 million to 1.8 million and the number of flexible jobs increased with 500,000 in this period, whereas the number of full-time jobs stabilised at 3.7 million (Hartog 1999). The opportunity for flex work (part time jobs) thus enabled a considerable part of the increase in labour participation. Again, consensus between social partners and government were the basis of this development.

Figure 4.5.1. Annual average of production days lost by strikes per 1000 workers, 1982-1998



Source: CBS, *Statistical Yearbook*, CBS: Voorburg/Heerlen.

indicates missing data for 1982-1984, 1986, 1987; * indicates missing data for 1998.

The reforms in social security are considered as the third kind of policy measures that directly contributed to the Dutch miracle. They lowered the replacement rate and thus stimulated the search for work. Furthermore, they had a positive impact on government finances, and thereby on taxes and insurance premiums. The lowering of taxes and premiums was used as support for the policy of wage restraint. Not all problems regarding social security were solved, however. This is elaborated in the next subsection.

4.5.3 The other side of the coin

As this chapter purports to illustrate that the so-called polder model and its inherent mutual trust among its main actors are to be seen as an essential condition for the Dutch miracle, we have, up to now, stressed the positive features of the model. Yet, of course there is also another side of the coin. Every system, also this one, has its specific drawbacks and flaws.

The critiques on the polder model can be split in two parts, comparable with the two-step structure of the chapter. The first type of criticism relates to the way mutual trust is formed among the actors. Here, it is the process of decision making which is criticised. The second type of criticism relates to the quality of the decisions made. Most prominent here are the problems with respect to the overloaded disability benefit scheme.

As mentioned above, the first type of critique relates to the process of decision making. One part of it criticises the consensus culture, the many ‘talking’ rounds and consequently the ‘stickiness’ of decision-making. The desire to reach consensus often proves to lead to long and repeated negotiations between all stake holding organisations. It is not easy to reach consensus when difficult issues are at stake. It involves a process of ‘giving and taking’ until all parties are more or less satisfied and can agree on the final compromise. We have seen that this process of consensus finding and ‘reiterating’ negotiations is favourable for the formation of trust, but its drawback is also clear. It can take a long time of negotiating and counselling before a decision is finally taken (or a unanimous policy advice is given).

A second element of this type of critique considers the lack of (a supposedly desirable) primacy of politics and the generic lack of ‘representativeness’ of corporatist actors. When corporatist actors are allowed to advise, prepare and/or decide on policy measures, this is favourable for the acceptance of these policy measures and for the formation of trust among the actors. However, it can be in conflict with the primacy of politics, i.e. to the monopoly of the state to devise policy measures because of its democratic legitimisation. Trade unions and employer federations do not have such a democratic legitimisation to impose policy measures, except for the making of agreements for their members. Here there is the problem of representativeness. The membership rate of unions is about 27 percent of the labour force in the Netherlands, but the unions negotiate labour agreements for entire industries. So, this system in which co-operative unions prevail leads on the one hand to the mitigation of hold-up problems and to a surge in mutual trust between employers and employees, as we saw in the previous section. On the other hand, the system also evokes free-rider behaviour of employees. They want to reap the benefits of the co-operative strategy of the union, but do not want to pay the contribution to become members of the union.

It is important to note that these criticisms do not attack the polder model for the failure to produce trust. On the contrary, trust among elite corporatist actors, to the extent that it contributes to the stickiness of the policy process and its lack of political representative-ness, is seen as the problematic feature of the polder model.

The second type of critique of the Dutch polder model is more substantial. It relates to actual and highly specific governance problems of industrial policy and corporate governance. The polder model is generally considered as too inefficient to solve these problems. The major problems are: (i) the long-time failure of the social partners to remedy the exploitation of the disability scheme; (ii) the questionable social efficiency of extending collective agreements to entire industry sectors and (iii) the issues of co-determination, i.e. whether co-determination of board members by the works council is an economically efficient means to induce supervision in corporate governance.

For already 15 years the overloaded disability scheme is seen as the most serious and urgent problem. We therefore elaborate this problem and do not discuss the other two. The

number of people that receive a disability benefit is reaching the one million at a total labour force of around eleven million people. This is about two to three times as much as in neighbouring countries. Social partners were reluctant in finding a solution for this problem. Attempts of the government to create financial incentives for sick and disabled workers to start working again, have been systematically countered by social partners. Decreases of the benefit level were all 'repaired' through collective labour agreements.⁷ Social partners also frustrated policies that were meant to curb the volume of benefit recipients. By having a majority in the managing boards of the organisations that were responsible for the implementation, administration and control of the social security system, they were able to grant easy access to benefits. The disability scheme became a 'dump' for less productive workers. It proved an easy way for employers to substitute older workers for younger, better-trained and cheaper ones. Employees preferred the structural higher benefits of the disability scheme above those of unemployment, and the bill was paid by society as a whole. Reforms in 1994 and 1996 created a privatised Sickness Insurance programme for employees. In 1995, as a 'punishment' the administration and operative control of unemployment, sickness and disability insurance was taken out of the hands of social partners and given to independent institutes. Yet, high social security expenditures for sickness and especially for disability (WAO) still constitute the major dark side of the success of the Dutch polder model. This problem will even aggravate in future with the further rise in labour participation and the ageing of the working population (see WRR 2000; Hazeu and Den Butter 2002). The Donner-committee and the SER have both written an advice about this issue. The government now has the task to initiate genuine institutional reform that will get sufficient political support and support from the social partners.

In the end, the efficiency of the Dutch polder model will be tested by its ability to resolve these issues. However, the conditions, under which the model is operating, are changing and not all for the better. Firstly, there seems to be a growing tendency for wage agreements to be negotiated at the firm, or even at the plant level. This tendency to decentralisation undercuts the Dutch polder model as this development puts considerable pressure on the government to end the current practice of extending collective wage agreements to entire industry sectors (i.e. make them legally binding for the entire sector, thus preventing free rider problems for the unions). In spite of severe opposition from the unions, the government has become increasingly unwilling to extend collective agreements, with potentially severe implications for the negotiating position of existing unions. The recent consolidation of Dutch unions in FNV Allies should be seen in the light of this.

A second tendency is the decline in union membership rates. Underlying causes for this tendency are the rising impact of information and communication technologies and the surge in more skilled and higher educated personnel. People are better informed and educated these days, and thus are more likely to feel strong enough to take care of their own business without the interference of a labour union. Especially in the ICT-sector, with many young and highly educated professionals, union membership used to be virtually non-existent. This trend increases the representative-ness problem. However, this tendency may be a little overrated due to the very positive cyclical tide of the last decade. Labour unions always experience a decline in membership rates when high economic growth translates in favourable labour market developments. It is remarkable to see that the end of the ICT-hype has been resulting in a steady surge of new union members from this industry sector. All in all, it seems that,

⁷ Although the benefit level in case of sickness declined from 80 percent of the normal wage to 75 percent in 1985 and to 70 percent in 1986, collective agreements made sure that sick employees received a benefit level of 100 percent from the first day of sickness.

given these contextual changes, the institutions of the polder model should be subject to gradual reform themselves in order to survive and enable trust formation to the benefit of macroeconomic performance (see also Wellink and Cavelaars 2001).

4.6 Conclusion

In an international perspective, the Dutch economy has shown a remarkable record of employment and welfare growth, starting in the beginning of the eighties. This chapter argues that the Dutch culture of consensus formation constituted a major driving force for this miraculous economic recovery. The institutional framework for social-economic policy preparation displays various features that are in line with theories about trust-formation in networks. Trust between the foremen of government and social partners have led to co-operative long-term views on the economic problems, which provided ample societal and political support for drastic policy measures. In this way, the Dutch institutional framework, with its specific formal and informal consultation structure, has functioned as an intermediary between trust at the micro level and macroeconomic performance of the country. The way in which the interaction between scientific economic analyses and policy making is organised, contributed to a major extent to the formation of trust and hence to societal support for policy measures that were instrumental in the economic recovery.

Of course, this chapter is narrative in the sense that it describes the link between the success of the polder model and the role of networks, trust and institutions by a one case study only. So our study cannot be regarded as an empirical test of the relevance of the theoretical argumentation. Actually, such an empirical test seems not feasible anyhow in discussions of the influence of institutions on macroeconomic performance. There are no 'winning' institutional models as the social and historical background is different for each country (see Freeman 1998).

4.7 Epilogue

Although this chapter was meant to provide an analysis of the period 1980-2000 only, recent developments in the polder ask for a comment. Shortly after the Dutch unemployment rate dipped below the two percent in 2001, the economy ran into a recession. The shortages on the labour market translated into upward pressure on wages. At the same time stock markets tumbled worldwide, which had international repercussions on demand, and the exchange rate of the euro vis-à-vis the dollar soared. As a consequence, Dutch exports suffered heavily, unemployment doubled in two years and government finances deteriorated sharply. The small government budget surplus in 2000 became a deficit of more than three percent in 2003, which resulted in a warning of the European Commission for breaking the rules of the Growth and Stability Pact. While the economic circumstances worsened and asked for policy interventions, policy makers were largely distracted by turmoil in the political field. A new populist political party, the LPF, won the elections of 2002 and obtained a place in the new coalition government Balkenende I. Unfortunately, the LPF suffered from internal frictions, partly because its leader and founder Fortuyn was murdered shortly before the elections. After six turbulent months, the government had to retreat. The new centre-right government Balkenende II, starting in 2003, immediately initiated actions to overcome the 'lost year'. It wanted to revive the economy and to restructure government finances. During the autumn consultation of 2003, government and social partners found each other in the 'Historical Agreement of The Hague'. Core of this agreement resembled that of the Wassenaar Agreement: wage moderation for the coming years. The polder model seemed to have delivered its trick again, but not all issues had been agreed upon. The discussion of the

government plans for a cut in the tax break provisions that facilitate early retirement were postponed to the spring consultation of 2004. This consultation round ended in disharmony. Government and labour unions could not agree on the restructuring of the early retirement scheme. As a result, the Agreement of The Hague became void. Labour unions threatened to neglect the agreement on wage moderation and to organise actions against the government's early retirement proposal. The government stated that it could do without an agreement with the social partners. It announced plans to cancel all tax break provisions for retirement before the age of 65, to stop extending collective labour agreements that lead to rising wage costs, to strengthen the criteria for entitlement of unemployment insurance benefits, to lower sickness benefits, and to extend the labour week from 36/38 hours to 40 hours.

What can we learn from these developments with respect to mutual trust and effectively taking care of economic problems? Three problems regarding trust as a co-ordination device come to the fore.

First, trust as a co-ordinating device has its limits in the sense that this type of policy concertation is, in the end, always subordinate to the power of market forces. With respect to the moderation of wages, it is possible to influence the wage development for some years with help of trust based consensus and agreements between policy makers, but the wage development in the middle long term is an autonomous process (also see Delsen 2002). As we see in Figure 4.2.3, wage moderation already set in a few years before the Wassenaar Agreement was negotiated. The reverse happened in the 1970s and the second half of the 1990s. The wish of the government to keep wages down was set aside by the 'uncontrollable' upward pressure on wages caused by a booming economy and labour shortages. It is easy for companies and employees to circumvent the centrally bargained maximum wage rises. Wages for new employees can be set at any height, incumbents can be promoted, and perks (like company cars) and other alternative forms of wages can be offered (like stock market options or pension entitlements). Although trust based central agreements cannot ignore market forces, they are not useless either. First of all, they can support the needed changes in wage policies. As said above, yearly adjustments to external shocks can better be made at the central level than at bilateral levels in order to prevent hold-up problems. Central agreements help to change directions of the economy in a tidy and fast manner. The oversight at external circumstances combined with the absence of hold-up problems at the central level leads to more adequate reactions to external shocks, in the sense that this reaction is faster and without inefficient reactions (such as strikes), than when wages have to be renegotiated on the bilateral level. A second reason why trust based policy concertation is not useless is because it enables all kinds of 'good causes' like education and training for workers or employer organised baby day-care that would otherwise be plagued by free rider behaviour.

Second, trust as a co-ordinating device has its limits in the sense that it is a feeble mechanism that can be easily disrupted. This feebleness works in two ways. First, when there is felt no need to intervene in the economy because of the perception that the economy is running smoothly (i.e. lack of 'sense of urgency'-feelings), the economic situation and international competitiveness may worsen quickly. This is what happened in the Netherlands from the end of 1990s to the beginning of the 2000s. Second, trust may easily be lost. It comes on foot but leaves on horseback. The 'trust crisis' in 2004 just happened, although all involved policy makers were professionals who understood the blessings and the functioning of the polder model, although they had all the frequent face-to-face contacts that were supplied through the institutional framework as described in the previous sections, and although the SER was presided by an extraordinarily consensus orientated chairman at that moment. Why did trust

still wither? One of the reasons suggested by newspapers is the *incompatibilité des humeurs* between the chairman of the unions, the chairman of the employer federation, the prime minister and the minister of Social Affairs and Employment. A second reason would lie in a breach of trust by the minister of Social Affairs and Employment against social partners, by promising, *ex ante*, to take over a SER advice on the disability scheme but refraining to do so, *ex post*, when this advice was delivered. The feebleness of the consensus system for this type of problems can be regarded as a considerable inherent weakness. Relatively small events may have large disruptive effects.

Third, trust as a co-ordinating device has its limits in the sense that it cannot overcome ideological differences between involved parties. Trust based policy concertation only works when all involved parties agree on the actual problems, agree on a shared understanding about the aims and mechanisms of economic policy, and believe that the other parties will do what they promise to do in order to tackle the perceived problems (Compston 2003). In 2004, government and labour unions seemed to disagree on the seriousness of the economic problems and certainly disagreed about the way the economy should be revived. Ideological differences, in specific about the way early retirement should be facilitated in a fiscal manner, and in general about the level of collectivity, solidarity and responsibility of workers themselves in the area of unemployment, disability, sickness and old age provisions, made a consensus solution illusionary. In the light of the economic situation, the government felt the urge to take major steps in restructuring (sobering) the welfare state and introducing more financial incentives for individuals to find a job, keep working until 65, stay healthy and not become unemployed. On the other side, the labour unions felt the responsibility to act as a 'shield for the weak' and make sure that solidarity would remain the main brick stone of the social welfare system – which implies somewhat more collectivity and somewhat less individual incentives in the provisions.

The unions' point of view is partly ideologically based and partly a direct consequence of the fact that they are special interest organisations that fear to lose the support of their members. Co-operation at the central level would imply a loss of trust of the union members in the union leaders. Core of the problem seems to be that the special interests of the labour unions and the common interest are diverging, because the background of the union members is getting less and less representative for society as a whole. It is decreasing in volume and becoming ever more biased to relatively old people, who have a relatively large preference for intragenerational solidarity which comes at cost of intergenerational solidarity. In other words, they favour a system in which the younger generations have to pay for the older generations. The special interest of the union members thus hinders the unions to operate as encompassing organisations that act in the common interest. This implies that the leaders of the union face a trade-off between within-group trust (trust between union members and leaders) and between-group trust (trust between union federations on the one hand and government and employer federations on the other hand), which is irreconcilable as long as the interests of union members and society diverge.

In the presence of this distance in ideology and interests between government and unions, trust cannot form a solution in the short term. There are two ways out from this point. The first option is to switch co-ordination regimes from 'consensus' to 'confrontation', what seems to have happened. The announcements of both government and unions suggest that both parties have accepted that they will not find a consensus solution and are prepared to test their power in a clash situation. Given all that is said in this chapter about the positive effects of trust based policy concertation, this option negatively affects societal welfare. The second way out is to 'agree to disagree' at the moment without falling back to an outright clash

situation, and try to come closer to each other in the next couple of months or years. This means a delay in finding a solution for the problems, but keeps the hope and ambition alive that the differences will decrease over time. In this process of trust restoration, the government has to make clear to the unions that the proposed reforms are really necessary to combat a serious economic problem and/or accept that solidarity is a necessary part of social welfare provisions. The unions have to make clear to their members that a short-term focus on their special interests may hurt these interests in two ways. First, it damages the unions' position and power in central bargaining situations, which is already under fire as a result of the declining membership rates. Second, this non-cooperative stance may hurt the common interest, and in this way also hurts their long-term special interests. Only then, the polder model might survive.

Chapter 5

Co-ethnic employment

Social ties, notably between kith, kin and co-ethnics, increase trust and trustworthiness, and thus mitigate breach of agreement. As such, ties have a commercial value where contract law or other methods of enforcement do not apply or are weak.

Salter (2002: 279)

5.1 Introduction

In many Western economies there is a fierce policy debate on the welfare effects of immigration and more specifically on the (lack of) integration of immigrant groups in the regular labour market.¹ Empirical evidence suggests that the workforce of a considerable number of firms with an ethnic minority owner consists for the larger part of co-ethnic employees. We call this clustering of co-ethnic workers co-ethnic employment. In this chapter, we study the questions why so many ethnic minority employees work in co-ethnic firms and how this translates in welfare effects for the employees, the firms, the ethnic minority group and the society. In doing so we seek to explain the rationale behind co-ethnic employment from the perspectives of labour economics and institutional economics.

Most of the existing research in this field focuses on ethnic minority entrepreneurs and their ways of doing business. Usually, just small attention is paid to the phenomenon that co-ethnic employees are over-represented in ethnic minority firms, and if this question is raised, the answer is often sought from the perspective of the employer. This chapter contributes to the literature by examining the issue of co-ethnic employment from a different angle, namely the perspective of the employees. Instead of studying why employers want to hire co-ethnic employees, we investigate the motivations of ethnic minority employees to work in co-ethnic firms. We argue that strong social networks and related high within-group trust constitute the major reasons for co-ethnic employment by lowering information and co-ordination costs. Asymmetric information is a well-known phenomenon in the principal-agent relationship between employers and employees. The information asymmetry between bosses and workers is smaller when both have the same ethnic background than when their ethnic backgrounds differ. Therefore search costs, monitoring and bonding costs are lower in co-ethnic employment principal-agent relationships than in the case that the principal belongs to another ethnic group (say a majority group) than the agent (say a minority group). A similar reasoning holds for informational differences and incompleteness of information between workers. Co-ethnic employment seems to lead to immediate positive welfare effects in the short run, but the welfare effects are less prosperous in the longer run, when the dangers loom of ethnic minority group lock-in and inertia.

¹ This chapter is largely based on Den Butter, Masurel and Mosch (2004).

The set-up of the chapter is as follows. Section 2 starts with a short overview of the literature on the labour market characteristics of immigrants. Here an operational definition is given and the incidence of co-ethnic employment is illustrated using the results of various surveys. Most of these results relate to our own country, the Netherlands. Given this empirical evidence, section 3 discusses the reasons for co-ethnic employment. Here the focus is on incentives and on the costs of information and co-ordination. Section 4 discusses the welfare effects of co-ethnic employment. Here we consider the positive and negative externalities associated with co-ethnic employment and its consequences for individual welfare and social welfare. This provides a clue for answering the question on policy options to enhance the (positive) welfare effects of co-ethnic employment in section 5, which also summarises the conclusions.

5.2 *Ethnic entrepreneurship and co-ethnic employment*

Before we start with a description of the characteristics of co-ethnic employment, we first have to make clear what we mean with this phenomenon. We define a co-ethnic firm as a firm of which the owner (the employer) has the same ethnic minority background as the majority of his personnel (the employees). Co-ethnic employment refers to the situation that a substantial part of the employees of a specific firm belong to the same ethnic minority group. In this chapter, ethnic minorities are considered to be non-Western immigrants of the first and second generation. We follow the definition of the Netherlands Central Bureau of Statistics by defining first generation immigrants as persons born in a foreign country with at least one parent born in a foreign country (CBS 2003). Second generation immigrants are persons born in the host country with at least one parent born in a foreign country. In short, immigrants are persons with at least one of their parents born in a foreign country.²

The major ethnic minority groups in the Netherlands consist of people from Turkey, Morocco, Suriname, the Netherlands Antilles and Aruba. The people from Turkey and Morocco were invited to work in the Netherlands to fill the labour shortages in the 1960s and 1970s. Suriname, the Netherlands Antilles and Aruba have been colonies of the Netherlands. Suriname became an independent country in 1975. Fear for poverty and the new government in Suriname motivated many Surinams to flee to the Netherlands. The Netherlands Antilles and Aruba are still part of the Kingdom of the Netherlands. This entitles the Antillans and Arubans to study, work and live in the Netherlands.

5.2.1 Labour market characteristics of ethnic minority groups

Three general observations emerge from the literature on the labour market characteristics of ethnic minority groups: bad labour market performance, high incidence of self-employment and entrepreneurship, and the important role of the own ethnic minority group.

The first observation is that immigrants tend to do worse on the labour market than members of the native born population, also when controlled for objective characteristics like education, gender, age, et cetera. This observation stands in shrill contrast with the popular fear that natives lose their job as a result of immigration. In the Netherlands, non-Western

² We are aware of the discussion that people who were born in a foreign country but migrated to the host countries before their sixth birthday, could be considered as second generation immigrants, because this early migration enabled them to receive their education in the host country (Veenman 1996). As this discussion is somewhat besides the main topic of this chapter, we leave this issue by this.

immigrants and their offspring have a relatively high incidence of unemployment and a relatively low labour participation rate, see Table 5.2.1. Studies for the United States (e.g. Chiswick, Cohen and Zach 1999) and for the UK (e.g. Wheatly Price 2001, Blackaby et al. 1997) show the same kind of immigrant labour market problems. This poor labour market performance of first and second generation immigrants in the recent past, and the resulting small or even negative contributions to welfare, contrast with historical accounts of immigration. For example, the German peasants that migrated to the Netherlands at the end of the 19th century) contributed considerably to welfare in the Netherlands (see also section 4).

Table 5.2.1. Labour market position of persons of age 15-64 years in the Netherlands, 1996-2002

	1996	1997	1998	1999	2000	2001	2002
Labour participation (%)							
Natives	61	63	64	66	67	67	68
Ethnic minorities	40	41	44	46	48	50	50
From:							
Turkey	34	35	37	40	44	48	46
Morocco	31	35	38	39	34	42	46
Suriname	53	52	58	58	63	62	61
NI Antilles and Aruba	46	45	50	53	55	54	57
Unemployment (%)							
Natives	6	5	4	3	3	3	3
Ethnic minorities	22	21	16	14	11	9	10
From:							
Turkey	24	22	16	13	9	8	9
Morocco	28	22	20	16	13	10	10
Suriname	15	13	12	10	9	6	8
NI Antilles and Aruba	21	21	16	14	8	8	10

Source: CBS 2003: 138.

The second labour market characteristic of immigrants is their overrepresentation in self-employment and entrepreneurship figures. Ethnic entrepreneurs are defined as being united by a set of connections and regular patterns of interaction among people sharing common national background or migration experiences (Waldinger, Aldrich and Ward 1990) or simply as business owners who are not of the majority population (U.S. Department of Commerce 1997). Ethnic entrepreneurship comprises a multi-faceted phenomenon that has at least as many sides as there are different ethnic groups. We refer to the studies of Boissevain and Grotenbreg (1986), Aldrich and Waldinger (1990) and Chaganti and Greene (2002) for general evidence and theory on ethnic entrepreneurship.

The motivations for immigrants to start an own firm vary widely. Negative reasons or push factors are high unemployment (Kloosterman, Van der Leun and Rath 1998), discrimination (Deakins 1999, Johnson 2000), socio-economic status and cultural factors (Rafiq 1992), leaving immigrants no alternative but to start for their own. Positive reasons or pull factors are the need for achievement and the wish to be own boss. Especially sectors with low entry barriers (like retailing and hospitality – bars and restaurants) are attractive for these start-ups; they usually set up their businesses in those sectors where informal production (with low government control) can provide a competitive advantage. This is also the case in the Netherlands, see Table 5.2.2. Compared to the native population, immigrants are over-represented in hospitality and commercial services.

Table 5.2.2. Persons of age 15-64 years with one or more jobs as an employee as percentage of the total ethnic group in the Netherlands, October 2000

Industry	Natives	Ethnic minorities
Agriculture and fishing	1.8	2.0
Mining	0.1	0.1
Industry	13.9	14.4
Utility companies	0.5	0.2
Construction	6.5	2.7
Trade	17.1	14.5
Hospitality	3.0	6.5
Transport and communication	6.4	5.5
Financial organisations	4.0	3.1
Commercial services	15.2	30.5
Public administration	7.2	4.8
Education	6.1	3.1
Health	13.4	9.1
Culture and other services	3.6	2.7
Unknown	1.2	0.7

Source: CBS 2003: 146.

The issue of ethnic minority entrepreneurship is discussed in the literature in the context of the incorporation of new immigrants into the labour market. Classical theories of assimilation assume labour supply as a pool in which immigrants start at the bottom and gradually (and occasionally) climb up the socio-economic ladder, while gaining social acceptance. Integration and emancipation are just a matter of time in this view. A second line of theories considers new immigrants as being mainly additions to the secondary labour market linked with small peripheral firms. According to this theory, ethnic minorities experience prolonged problems in entering the regular labour market and thus seek refuge in self-employment. Wilson and Portes (1980) introduce a third possibility: the enclave economy, which consists of immigrant-owned firms that are isolated from the regular economy, thus constituting a dual labour market. In the words of Portes (1998: 13), enclaves are “dense concentrations of immigrant or ethnic firms that employ a significant proportion of their co-ethnic labor force and develop a distinctive physical presence in urban space” (see also Peterson and Roquebert 1993). The separation of the regular and the ethnic minority labour market is permanent in this case and integration has failed completely.

The third typical aspect of ethnic minority labour and, especially, ethnic minority entrepreneurship is the crucial role of the own ethnic group. Almost by definition the entrepreneur has a strong focus on his (or her) own group, especially the first generation who starts for his (her) own. Nijkamp (2003) stresses that, although network participation by creative entrepreneurs does not necessarily need an urban base, informal spatial networks may be favourable for ethnic entrepreneurs.³ In the fields of clients, finance, information and employment the ties with the own ethnic group strongly dominate (Waldinger et al. 1990, Ram 1994, Greene 1997, Kloosterman, Van der Leun and Rath 1998). Van Delft, Gorter and Nijkamp (2000) argue that ethnic related social networks appear to be multi-faceted and flexible, and offer good possibilities for the efficient recruitment of personnel and capital. In general, ethnic businesses rely heavily on labour from their particular ethnic group or, more

³ According to De Graaff (2002), minimising the costs of adaptation (or migration costs) is the main reason for the spatial clustering of immigrants. This can be translated into various positive spatial externalities, such as the possibilities of obtaining information, housing and even finding future spouses.

specifically, the (extended) family.⁴ Also capital can be more easily borrowed informally (Van Delft, Gorter and Nijkamp 2000). In addition, within the network of the ethnic group, individuals are depending on informal ways of doing business and exchanging information, because there is mutual trust within the network. Lee, Cameron, Schaeffer and Schmidt (1997) call this phenomenon the social resources explanation: the success of ethnic minority business can in part be explained by the existence of such social resources as rotating credits, a protected market, and a labour source.

This third typical aspect of co-ethnic employment is elaborated further in the next section from the general perspective of relative small information and co-ordination costs, but we will first consider the question whether we can find empirical evidence on over-representation of ethnic minority employees in co-ethnic firms.

5.2.2 Empirical evidence

A number of studies indicates that co-ethnic employees dominate in ethnic minority firms, see Table 5.2.3. All of these studies are based on interviews with managers (mostly the owners) of small firms in or around Amsterdam. Most firms operate in the retail sector or in the hospitality sector. Together they form a dataset of 120 ethnic minority firms. Between 50 and 84 percent of these firms only employ co-ethnic personnel. Some firms employ personnel with mixed co-ethnic background and between 16 and 33 percent of the firms only employ non co-ethnic personnel. When we compare these figures with the benchmark of the size of the ethnic minority groups as percentage of total population, this gives a clear idea that co-ethnic employment is a real phenomenon.

Other evidence for the proposition that co-ethnic employees tend to cluster together in firms comes from a survey conducted by the Netherlands Economic Institute for the Construction Industry (EIB 2003). Their survey was sent to 8883 firms and responded by 3573 firms (40 percent response rate). The definition of an ethnic minority employee in this research is a person of whom at least one parent was born in a non-Western foreign country. A typical aspect of the construction industry is that members of ethnic minority groups are underrepresented in its employment, also see Table 5.2.2. Reported causes are the informal way of attracting new employees (which leads to a path dependency), the 'tough' culture in this profession, and discrimination and prejudice among employers about the language skills and the productivity of immigrants (EIB 2003: 23). About 90 percent of all firms in the construction sector report to have no ethnic minority personnel.

The prevalence of ethnic minority personnel in the construction industry in firms with at least one ethnic minority employee is shown in Figure 5.2.1. The interesting aspect of this figure is the 'fat tail' on the right. One would expect that the frequency of firms decreases when the prevalence of ethnic minority personnel rises. This can indeed be seen in the figure until a prevalence of 80 percent. After this, in the 80-100 percent prevalence area, we see an unexpected hump that indicates that there is a substantial number of firms which mainly consist of co-ethnic employees. This confirms the idea that co-ethnic employees tend to flock together. Note however, that we do not know the ethnicity of the entrepreneur in this case.

Although the information from empirical research on co-ethnic employment is scarce, the data that we find all point in the direction that co-ethnic employment is a real and substantial

⁴ This may be a result of labour market discrimination, which is defined by Borjas (1996) as the arise of differences in earnings and employment opportunities among equally skilled workers employed in the same jobs simply because of the workers' race, gender, national origin or sexual orientation and other seemingly irrelevant characteristics. This argument goes back as far as Becker (1957).

phenomenon. However, there is ample scope for further research on the prevalence and magnitude of co-ethnic employment in different sectors of industry and in different countries.

Table 5.2.3. Prevalence of co-ethnic personnel in ethnic minority firms in the Netherlands^a

Study	Ethnic background of owner ^e	Number of firms in dataset	Only co-ethnic personnel (% of firms)	No co-ethnic personnel (% of firms)	Personnel with mixed ethnic background
Masurel et al. (2002) ^b	14 Turkey, 15 Pakistan/India, 12 Morocco	41	84 %	16 %	0 %
Baycan Levent, et al. (2003) ^c	Turkey	25	69 %	31 %	0 %
Masurel et al. (2004) ^d	Morocco	14	67 %	33 %	0 %
Masurel and Nijkamp (2004)	Turkey	40	50 %	25 %	25 %

^a The empirical evidence does not come from the papers as such, but from the underlying databases. It should be noted, furthermore, that we did not make a sharp difference between active family members and formal personnel.

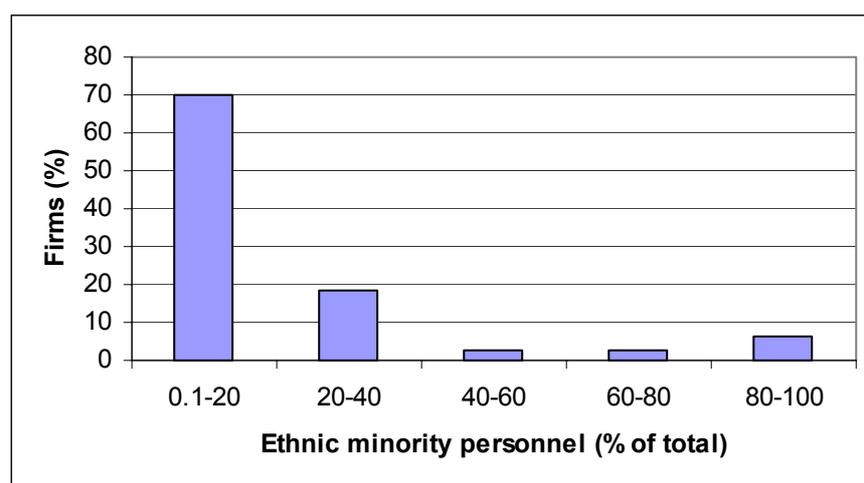
^b 2 respondents work alone, 32 work with employees and the remaining 7 do not work alone, but without employees, but with business partners, spouse and or family members. Other ethnic minority personnel accounts for 6.3% of the cases: this is now part of 'no co-ethnic personnel'.

^c 13 of the 25 firms had employees. Only percentages of total volume were available. 5% of the employees were family members.

^d 6 work only with Moroccan employees, 5 only with Moroccan family members, 2 with only native employees, and 1 with native employees and Moroccan family members.

^e People from Turkey, Pakistan/India and Morocco as percentage of total population in 2002, respectively 2.1, 0.1 and 1.8 (CBS 2003: 116).

Figure 5.2.1. Prevalence of ethnic minority personnel in the Dutch construction sector in



firms with ethnic minority personnel, 2003

Source: calculations based on the survey reported in EIB (2003).⁵

⁵ We acknowledge the help of the EIB for providing us these data from the survey.

5.3 Reasons for co-ethnic employment

Given this empirical evidence on over-representation (and under-representation) of ethnic groups in specific firms and sectors of the economy, we now try to explain this phenomenon from the theoretical perspective of information and co-ordination costs.

5.3.1 Social capital, networks and trust

In general social networks and social capital are seen as major reasons why ethnic firms hire a disproportionate amount of co-ethnic workers and why co-ethnic workers want to work in co-ethnic firms. Social networks are networks based on some shared characteristics of people, e.g. they have the same ethnic, cultural or religious background, live (or have lived) in the same region or neighbourhood, speak the same language, and/or have the same social-economic status. The importance of these networks is that they can create resources for the members of the network, which is known as social capital. In the words of Bourdieu (1986: 248), social capital is “the aggregate of the actual or potential resources which are linked to possession of a durable network of more or less institutionalized relationships of mutual acquaintance and recognition – or in other words, to membership in a group”. These resources range from highly implicit to concrete material benefits.

Immaterial benefits are generated by the social control function of the network. This involves the creation of uniform values and norms, which ease the co-ordination of behaviour. Values and norms make the behaviour of other people more predictable. This lowers information costs as part of transaction costs by reducing uncertainty without needing the help of expensive formal co-ordination systems, like the police and the legal system. Social control and social sanctions uphold these informal rules. Breaking the rules leads to a depreciation of the reputation of the violator of the rules, sometimes with consequences for his whole family. This can go as far as social ostracism, which has serious consequences for the offender's social, religious and business life. But values and norms also create loyalty of individual members to (other members of) the group. Even when the network is putting pressure on an individual member, he may decide to stay in the network (not to exit), not to raise his voice and protest (not to voice his anger), but to support the network (to be loyal) (Hirschman 1970).

The advantages of the network can also be found in its function as a communication device, through which reliable information, about for example job opportunities, is spread through the community quickly and efficiently (Portes 1998). Networks can also be helpful in starting up businesses by acting as a lending channel. A famous example are the Korean rotating credit associations in the United States (Light and Bonacich 1988).

The main force behind the networks is that the members see themselves as belonging to the same group of people, who are ‘in the same ship’, and have to co-operate to ‘survive’ in the strange and maybe ‘hostile’ environment they have migrated to. This leads to, as Putnam (1993) calls it, general reciprocity. Members of the network help each other. They do not do this to get their favour returned in the same amount, from the same person and as soon as possible, but in the idea they will receive some kind of help from someone in the network somewhere in the future when they need it in their turn. A characteristic of these networks is that there exists mutual trust, i.e. the members of the network expect that the other members will co-operate and will reciprocate in the future the favours received now.

Results of micro-economic game experiments are in line with the above mentioned characteristics of networks. People tend to have more trust in people that are of the same race or nationality than in other people (Glaeser et al. 2000, Alesina and La Ferrara 2000, Buchan

et al. 2002). Reciprocity has also been tested in laboratory experiments. The results suggest that both positive and negative reciprocity influence people's behaviour (Fehr and Gächter 2000).

The effects – advantages and disadvantages – of networks are highly dependent on their degree of density. The more closed and dense the network, the better are the members able to uphold the implicit values and norms of reciprocity and trustworthiness, and the better they are able to circulate information. However, this can easily turn into a disadvantage, as a closed network impairs the risk to miss new, potentially beneficial influences from outside the network. A feature of many high-density networks with high mutual trust among its members is that they expose very little trust in people from outside the network. Fukuyama (1995) argues that this could be the reason that countries in which people only have trust in their (extended) family seem to have relatively less large firms than countries in which people have a higher general trust in strangers, i.e. in people from outside their own (extended family) network. For a firm to grow large, it is necessary to attract strangers with certain skills and capabilities that cannot be found in one's own network or family. This hypothesis has been corroborated by the empirical research of La Porta et al. (1997). If the above is true, then it should be the case that firms owned by migrants from 'low trust' countries (like China, Turkey, South-Italy and France) have a larger portion of co-ethnic employees than firms owned by migrants from 'high trust' countries (like Japan, Germany, North-Italy, Netherlands and the United States).⁶ When appropriate data were available, this hypothesis could be tested in future research.

5.3.2 Utility of co-ethnic employment

We now turn to the incentives for a member of an ethnic minority group to find a job in a co-ethnic firm or a regular firm. A regular firm is a firm in which ethnic minorities are not over-represented in the personnel structure as compared with the prevalence of the ethnic minority group in the total population. A regular job is a job in a regular firm and a co-ethnic job is a job in a co-ethnic firm. We start with the basic assumption that a person wants to maximise her utility function. She can choose between a regular job and a co-ethnic job. The utility she derives from a job depends on the chance of finding the job (and the search costs) and the rewards of the job (corrected for investment costs in education et cetera). She chooses a regular job if the utility of a regular job is higher than the utility of a co-ethnic job. We first look at the incentive structure that is connected to the rewards, after that we continue with the incentives arising from the search process.

Rewards – management problems

The rewards of an employee are largely determined by her productivity. A widely recognised problem considering productivity is that productivity is hard to measure. Asymmetric information with respect to tasks and their fulfilment between managers and personnel leads to the well-known principal-agent problem. The principal (the manager) has other objectives than the agent (the employee), but is not able to monitor the behaviour of the employee completely. Strong formal monitoring on the aspects of the employee's behaviour that can be monitored often leads to perverse consequences. The employee will tend to do her utmost best to perform well on the monitored tasks but will neglect her other duties. The principal-agent problem is aggravated by the inherent incompleteness of contracts. It is very costly to gather

⁶ This distinction in high and low trust countries is based on Fukuyama (1995).

information, some information cannot be obtained at all, it is costly to write down an extensive contract and writing down all possible events may even create distrust among the contracting parties. Furthermore, even with a complete and legally binding contract, severe costs are involved with the enforcement of this contract through judicial procedures. They are costly, time consuming and some parts of the contract cannot be verified by third parties like judges. These highly incomplete contracts give contracting parties opportunity and incentives to shirk on the expense of the other party (Williamson 1985).

Besides this monitoring problem, also the bonding problem comes forth out of the combination of bounded rationality, scarcity of information and contracting problems. The productivity of an employee rises when she works longer in the same firm (learning by doing) and when specific investments are made. Specificity of an investment means that the value of an investment is directly dependent of the continuation of the relationship. An example is a firm investing in the skills of an employee while these skills are only valuable in this particular firm. The productivity of the employee in this firm rises and, as long as the employee stays within the firm, the investment leads to extra rents (to be divided between firm and employee). The lack of complete contracts hinders mutually advantageous investments in this case, because the *ex ante* (before the investment) commitments are not credible in the post-investment phase. The incentives for splitting the rents and continuing the relationship have changed by then. Although there are profitable investments to be made, potential investors may refrain from doing so, because they are afraid that their transaction partner will hold them up.

This means that there is no formal way to solve the principal-agent based monitoring and bonding problems. The principal and his agent have to trust each other, i.e. they expect that the other will refrain from opportunistic behaviour and perform according to the letter and spirit of the agreement. As we discussed in chapter 2, the ability to trust is an important element of social capital, while networks form the framework for the development of trust and social capital. Within a certain network, e.g. an ethnic minority group, members can easily transpose and enforce collective values and norms, which creates mutual trust. Acting in accordance with these values and norms leads to the positive reward of social recognition, while 'bad' behaviour results in a loss of reputation and, in the worst case, exclusion from the network. Because it takes some time to create a solid reputation – a valuable asset as it is useful in both business and social matters – while it can be destroyed at once by one unwise malevolent act, the implied trigger mechanism forms an indisputable strong incentive to behave by the rules.

From this perspective, the ethnic network can be seen as a trust creating device, which makes it possible to economise on the transaction costs that accompany management problems. The informal ties are used as a means of managerial discipline that mitigates the monitoring and the bonding problem. Another advantage of this management device is that it is helpful in substituting formal procedures. Especially in the case of ethnic minority firms, the firm owner might have little or no knowledge of the official labour market and its regulations. Co-ethnic employees are for these reasons more productive in co-ethnic firms than employees with other ethnic backgrounds. The resulting extra rents for the co-ethnic firm may be split among owner and personnel, which forms a monetary incentive for co-ethnic employment.

If the monitoring and bonding problems analysis is correct, we expect that the average tenure of ethnic minority personnel is lower in regular firms than in co-ethnic firms. The trust creating network aspect is missing in regular firms, while it is doing its beneficial work in co-ethnic firms. It is hard to find data on firing decisions or average tenure of ethnic minority group members, but the EIB survey (2003: 36) about ethnic minorities in the Dutch

construction industry reports an extraordinarily high volatility in ethnic minority personnel. Both inflow and outflow are about 25 percent of the total number of ethnic minority employees per year. This could be regarded as an indication that firms with a non-co-ethnic owner suffer substantial management problems to keep their ethnic minority labourers inside the firm.

Rewards – general and culture specific skills

A more direct link between rewards and productivity involves the issue of general skills. General skills originate in formal education and raise the productivity of the employee and thereby her rewards. These skills are extremely important in regular jobs and natives might have a natural lead, for example because they are better speakers of the native language. In ethnic firms, these general skills might be somewhat less important, because the on average small size of these firms requires an on average lower level of skills and also fluency of the majority language may be less of a necessity.

Culture specific investments in knowledge of one's own ethnic minority culture and language are useless for regular jobs, but are valuable for co-ethnic jobs. Knowledge of the specific culture and language gives the employees a comparative advantage to non-co-ethnic people in communicating with the co-ethnic boss, the other employees, the suppliers and the customers. This might also involve 'tacit knowledge' about the product, for example how it should taste or look like. Furthermore, the customers might expect co-ethnic personnel, for example in a restaurant. So, because of their culture specific skills, co-ethnic employees are more productive in co-ethnic firms than in non-co-ethnic firms, and co-ethnic employees are more productive in co-ethnic firms than employees with a different cultural background. Both reasons form incentives to work in a co-ethnic firm.

Rewards – positive and negative discrimination

Obviously discrimination in regular firms has a negative effect on rewards for members of ethnic minority groups. Discrimination on cultural background leads to both monetary disincentives to work for a regular firm (not making promotion, not receiving bonuses) and non-monetary disincentives (victim of teasing by colleagues, always having to do the dirty jobs). Discrimination may work the other way round in co-ethnic firms. The employer might feel a moral obligation, resulting from the social network, to help and comfort co-ethnic employees. The employer is more benevolent to his co-ethnic personnel than a non-co-ethnic boss. This might even offer the possibility for the workers to have a 'good time' and shirk. A job in a co-ethnic firm might also offer better career perspectives, for example to get promoted, to become a partner or to take over the business when the owner retires.

This issue can also be related to trust and networks. Ethnic minority employees only trust co-ethnic employers to be fair to them and to not discriminate against them. They might have less or no trust in (or are unaware of) the official labour market regulations and/or the motivations of non-co-ethnic employers. Their trust in co-ethnic employers is based on the knowledge that they can rely on the social network in case they are mistreated by their co-ethnic boss, while this protection mechanism is not available when a non-co-ethnic employer is involved.

The networks also deliver non-monetary rewards to the employees in the sense of a certain social recognition from other group members, when employees decide to work for a co-ethnic firm. In this way, both employers and employees obey to an informal moral obligation to help

each other. The employer helps the members of his co-ethnic group by offering employment. The employees help the co-ethnic employer by offering their labour.

We now turn our attention to the incentives that come forth out of the search process.

Search – signalling

As we saw above, principal-agent problems arise because of information asymmetries between employers and employees. The equivalent of this management problem for the search process emerges from the differences in asymmetric information about the qualities of applicants. Applicants know more about their own skills and motivations than the potential employer does and tend to present an overoptimistic view of their qualities. There are three reasons why ethnic minority applicants could make a better impression on a co-ethnic employer than a on non-co-ethnic employer.

First is the problem that certain foreign diplomas are not recognised by native employers, but are recognised by co-ethnic employers. The magnitude of this problem increases when it is combined with communication problems between the employer and the applicant, for instance when the candidate has trouble in expressing herself in the majority language of the host country. This makes it more difficult for the applicant to communicate her skills and motivations to the native employer, while she has no problem discussing this subject in her native language with a co-ethnic employer.

Second is the problem of discrimination. This can be outright discrimination, but also statistical discrimination (Loury 1977). When a certain ethnic minority group gets a stigma attached for being 'lazy', 'unproductive' or 'fraudulent', this diminishes the chance of all members of this stigmatised group to get employed in a regular firm. Bad employees will drive out good employees. Since the rate of rejection is so high, it is not worthwhile anymore for 'good', unrightfully stigmatised employees to invest in applications for such jobs. Only the 'bad' applicants keep on applying, because for them the rewards of success are much higher, as it enables them to shirk at the expense of the hiring firm. This confirms the stigma and increases the prejudice against members of this ethnic minority group. Even more good employees stop applying for jobs in the regular sector, and so on and so forth.

A third issue is that applicants are backed by members of their own network. The credentials of native applicants are thus for the greater part backed by other natives who might be higher valued by native employers than the ethnic minority references of ethnic minority applicants. This holds vice versa for applicants at ethnic firms.

These are three objective reasons why it might happen that ethnic minority employees end up in co-ethnic firms, even if they themselves have no preference for the one above the other.

Search – search channels

Social networks are often used as a channel for information about vacancies and job opportunities. Nan Lin has written extensively on this subject (e.g. Lin, Ensel and Vaughn 1981). Especially the 'weak links' of one's network can be very helpful in finding a job (also see Granovetter 1974). Given that the network of an ethnic minority group member consists for the larger part of other members of this group, information about vacancies will mainly consider job openings in ethnic firms. This information function of the network also works the other way round. Co-ethnic employers can more easily find a suitable co-ethnic employee than a non-co-ethnic one. The transaction costs involved in the search process are lower when using the social network than the official canals.

Using panel data for the United Kingdom Frijters et al. (2003) report on how the job search methods of unemployed immigrants vary from those of the native born. Striking result of this research is that all immigrant groups and especially South Asian immigrants rely more on their social networks for job search than the UK born. The researchers conclude however that the relative failure of immigrants to find a job “cannot generally be explained by differences in the choice of main job search method or in observable characteristics” (Frijters et al. 2003: 1). This confirms the idea that immigrants make a relatively strong use of social networks to find a job. It also confirms that this is a rational thing to do, because it does not influence (read: it does not worsen) the probability of immigrants to find a job. The result of the extensive use of this search channel however is that ethnic minorities end up to be over-represented in co-ethnic firms.

5.3.3 Conclusion

We conclude from our economic analysis of the labour market incentives of ethnic minority group members, that there is much economic rationality for ethnic minorities to find a job in a co-ethnic firm instead of in a regular firm. Their ethnic background makes them more productive in co-ethnic firms, because it enables firms to economise on management control and bonding costs. A second source of their higher productivity lies in the specific cultural capital they have accumulated and that is valuable in certain ethnic business niches. Discrimination and problems with the verification of their qualities form clear disincentives to work in regular firms. Finally, the social network allows ethnic minorities to lower their search costs when looking for a job.

The fact that the behaviour of immigrants to find a co-ethnic job is rational does not automatically imply that this behaviour is beneficial for them in the longer term or beneficial for their employers, their ethnic community or for the society as a whole. We explore the positive and negative externalities of co-ethnic employment in the next section.

5.4 *Welfare effects of co-ethnic employment*

The emphasis of this section lies on the welfare effects of co-ethnic employment. We first present a broad historical perspective of the welfare effects of immigrants, we continue with a somewhat smaller scope about the welfare effects of ethnic entrepreneurship and end with an analysis of the welfare effects of co-ethnic employment in the short and long run.

5.4.1 Welfare effects of immigrants

In the Dutch history the freedom of the Protestant religion, the high tolerance to other religions and the economic prosperity of the region attracted several waves of immigrants, particularly in the 16th to the 19th century. Among them were the Huguenots, who fled France after the revocation of the edict of Nantes in 1685 that was directed against Protestantism, and among them were many (Portuguese) Jews who saw their lives threatened for religious reasons in other parts of Europe. These influxes of highly skilled and wealthy immigrants are generally seen as important contributions to the rise of the Low Countries as an economic superpower in the 17th century (De Vries and Van de Woude 1995). For the immigrants themselves, their migration benefited them at least in the sense that it provided them a way to survive the religious feuds in Europe. But even at the end of the 19th century immigration was substantial, especially from the poor regions of Germany. This wave of immigration benefited the Dutch economy in the sense that it provided a source of cheap

labour. At the same time, it was beneficial for the immigrants, because they earned a better salary than at home.

This picture has changed dramatically. Evaluations by the CPB Netherlands Bureau for Economic Policy Analysis (Roodenburg et al. 2003) and the Netherlands Scientific Council for Government Policy (WRR 2001) are not optimistic about the contributions of recent immigrant inflows to the Dutch economy. Non-Western immigrants have a relatively low labour participation, have a relatively high unemployment rate and make a relatively high use of social security. Remarkably, these differences between the native population and immigrants are much larger in the Netherlands than in other countries, like Italy, Spain, Canada and Australia (WRR 2001: 121). The welfare effects of new immigrants whose social-economic characteristics correspond to those of the average non-Western resident are likely to be small and maybe even negative on residents' incomes and are a burden for the public budget (Roodenburg et al. 2003: 7-8). This can be partly blamed on the lagging performance of immigrants on the labour market, but is "also the reflection of the generous system of Dutch collective arrangements" (Roodenburg et al. 2003: 8).

5.4.2 Welfare effects of ethnic entrepreneurship

In 1998 the Netherlands Social Economic Council (SER) wrote an advice to the government on ethnic entrepreneurship as a reaction on the perceived labour market problems of immigrants (SER 1998). The SER concludes that entrepreneurship of ethnic minorities is part of the solution of the problem and should therefore be stimulated by the government. The government has underwritten this advice in its official reaction. According to the SER, weak points of the present ethnic minority firms are the lack of entrepreneurial skills, the relative weak basis of much firms, the lacking presence in business networks and the insufficient accessibility of services for ethnic entrepreneurs.

We agree that ethnic entrepreneurship is, in principle, a positive phenomenon that contributes to the integration and economic emancipation of ethnic minority groups. However, we have more doubts about the co-ethnic employment that is often involved with the creation of ethnic firms. We sum the pros and cons later, but first look at some actual developments.

The number of ethnic enterprises in the Netherlands has sharply risen over the last 10 years (Van den Tillaart 2001). The type of firms is also changing. Originally, most ethnic firms were in the hospitality and retail sector. Newly founded firms, mostly by second generation migrants, are more and more in commercial services. In this new sector, second generation ethnic entrepreneurs often choose more sophisticated branches like advice and consultancy, research and public-relations offices and travel agencies instead of car driving schools and cleaning services (Van den Tillaart 2001). Does this mean that the differences between ethnic and native entrepreneurs are disappearing? Yes and no. On the one hand we see that the distribution of firms over the different sectors of second generation ethnic entrepreneurs has become more similar to that of the native entrepreneurs than it has ever been with regard to the first generation immigrants. This is in line with the thought that the second generation of immigrants has less strong ties within the migrants' community. The rules and resources of the social ethnic network are less applicable to 'newer' generations. Although these figures only give an indication about the sectors of activity and not about employment policies, the broader picture that arises from it is that the phenomenon of co-ethnic employees and employers is less pregnant for newer generations, because they 'break out' of the old structures.

On the other hand however, one can notice that a part of the second generation ethnic entrepreneurs is explicitly focusing their activities on their own ethnic group. They develop ethnic niches to exploit, for example in culture, recreation and sports (Van den Tillaart 2001). In general, the Scientific Council for Government Policy concludes that it is very troublesome that the immigrants – especially those coming from Turkey and Morocco – mainly use their own ethnic network to find a job, because of the restricted and internal focus of these networks (WRR 2001: 119).

5.4.3 Welfare effects of co-ethnic employment

In this subsection we discuss the welfare effects of co-ethnic employment for employees, co-ethnic firms, the ethnic minority group and the society as a whole. Most of the positive welfare effects seem to lie in the short run. Structural problems that lead to negative welfare effects come to the fore when we analyse the long-term effects of co-ethnic employment. We pay extra attention to externalities: the external effects (positive and negative) that arise for society as (unintentional) consequences of individual behaviour.

Positive welfare effects and externalities

The immediate effects of co-ethnic employment are positive at every level of analysis. The major reason why co-ethnic employment is associated with positive externalities is that it creates jobs for ethnic groups. This increases the labour participation and work experience for the individual employees. Although some of these jobs may be ‘network subsidised’ jobs, such a job in a co-ethnic firm is better than no job at all. Another positive welfare effect for individual employees results when their rewards are higher in co-ethnic firms than in regular firms. The monetary rewards may be higher, because their culture specific skills enhances their productivity in co-ethnic firms (especially when active in ethnic niches) and lowers management and search costs for firms. The non-monetary rewards may be higher, because co-ethnic employment leads to moral appraisal and recognition from the ethnic group.

The co-ethnic firm benefits from co-ethnic employment for the same reasons. The productivity of co-ethnic personnel may be higher than the productivity of other personnel, and because of reductions in management and search costs.

The welfare benefits for the ethnic group lie in the fact that all value created by the ethnic firms stays inside the ethnic group. The rents are split among the co-ethnic suppliers of capital, management and labour. It also makes the group less dependent on outsiders. A feeling of autonomy can be regarded as valuable. Above all, the ethnic network stays intact and dense. This makes it easier to uphold the (traditional) values and norms.

The welfare effects for society are the less recourse to social security combined with higher income taxes. Moreover, poverty reduction among ethnic minorities is a positive good in itself. When one believes in the existence of poverty related crime, one can argue that this poverty reduction may have positive external welfare effects for the society, because it translates in a reduction of the crime rate among ethnic minority groups.

Negative welfare effects and externalities

There is also a number of negative externalities associated with co-ethnic employment. To start with, it may prevent the development of general skills among the co-ethnic employees. It reduces the necessity of (fluently) speaking the majority language and co-ethnic employees are not confronted with the native ‘work ethics’. Regardless of the fact whether this work ethic is better or worse, not being familiar with it does not improve your chances on the

regular labour market. When for some reason immigrants lose their job at the co-ethnic firm, the pool of potential new employers is restricted for them to the part of co-ethnic firms, while the possession of general skills would allow them to seek a job across all firms in the economy.

A second negative welfare effect for employees may result from the fact that they keep very closely attached to their social ethnic network when they work in a co-ethnic firm. This makes it relatively easy for the other network members to enforce network rules, values and norms upon them. Social control co-ordinates the behaviour of group members and thus prevents sub-optimal outcomes in social dilemma situations. However, it also restricts individual freedoms. It impedes individual welfare, when social control and sanctions are used to enforce unwanted solidarity with other group members. In the worst case, this results in the exploitation of co-ethnic employees, who are obliged to work in ethnic firms under bad working conditions (hard work, low salary). Social pressure exercised by the network then sacrifices the welfare of the individual for the good of the group.

The welfare or development of firms is faced by two dangers resulting from co-ethnic employment. The first relates to the fact that easy access of ethnic minority group members to employment in the firm automatically implies that applicants with other ethnic backgrounds are barred from access. This has two consequences. First, it may lead to a very narrow focus of the ethnic firm regarding suppliers and customers, because there are no natural links (established through the networks of employees) with suppliers and customers from outside the own group. Second, it may be problematic to find suitable employees within the own group, especially for certain specialised functions (Fukuyama 1995). Both restrictions might seriously hinder the small family firm to develop into a larger scale enterprise.

The second danger for the development of the firm also results from the situation that the firm becomes too enclosed in the social ethnic network. In some cultures, strong norms of mutual assistance and solidarity lead to high free-riding problems, because successful firms are overloaded with requests for loans and jobs from fellow kinsmen (Geertz 1963, Portes 1998). The social norms that allow for these excess claims on more successful group members severely impede the accumulation of wealth (and thus the incentives to gather wealth) that is needed for entrepreneurial success and development.

Negative externalities of co-ethnic employment for the ethnic group also arise from the fact that co-ethnic employment leads to less interaction between different ethnic groups and networks. This implies that the separate networks stay relatively closed, small and isolated. One misses the positive external effects that would result from a single 'combined' large network. An example of a negative externality of co-ethnic employment is that information about job opportunities and applicants' skills is not public for all networks. As a result, members of ethnic minority groups may fall in the 'ethnic trap'. They must find a job in the co-ethnic network, because they do not avail of contacts in other networks. As a result, they also do not become a member of other networks, which reduces the chance of other ethnic minority group members to find a job outside the social ethnic network. This problem of path dependency is worsened by the phenomenon of co-ethnic employment.

A more extreme situation occurs when "group solidarity is cemented by a common experience of adversity and opposition to mainstream society" (Portes 1998: 17). Co-ethnic employment can be seen as a form of group solidarity. A prolonged period of discrimination by mainstream society may lead to downward levelling norms in the group. The group members do not believe anymore that they can be successful in society. This implies that there is no use in going to school or in making other long term investments. Pride in the own group for its own sake is the only thing that remains. Ambitious group members, who do manage to be successful in the 'hostile' outside world, however, are perceived as traitors,

because they undermine the group cohesion that is built on the alleged impossibility of such events. In this situation, the social norms of the group work out as a public bad, because they form fatalism based disincentives for the social and economic emancipation of the group.

The negative externalities for society originate in the missed network opportunities that result when ethnic groups keep a distance from the rest of society, for example by a high prevalence of co-ethnic employment. A major example is that the emergence of common values and norms in the society is hindered. Common values and norms streamline the co-ordination of human behaviour in (economic) activities, because they form informal guidelines for behaviour. In this way, they reduce the transaction costs involved with co-ordination problems. Another example is that the economy is not running on its potential optimum, because best matches between vacancies and applicants are missed. This hinders the personal development of the employees, the emergence of strong firms and the growth of the national economy.

More in general we may conclude that co-ethnic employment enhances segregation instead of integration. The worst case situation would be the emergence of an ethnic minority enclave economy without ties to the rest of society. This would imply an isolated sub-society in a society and the complete failure of integration policies.

5.4.4 Conclusion

The immediate effects of co-ethnic employment seem to be positive on balance. In the short run, co-ethnic employment leads to more jobs for employees, easy access to labour for ethnic minority firms, strengthening of the group values and norms, and less unemployment and social security problems for society. This bright picture is obscured when we take a long-term perspective. Co-ethnic employment might form an obstacle to the social and economic emancipation of ethnic minority groups, because it generates disincentives for individual group members to acquire general skills, hinders the development of ethnic minority firms, fosters the danger of the ethnic trap and may stimulate the emergence of an enclave economy. An enclave economy does not seem to be a realistic threat for the Dutch society, but the other dangers certainly are. We therefore look at the possible policy options in the next section.

5.5 Concluding remarks and policy options

Survey data from various sources in the Netherlands confirm anecdotal evidence of over-representation of co-ethnic employees in ethnic minority firms. This major characteristic of ethnic minority employment can be explained by the relatively low information and co-ordination costs in labour relationships in co-ethnic firms. When people belong to the same ethnic group, or network, they are bound to the same cultural values and norms, and this will enhance trust, e.g. within a group of immigrants from the same country or background. It implies that within a group of workers from the same ethnic origin information is less asymmetric and less incomplete than between workers of different ethnic origins. In a hierarchical relationship between a supervisor and subordinates the monitoring and bonding costs may be lower in the case that all belong to the same ethnic groups than when they have different ethnic backgrounds. A similar argument holds for search costs when employing workers.

These economics of co-ethnic employment suggest that there are both positive and negative externalities associated with this phenomenon. A positive externality is that it enhances labour participation and therefore reduces demand for social security provisions. However, a negative externality is that it hinders integration of minority groups in the society

which will eventually cause these members of minority groups to be less productive. These positive and negative externalities can be considered as market failures. The economics of the public sector teach us that government policy should try to repair such market failures as much as possible. Hence the general rule for government intervention in the case of co-ethnic employment is to design policy options which will minimise the negative externalities and which will exploit the positive externalities.

The biggest structural problem seems to be that the business networks of native and ethnic minority entrepreneurs are separated from each other. In the most extreme case, this would mean the complete isolation of an ethnic minority part of the regular economy: the enclave economy. To prevent the emergence of enclave economies in the Netherlands and to reap the positive external benefits of extended (business) networks, the government has a role to foster the integration of native and co-ethnic business networks. With respect to the phenomenon that co-ethnic firms are used as a 'last resort' for unskilled ethnic minority members, additional schooling programs for co-ethnic employees are necessary to give them a chance on the regular labour market. Concerning the diploma comparison problem in the search process, one could think of government support in the form of a databank for diploma comparison.

Furthermore, positive externalities should be exploited by promoting businesses of ethnic minorities, e.g. by providing assistance in setting up a business (through chambers of commerce), and guarantees for loans, and by not too much strict regulation. The chambers of commerce could play an important role in this process. They have information about the ethnic background of firm owners and play a natural role in stimulating entrepreneurship.

Chapter 6

Trade, trust and transaction costs

[T]here is an element of trust in every transaction.

Arrow (1973: 24)

Businessmen have learned from experience, even though their theory and ideology are against it, that the market mechanism will not run at all perhaps, and certainly not very well, if they cannot trust one another.

Macaulay (1963: 64)

6.1 Introduction

The ‘mystery of the missing trade’ (Trefler 1995, Davis et al. 1997) refers to the gap between the volume of trade that would be optimal according to the standard neo-classical models of trade theory – based on the Heckscher-Ohlin-Vanek theorem which states that countries export abundant factors – and the actual volume of international trade.¹ According to model calculations international trade should be much larger than it actually is. A major reason for this gap is that the traditional neo-classical models do not account for transaction costs in international trade. Eaton and Kortum (2002), for example, provide a framework that shows that international trade would rise to a fivefold level when physical distance and other trade barriers would not exist. The observation of the home bias in trade provides some further insights into this conundrum. Calculations by McCallum (1995) and Helliwell (1998), who control for ‘objective’ variables like distance between countries, size of the country, geographical barriers, language (dis)similarity and trade policies, show that Canadian provinces are trading much more with each other than with US states, in the order of 12 to 20 times as much.

These calculations prove that transaction costs play a major role in limiting (international) trade flows. It is obvious that trade, which is in a broad sense an exchange of property rights, is not for free, but has its price. Transaction costs in trade do not only comprise traditional costs associated with transportation (distance), trade barriers, tariffs, et cetera, but also search costs, costs on gathering information of product quality and the reliability of the trading partner, legal costs, control costs and costs associated with international payments.

¹ This chapter is largely based on Den Butter and Mosch (2003b). Some ideas have been published before in Den Butter and Mosch (2002), De Beer, Den Butter, Van Dalen and Mosch (2002), Mosch and Van den Berg (2003), and Mosch (2003).

This chapter provides an empirical investigation of the influence of trust as a specific part of transaction costs on international trade flows. Hence, the focus in this chapter is not on physical distance, but on cultural and institutional distances. We believe that institutions and cultural values and norms are in themselves beneficial for trade within a specific region or between people belonging to a specific group, but can be disadvantageous for trade between regions and people with a different cultural background. They may be well suited to lower transaction costs for domestic trade, but can be seen as having negative externalities by increasing the transaction costs in international trade. In our opinion, trust problems are the source of this type of transaction costs. Trust problems relate to the contingent behaviour of (potential) trading partners: can they be trusted, or not, to be able (competence) and willing (intention) to perform in letter and spirit of the agreement, even when circumstances occur that make it favourable for the transaction partner to deviate? In fact, enhancing trust between trading partners (nations) leads to a reduction of transaction costs, and therefore to an increase in trade and welfare.

We distinguish two types of mechanisms to mitigate the trust problem. The first mechanism is based on formal procedures, the second on informal ones. Our hypothesis is that both types of trust reduce important parts of transaction costs and may explain part of the actual size of international trade flows. The more trust, the less missing trade. In order to test this hypothesis, we use a gravity equation framework to which we add indicators for formal and informal trust. Both types of trust mechanisms appear to have a substantial influence on the volume of trade indeed. When we assume an increase in informal trust by one standard deviation, the combined effects of formal and informal trust may add up to a 90 to 150 percent change in bilateral trade, depending on the legal system. Moreover our estimation results suggest that the causal relation runs primarily from trust to trade, and that a trade-off exists between formal and informal trust.

The chapter can be placed in the literature at a crossroad of different streams. It combines the idea of transaction costs from the New Institutional Economics (Williamson 1979, 1985) with the ideas about the influence of trust and social capital on the functioning of economic mechanisms (Coleman 1990, Putnam 1993, Fukuyama 1995, LaPorta, et al. 1997, Knack and Keefer 1997, Woolcock 1998, Dasgupta 1999, Zak and Knack 2001). The resulting hypotheses are tested with use of the gravity model in which there is surge of interest lately (see e.g. Wei 1996, Portes and Rey 1999, Frankel and Rose 2002, Glick and Rose 2002, Rose 2002, Méliz 2002, Loungani et al. 2002, and Rauch and Trindade 2002).

The structure of the chapter is as follows. Section 2 takes a closer look at the connection between trade, trust and transaction costs from a theoretical perspective and formulates several hypotheses. In section 3 these hypotheses are tested with use of a gravity model. After some initial regression results we test the robustness of these results by using alternative indicators of trust, by changing the reference period and by investigating the simultaneity in the relationship between trust and trade flows. Section 4 discusses the results and indicates the policy implications in the light of globalisation and the developments in information and communication technologies.

6.2 Theories on trade, trust and transaction costs

This section gives a theoretical perspective on the linkages between trade, transaction costs and trust. As noticed before, we regard trust problems as a major source for trade barriers and transaction costs. Greif sees trust problems as an inherent consequence of the character of sequentiality of most transactions and labels this as the fundamental problem of exchange:

“one will not enter into an objectively profitable exchange relationship unless the other party can *ex-ante* commit to fulfil his contractual obligations *ex-post*” (Greif 2000: 254, original italics). In order to illustrate how trust problems can enhance transaction costs, we take a closer look at three types of transaction costs and then examine their link with trust.

6.2.1 Trade and transaction costs

The concept of transaction costs is a central theme in the New Institutional Economics (see Williamson (2000) for an overview of this field of research). Transaction costs can be defined as the friction costs that appear while pursuing the gains of trade. Although an operational definition of transaction costs is difficult to give, studies that try to measure this concept indicate that transaction costs can be very large. Wallis and North (1986) find that 45 percent of the United States' GNP was devoted to the transaction sector in 1970. Klammer and McCloskey (1995) note that one quarter of the GDP is related to persuasion, i.e. talks to make “real production” possible. Van Dalen and Van Vuuren (2003) show that approximately 29 percent of the working population of the Netherlands had a job in the trading sector in 1997.

Three stages can be distinguished in a trade transaction: (i) contact, (ii) contract and (iii) control (cf. Nooteboom 2002). In all three stages, transaction costs emerge.

In the *contact* phase of a potential transaction, the buyer is looking for information about his preferred product (price and quality), potential suppliers, or, when the product does not yet exist, which producer could invent and/or produce it for him. The seller is trying to find a buyer for his product through marketing activities. Transaction costs emerge, because information is not free, not complete and not easily accessible. Traders have to invest in search. Evidently, this search for information is more difficult when, in an international context, communication is blurred by differences in language, differences in ways of information distribution and differences in culture based business norms. Reduction of the transaction costs of contact involves a mechanism with two essential characteristics. First, information about business opportunities must be spread to all members of the business community who might be interested to be informed. Second, it must be guaranteed that this information is of high quality, i.e. the information can be trusted to be relevant and true. The distribution of reliable information is a characteristic function of networks (Casson 1997). Mutual trust among the members of the network increases the quality of the information. Some empirical backing for this claim can be found in the studies of Rauch (2001) and Rauch and Trindade (2002) that point at the role of co-ethnic business networks in solving this problem of missing information about business opportunities. Ethnic (Chinese) networks seem to be more influential in bilateral trade on differentiated than homogeneous goods. Portes and Rey (1999) note the importance of the “geography of information”, measured by e.g. telephone call traffic and multinational bank branches, in a study on bilateral cross-border equity flows. Combes et al. (2002) present empirical support for their claim that business and social networks help to reduce informational trade barriers in France.

The *contract* phase starts directly after the moment the potential trading partners have found each other and are inclined to make a deal. Here transaction costs are made in negotiating the terms of the contract. Parties have to decide on how to make a reasonable split-up of the expected rents of the transaction and what to write down in the contract. They should not aim to put all eventualities in the contract. It is costly to write out all details, it is useless because some arrangements cannot be verified by third parties (verification problems), it is impossible because many eventualities can not be foreseen (fundamental uncertainty) and it may have

unwarranted side-effects in the form of growing distrust between the parties if one takes explicit account of everything that might go wrong. Contracting becomes even harder in an international context. Parties have to learn the particularities of the legal system of the other country. In addition, cultural problems appear when one is contemplating what to write down (and what not) in the contract. The appropriate business norms vary between cultures. For example, in the United Kingdom it is common to write down every detail, while in other cultures, like the Dutch, it is customary to just write down the rough outline of the agreement and to fill in the details later, during the fulfilment of the agreement. These differences can lead to misunderstandings. Writing down all details creates a sphere of security in one case (the contract provides a solution for every problem that might occur), but it can also give a signal of distrust (why does the other party want to write down all these eventualities, does he foresee problems, doesn't he trust me?).

Cooray and Ratnatunga (2001) illustrate the problem in an interesting account of the troublesome co-operation between a Japanese customer and an Australian producer. They show how cultural differences lead to completely different perceptions about how to build a co-operative relationship. The Japanese buyer was focused on developing a long-term close relationship with his Australian partner, because it is customary in Japan to stay with a producer as long as the producer sells the product. It is a strategic decision with long-term consequences for a Japanese firm to choose a supplier. The Japanese therefore asked for much information about the quality and price of the product, and installed own personnel in the Australian firm, also because they are accustomed to co-operate with their producers to improve the product. The Australian firm however was not used to provide such detailed information about their production process and costs. A second problem arose, because the Australians wanted to develop the relationship along personal lines, while the Japanese counted on strict formal control and evaluation procedures. In the end, a 'link-pin', with knowledge of both cultures and companies, was hired to solve the mutual adjustment problems.

In general, striving for low contract transaction costs implies quick negotiations that result in a fair distribution of the rents.

The phase of *control* consists of the monitoring and enforcement of the contract. Both involve high transaction costs, especially at large distances. Monitoring means that business partners check whether the other party is doing what he promised to do. If the check turns out that this is not the case, the next step is enforcement of the contract. The most common solution for enforcement is to start a legal procedure. Especially in international trading relationships, this is often a troublesome affair. It takes time and money in large quantities and foreigners often feel being mistreated by prejudiced national courts when they file a claim against a national company. The outcome of the process can be quite uncertain. In general, there is the verification problem, which means that it is often very difficult or even impossible for third parties, like judges, to value the quality of the goods or services delivered. Country specific cultural values and norms also penetrate the national legal systems (see Bachmann 2001). In the United Kingdom, the law is commonly regarded as a device to protect the people from the government. The basic thought is that the government should not interfere in private matters. British judges therefore base their decisions in legal disputes extensively on what parties have voluntarily agreed on, even when power asymmetries might have influenced the voluntary element. In contrast the German and Dutch legal systems take the idea that contracts should be 'reasonable' for both parties. The government is seen as a mechanism to correct injustices. German and Dutch judges therefore have and use the right to reinterpret and reconstruct contracts until their outcome can be considered reasonable for both parties. This means that

two contracts with the same wordings can lead to different legal decisions, depending on the kind of legal system in the country in which the file is claimed.

Here, the control transaction costs can be held low in cases where the transaction partners comply with the terms of the agreement, so that there is no need for intensive monitoring or legal enforcement.

6.2.2 Trust and transaction costs

Obviously, the transaction costs in the contact, contract and control phase are closely linked to the trust problem. The trust problem is at the core of finding reliable information about business opportunities, about potential business partners and about their trustworthiness (contact phase). Trust is also important when negotiating on how to split the rents and what (not) to put in the contract (contract phase), and it is a dominant factor at the decision on how and to what extent the agreement will be monitored and enforced (control phase).

In fact, in many circumstances trust between trading parties can be seen as a co-operative solution of a prisoners' dilemma where the trigger mechanism built in the repeated game does not completely exclude cheating. So placing trust is not a free lunch, there is a risk involved. That makes agents cautious to gather reliable information about potential business partners (contact), to carefully formulate the agreement (contract) and to adequately monitor and enforce it (control). What do people indulge to accept these risks and to trust the other, or how can this risk be contaminated so trust can develop? In order to answer this question, we distinguish two main types of trust generating mechanisms, respectively with a formal and an informal basis.

Trust mechanisms with a formal basis are the mechanisms that build trust that is, in the end, based on formal (legal) agreements and enforced by formal (legal) procedures. This 'formal trust' is related to the instrumental trust and system trust of our trust typology of chapter 3. Formal trust is closely linked to what is known by other authors as instrumental trust, rational trust, calculative trust (Williamson 1993), self-interested trust (Lyons and Mehta 1997), synthetic trust (Putnam 2000), fragile trust (Lindenberg 2000), narrow trust or egoistic trust (Nooteboom 2002) and, to some extent, system trust (Luhmann 1979, Bachmann 2001). All these notions of trust are related to each other, in the sense that they see this type of trust as being about the calculation of selfish interests in pecuniary terms. It takes the 'homo economicus' view of mankind as its central perspective. It expects that people take into account all financial incentives involved, use a 'rational way of thinking' and are not 'hindered' by emotions. So, if it is profitable to cheat, one will cheat without remorse. People will act trustworthily when it pays to act trustworthily. The main idea of this approach is that the trust problem can be understood as a social co-ordination problem. In order to prevent that both players end up in the Nash equilibrium outcome of the prisoner's dilemma (both players playing the uncooperative or untrustworthy strategy), there are several solutions. We recall the trust mechanisms of performance, pre-commitment, reputation, and accountability (see chapter 3). As was already mentioned in chapter 3, these trust mechanisms on a formal basis cannot take away all risk. Bounded rationality and imperfect information make it impossible to make all necessary calculations, and the behaviour of other people is guided by fundamental uncertainty called free will. Furthermore, we already noted that legal contracts can be expensive, inherently incomplete, unverifiable, and subject to the particularities of the addressed legal system. On top of this, too much emphasis on formal trust might hurt informal trust. When relationships are guided by too much formal trust, based on extrinsic motivations, this can 'crowd-out' informal trust which relies on intrinsic motivation (Tyler 1998, Ostrom 2000, Frey and Jegen 2001, Bénabou and Tirole 2003).

Trust mechanisms with an informal basis cover the social and normative mechanisms that we distinguished in chapter 3. Informal trust is largely based on intrinsic motivations (Frey 1993). This type of trust is closely related to the concepts of social trust, moral trust, personal or blind trust (Williamson 1993), socially-oriented trust (Lyons and Mehta 1997), resilient trust (Lindenberg 2000), broad or altruistic trust (Nooteboom 2002), generalised trust (Putnam 1993) and social capital (Fukuyama 1995). Both at the individual level and at the institutional level, there are a number of different mechanisms that generate informal trust. We recall the mechanisms of basic trust, satisficing, tolerance, informalisation, distortion, social control, social sanction and status mechanisms (see chapter 3).

The advantage of informal trust mechanisms above formal trust mechanisms is that one does not have to pay to keep afloat an entire legal system with its lawmakers, lawyers, judges and police. However, building informal trust can be a very difficult and lengthy process, especially when one wants to enter a group or network of which the membership ties are based on kinship, ethnicity, religiosity or place of birth. Examples of such closed trade network date from the Maghribi traders in the eleventh century (Greif 1989, 1993), the Jewish diamond merchants in the 1960s (Wechsberg 1966), to nowadays ethnic Chinese networks (Rauch and Trindade 2002).

Micro economic game experiments suggest that these informal forms of trust are relevant to explain human behaviour in economic situations. A common conclusion of those experiments – often shaped as social co-ordination problems – is that people are indeed inclined to behave trustingly and trustworthily (guided by norms as reciprocity and fairness), instead of playing the ‘fully rational’ strategy of non co-operation. This result even holds true when high sums of money are at stake, when the participants are not students, and when no reputation effects can be built up (one-shot interaction with anonymous strangers); see Camerer and Thaler (1995), Berg, Dickhaut and McCabe (1995), Cameron (1999), Fehr and Gächter (2000), and Ostrom (2000).

The survey of the literature above provides insights in some general mechanisms, which govern the relationship between trade, transaction costs and trust. It gives rise to the following hypotheses to be tested in our empirical analysis where the focus is on the influence of problems of trust on (missing) trade:

1. Trust problems are a source of trade barriers and transaction costs. More trust means less trade barriers and less transaction costs. Thus, more trust leads to more trade.
2. Two types of trust can be distinguished: formal trust and informal trust. Both types are important in international trade.

We test these hypotheses in the next section and investigate whether our measurement of the influence of trust on trade flows is robust with respect to alternative models and indicators of trust.

6.3 Tests on trade, trust and transaction costs

6.3.1 Model and data

For the test of the two hypotheses, we use a gravity model framework. The basic gravity model explains the value of bilateral trade with use of two determinants: the distance between the trading countries and their (economic) mass. The shorter the distance and the greater the GDP, the more trade will occur. This specification of the model has proven to be an effective tool for ‘explaining’ about 60-80 percent of the variance in the volume of trade between countries (Bergstrand 1985, Frankel and Rose 2002). Evenett and Keller (1998) have shown that the specification of the gravity model can be derived from the Heckscher-Ohlin model and/or from models with increasing returns to scale advantages of the new trade theory literature. The model is suitable for testing our hypotheses, since it easily allows for adding new variables to the basic framework. Often used additional variables – additional to distance and GDP – include GDP per capita (in combination with GDP, this is an implicit way of adding the variable population) and dummies for common language, sharing a border, access to sea, being an island, having a common (colonial) history and sharing the same currency (Bergstrand 1985, Frankel and Rose 2002, Rose 2000, Glick and Rose 2002, Rose 2002, Méltz 2002, Loungani et al. 2002).

The theoretical argumentation of the previous section suggests that a higher level of trust leads to less transaction costs and consequently to more trade. However, we are unable to test directly whether trust problems lead to higher transaction costs, because we do not avail of data on the level of transaction costs. Even if we would know how many transaction costs are involved in all international transactions today, this would still be insufficient for our purpose. When, due to low levels of trust, transaction costs would be high, there would be no transactions at all, which is reflected in trade flow data but not in data on transaction costs. That is why the tests of our first hypothesis boil down to testing whether trade volumes are higher in cases in which trust problems are lower. Trust problems are lower when mutual trust is higher. Consequently we test our second hypothesis by distinguishing between indicators for formal and informal trust and their respective effects on the volume of trade.

As an indicator for formal trust, we use a dummy variable ‘formal trust’ that is unity when the origins of the legal systems of two countries are similar, and is zero otherwise. A similar origin of the legal system makes it easier to contract and enforce the contract than when the legal systems of two countries differ, because major choices that can be made in the set-up of a legal system are corresponding. Sharing the origin of the legal system thus means a higher formal trust. The construction of our indicator for the origins of legal systems of countries is based on Zweigert and Kötz (1998) and LaPorta, et al. (1998). In our dataset of 25 countries, we distinguish five different systems. In addition to the four systems (French, German, English and Scandinavian) that are also distinguished by Zweigert and Kötz, and by LaPorta et al., we add a fifth type for the former socialist countries, as the legal systems in these countries form a kind of their own after 45 years of communist governance (see Table A6.5.3 in the appendix for an overview).

As an indicator for informal trust, we use the results of the EuroBarometer survey 46 (EB) held in 1996, of which one of the questions was: “I would like to ask you a question about how much trust you have in people from various countries. For each, please tell me whether

you have a lot of trust, some trust, not very much trust or no trust at all?”² In fact there are two types of data with respect to this question. The question has been answered *by* the inhabitants of the 15 EU-members in 1996 (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, Netherlands, Ireland, Spain, Sweden, Portugal and United Kingdom). However, the questionnaire did not only ask about the trust in these 15 EU-member states, it did also ask about trust in 10 additional countries (Czech Republic, Hungary, Japan, Norway, Poland, Russia, Slovak Republic, Switzerland, Turkey and United States). It means that we have more information about the 15 EU-countries than for the 10 additional ones. For all 25 countries, we know how much they are being trusted by the EU-countries. For the EU-countries, we also know how much they themselves trust the other 24 countries. We therefore created two different variables for informal trust. The first is ‘informal mutual trust’. This indicates the mutual informal trust and is computed as the product of the trust of country A in country B and the trust of country B in country A. This variable only exists for country pairs of two EU-countries. The second variable is called ‘informal average trust’. It is computed as the product of the average trust of the EU-countries in country A and the average trust of the EU-countries in country B. We avail of this variable for all country pairs.

These indicators for (informal) trust are different from the one that is often used in research on trust and social capital. For example Knack and Keefer (1997), LaPorta et al. (1997) and Zak and Knack (2001) used the question on trust of the WorldValuesSurvey (WVS): “Generally speaking, would you say that most people can be trusted or that you can’t be too careful in dealing with people?” We believe that the trust variable from the EB is, for our purpose of measuring the influence of trust on trade, more adequate since it directly indicates how inhabitants of various countries do trust each other. The trust variable from the WVS measures trust in a far more general way and is more an indicator for trust in (strangers in) one’s own country.

For all other data for the gravity model (value of bilateral trade, distance, GDP, control variables) we use a data set constructed by Rose (2002).³ Table A6.5.1 and Table A6.5.2 in the appendix provide lists of all variables and sources.

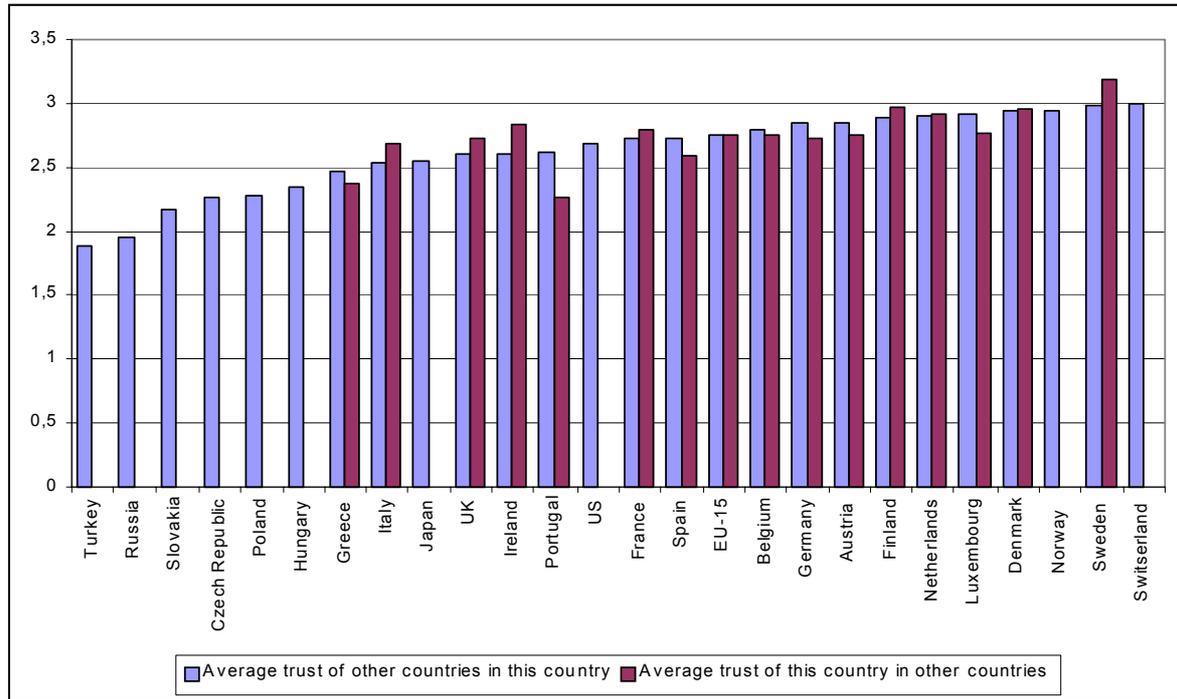
Figure 6.3.1 illustrates some characteristics of the indicators for informal trust in our analysis. The, on average, most trusted countries are Switzerland and the Scandinavian countries, the least trusted are Turkey and the East-European countries. The trust of a country in other countries goes hand in hand with being trusted by other countries: ‘do well and have well’.⁴ Only Sweden and Ireland seem to trust other countries somewhat more than they are themselves trusted, while the opposite is true for Portugal.

In order to get a better feeling for the differences in trust, we note that the spread in the product of mutual trust (‘informal mutual trust’) is 7.17, ranging from relatively high mutual trust between Denmark and Sweden (12.21) to relatively low mutual trust between Germany and Greece (5.04). See Table A6.5.2 in the appendix for summary statistics on ‘informal mutual trust’ and ‘informal average trust’.

² We calculated means by applying the coefficient four, three, two and one respectively to the various answer codes; “no reply” answers have been excluded from the calculation. The mid point is then two-and-a-half. Below this level, the negative answers predominate and above, the positive ones.

³ We are highly indebted to Rose for being able to use his data set, which can be found on his website.

⁴ The correlation of 0.7 is significant at the 0.01 level.

Figure 6.3.1 Average trust in other countries and average trust by other countries, 1996

Source: EuroBarometer survey 46, 1996.

6.3.2 Basic results

We start our empirical analysis with estimating simple regression specifications where, in addition to the usual explanatory variables of gravity equations, the indicators for formal trust ('formal trust') and informal trust ('informal mutual trust') are included to explain bilateral trade flows in 1996 as year of observation. The results are reported in Table 6.3.1. The indicators for formal trust and informal trust are both significant and do explain a substantial part of bilateral trade flows. The coefficient of the dummy variable for a similar legal system varies between 0.38 and 0.61. This means that country-pairs with a similar legal systems trade some 46 to 84 percent more with each other than countries with a different system.⁵ The fact that both indicators for trust obtain significant positive coefficients when included together in the equation indicates that both types of trust distinguished in this chapter are of importance in international trade. It also indicates that the two variables represent different phenomena; they are not the same. The coefficient of the indicator of informal trust (with values ranging between 0.13 and 0.18) indicates that a change of mutual informal trust of the size of a standard deviation leads to a change of 24 to 34 percent in trade volume.⁶ The combined effects of formal and informal trust add up to a 70 to 118 percent change in bilateral trade, depending on the legal system and a difference of a standard deviation in informal trust. Furthermore, the effect of distance becomes smaller when the trust variables are added to the estimation model. These trust variables apparently filter some elements of cultural distance out of the physical distance parameter. So we conclude that these first results strongly corroborate our hypotheses on the relationship between trust and trade.

⁵ $(e^{0.38} - 1) * 100 = 46$.

⁶ $1.71 * (e^{0.13} - 1) * 100 = 24$.

With these estimation results of our basic specification as a starting point we investigate the robustness of these results by considering alternative specifications of the model and by applying different estimation methods. We start by changing the indicator of informal trust where we now use the indicator for total average trust ('informal average trust') instead of the indicator for mutual trust, which we would prefer from an economic point of view. Inclusion of this indicator in our specification allows us to use a larger data set where we have 231 observations (for 25 countries) instead of 78 observations (for 15 countries). Table 6.3.2 gives the estimation results for this alternative indicator for informal trust. With this broader dataset, we see that the coefficient for formal trust, 'formal trust', is on average somewhat higher than in our basic estimation results of Table 6.3.1. The effects of the alternative indicator for informal trust are also somewhat larger than the influence of the previous indicator.⁷ These differences can be easily explained when we realise that the legal and cultural differences between the 15 EU-countries are relatively smaller than between the 25 EU and non-EU countries.

Table 6.3.1. Estimation results for simple gravity equations explaining bilateral trade flows with additional indicators for formal and informal trust, 1996^a

Dependent: value of bilateral trade.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Distance	-1.05 (0.10)	-0.85 (0.09)	-0.75 (0.08)	-0.93 (0.10)	-0.70 (0.09)	-0.86 (0.09)	-0.69 (0.08)
GDP	0.75 (0.03)	0.80 (0.03)	0.82 (0.03)	0.71 (0.03)	0.68 (0.03)	0.82 (0.04)	0.77 (0.04)
GDP per capita				0.54 (0.16)	0.99 (0.16)	-0.11 (0.20)	0.42 (0.20)
Formal trust			0.38 (0.09)		0.61 (0.11)		0.50 (0.10)
Informal mutual trust		0.16 (0.03)	0.18 (0.02)			0.18 (0.04)	0.13 (0.03)
Year	1996	1996	1996	1996	1996	1996	1996
Number of obs.	78	78	78	78	78	78	78
Adj. R2	0.92	0.95	0.96	0.93	0.95	0.95	0.96
Method	OLS	OLS	OLS	OLS	OLS	OLS	OLS

^a Standard errors in parentheses. Intercept not reported.

6.3.3 Time series for trade

The relatively small data set used in the regressions so far has two major disadvantages. The first is that it has too little observations to include the often used control variables, for example for countries that share a border or a language, countries that have no direct access to sea or are surrounded by water. The second disadvantage is that world trade can be very sensible to variations in world economic growth (e.g. recession in the beginning of the nineties), monetary problems (e.g. Mexican peso-crisis, banking crises and other financial problems in East Asia and Russia in 1998) and political turmoil (e.g. Gulf War). Although 1996 was largely free of such major events, as yet it is appropriate to investigate the robustness of the estimation results when a larger time span is considered.

⁷ The estimation result in column 4 of Table 6.3.2 could be understood as follows. An increase of informal trust by one standard deviation leads to a rise in bilateral trade of 69 percent.

Table 6.3.2. Estimation results for gravity equations explaining bilateral trade flows in 1996 with an alternative indicator for informal trust^a

Dependent: value of bilateral trade.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Distance	-1.13 (0.07)	-1.07 (0.07)	-1.01 (0.05)	-0.93 (0.05)	-1.07 (0.05)	-0.99 (0.05)	-1.04 (0.05)	-0.96 (0.05)
GDP	0.95 (0.03)	0.94 (0.03)	0.89 (0.02)	0.87 (0.02)	0.78 (0.03)	0.75 (0.03)	0.83 (0.03)	0.80 (0.03)
GDP per capita					0.81 (0.06)	0.84 (0.06)	0.45 (0.16)	0.50 (0.15)
Formal trust		0.46 (0.14)		0.58 (0.10)		0.60 (0.10)		0.60 (0.10)
Informal average trust			0.48 (0.04)	0.50 (0.04)			0.23 (0.10)	0.22 (0.09)
Year	1996	1996	1996	1996	1996	1996	1996	1996
Number of obs.	231	231	231	231	231	231	231	231
Adj. R2	0.81	0.82	0.89	0.90	0.89	0.90	0.89	0.90
Method	OLS	OLS	OLS	OLS	OLS	OLS	OLS	OLS

^aStandard errors in parentheses. Intercept not reported.

We therefore extend the analysis by using a time series of yearly data on bilateral trade flows for the seven-year period (1993-1999). This also solves the problem of the little number of observations, so that we are able to add several control variables. But it creates a problem in the sense that we only have data on informal trust for 1996. By enlarging the time span, we thus implicitly assume that informal trust is constant for the three years preceding and the three years following the year 1996. According to Putnam (1993) and Fukuyama (1995), this is a plausible assumption. They consider trust as a cultural characteristic that is highly path-dependent and develops in centuries rather than in years. Somewhat contrarily, Putnam (2000) notes a significant decline in trust in the US in a period of decades. However, the small period of 7 years for which we assume that trust is time invariant is still clear within these limits. Furthermore, the political and economic relationships between the EU-countries have been stable in this period. This is somewhat different for the East-European countries, which saw a major change in their political and economic regimes around 1990. It could be argued that trust in these countries has changed during the 1990s as a result of closer political and economic connections with the EU-countries. But in general we believe that the variables for informal trust can indeed be considered time invariant for this short period.

The estimation results for the period 1993-1999 are given in Table 6.3.3. The indicators for informal trust all obtain positive and significant coefficient values, ranging from 0.18 to 0.71. The coefficient of the indicator for formal trust is somewhat less significant if combined with the original indicator of mutual informal trust but fairly significant if combined with the indicator for average informal trust. The extension of the time span to seven years and the inclusion of several control variables (including year controls) do not alter the conclusions about formal and informal trust from our basic specifications. Both indicators still contribute to the explanation of trade and even seem to outperform as explanatory variables for trade the control variables usually found in other studies. In our estimations we find that the coefficient values of these traditional control variables are hardly significant, with the dummy for landlocked countries – countries which have no direct access to sea – as an exception. For example, high mutual trust appears to be more important than sharing the same language, which is in contrast with the studies of Frankel and Rose (2002) and Méltitz (2002). An

explanation for this result might be that our dataset consists of countries with a relatively highly educated population, probably also in the field of foreign languages. Apparently, differences in (native) languages do not form a serious problem then. But even when communication is not bothered by language problems, the trust problem is still present for these countries. In other words, a language can be learned, but trust has to be earned.

Table 6.3.3. Estimation results for gravity equations explaining bilateral trade flows in the period 1993-1999^a

Dependent: value of bilateral trade.

	(1)	(2)	(3)	(4)
Distance	-1.19 (0.14)	-0.89 (0.11)	-1.10 (0.09)	-0.92 (0.08)
GDP	0.66 (0.05)	0.82 (0.04)	0.74 (0.03)	0.87 (0.04)
GDP per capita	0.21 (0.13)	-0.25 (0.15)	0.27 (0.06)	-0.53 (0.10)
Land area	0.17 (0.05)	0.03 (0.05)	0.15 (0.04)	0.07 (0.04)
Landlocked	-0.73 (0.12)	-0.61 (0.09)	-0.26 (0.09)	-0.17 (0.09)
Island			0.34 (0.22)	0.36 (0.22)
Common border	-0.08 (0.17)	0.12 (0.16)	0.34 (0.20)	0.28 (0.19)
Common language	0.25 (0.22)	0.12 (0.21)	0.21 (0.15)	0.09 (0.17)
Formal trust		0.16 (0.09)		0.43 (0.10)
Informal mutual trust		0.18 (0.03)		
Informal average trust				0.71 (0.07)
Year	1993-1999	1993-1999	1993-1999	1993-1999
Number of obs.	627	627	1800	1800
Adj. R2	0.94	0.95	0.84	0.88
Method	OLS	OLS	OLS	OLS

^aStandard errors robust to country-pair clustering recorded in parentheses. Intercept and year controls not reported.

6.3.4 A further look into the dynamics of trust and trade

As noted above, by extending the estimation period to seven years, we implicitly assume that informal trust is constant over this period, although it is only measured in 1996. In order to test whether this assumption is plausible, we repeat our regressions for two sub-periods, namely 1993 to 1995, and 1997 to 1999; Table 6.3.4 gives the results. A comparison of column (2) with (3) and of column (5) with (6) suggests that the assumption of constant trust is quite heroic. Trust seems to have far more explanatory power for trade in the three years after 1996, than for trade in the three years before 1996. These results also give a clue about how causality runs between trust and trade. In general, it can be argued that higher trust leads to more trade, but also that more (successful) trade will lead to higher trust. As we find that a given level for informal trust is better able to explain future trade than past trade, this strongly suggests that causality runs from trust to trade. We note that Knack and Keefer (1997) applied

a similar methodology in order to test whether trust leads to economic wealth, instead of the other way around.

Table 6.3.4. Estimation results for gravity equations explaining the dynamics between bilateral trade flows and trust^a

Dependent: value of bilateral trade						
	(1)	(2)	(3)	(4)	(5)	(6)
Distance	-0.92 (0.08)	-1.00 (0.09)	-0.90 (0.08)	-0.89 (0.11)	-0.78 (0.11)	-0.96 (0.13)
GDP	0.87 (0.04)	0.75 (0.05)	0.88 (0.04)	0.82 (0.04)	0.67 (0.04)	0.82 (0.05)
GDP per capita	-0.53 (0.10)	0.58 (0.19)	-0.54 (0.09)	-0.25 (0.15)	0.67 (0.21)	-0.34 (0.16)
Land area	0.07 (0.04)	0.03 (0.05)	0.07 (0.04)	0.03 (0.05)	0.02 (0.05)	0.04 (0.05)
Landlocked	-0.17 (0.09)	-0.07 (0.10)	-0.17 (0.08)	-0.61 (0.09)	-0.46 (0.08)	-0.70 (0.11)
Island	0.36 (0.22)	0.40 (0.22)	0.11 (0.22)			
Common border	0.28 (0.19)	0.20 (0.21)	0.31 (0.18)	0.12 (0.16)	0.10 (0.15)	0.15 (0.18)
Common language	0.09 (0.17)	-0.14 (0.17)	0.07 (0.16)	0.12 (0.21)	-0.00 (0.20)	0.05 (0.21)
Formal trust	0.43 (0.10)	0.55 (0.11)	0.40 (0.10)	0.16 (0.09)	0.39 (0.09)	0.16 (0.09)
Informal mutual trust				0.18 (0.03)	0.09 (0.03)	0.18 (0.04)
Informal average trust	0.71 (0.07)	0.23 (0.10)	0.58 (0.07)			
Year	1993-1999	1993-1995	1997-1999	1993-1999	1993-1995	1997-1999
Number of obs.	1800	924	876	627	234	315
R2	0.88	0.91	0.88	0.95	0.97	0.95
Method	OLS	OLS	OLS	OLS	OLS	OLS

^aStandard errors robust to country-pair clustering recorded in parentheses. Intercept and year controls not reported.

These estimation results for two sub-periods also reveal a second dynamic effect, namely a trade-off between formal and informal trust. When informal trust rises in importance, formal trust becomes less relevant. We can think of several explanations for this phenomenon. First, it could be a substitution effect between formal and informal trust. One needs either a substantial amount of formal trust or of informal trust, but is not necessary to have them both. Possibly, there are even crowding-out effects between them. See the closely related literature on substitution effects between extrinsic and intrinsic motivations (Frey and Jegen 2001, Bénabou and Tirole 2003). Second, it could be that the legal systems of the EU-countries are converging because of extended harmonisation through EU-legislation. The effect of differences in national legal systems then disappears and our indicator for formal trust becomes void, in which case informal trust problems become relatively more important. A third explanation could be a change in the inherent characteristics of the traded goods. When the composition of the trade switches from homogeneous to more differentiated goods, the importance of informal trust versus formal trust increases. Differentiated goods are goods for which, in contrast with homogeneous goods, it is not easy to provide an objective measurement of their quality (e.g. experience goods) and/or are goods combined with services

(e.g. helpdesk services for software packages). Formal trust is less appropriate to deal with differentiated goods, because of contracting and verification problems. The relative importance of informal trust thus increases. From our data, we cannot make up which of the three explanations is the most plausible. It is of course also possible that the three effects appear simultaneously.

6.3.5 Robustness tests using other estimation methods

Up to now we have used OLS regressions to establish the relationship between trust and trade. Here two problems arise. The first is the problem of simultaneity because some of the explanatory variables probably are not fully exogenous. As GDP and GDP per capita (or population) are commonly used in gravity model estimations and simultaneity problems with respect to these variables have been amply discussed (see e.g. Frankel and Rose 2000), we disregard these problems here. Therefore we focus on possible simultaneity problems in the relation between trust and trade. As we have seen above, there are some comforting indications that causality runs from trust to trade.

The second potential problem stems from unobserved characteristics of country-pairs that influence their trading behaviour. In the OLS estimations above, we tried to circumvent this problem by using the cluster function, which generates robust standard errors. A more general solution to address these problems is to use a fixed effect estimator. However, this is not a viable option here, because almost all relevant variables (formal trust, informal trust, distance, landlocked, island, common border, common language) are time invariant and can therefore not be estimated in a fixed effect estimation procedure.

As yet, there are two other solutions. The first is by using a random effects regression model, the second is by using instrument variables. The results of the random effects Generalised Least Squares model estimation are given in Table 6.3.5. Here we obtain estimation results that are somewhat different from the results reported above. The coefficients for both indicators of informal trust are positively significant, but are rather large (1.09) for average informal trust. This would imply a rise in trade of 215 percent when informal trust rises, according to this indicator, with an impulse of one standard deviation. Moreover, the coefficient of formal trust appears to be no longer significant when combined with the other indicator of informal trust, ‘informal mutual trust’.

We proceed by exploring the second alternative for testing possible endogeneity problems with respect to the indicators for informal trust using the Two Stages Least Squares method. As an instrument we choose the trust variable from the World Values Survey. This variable can be considered as the amount of trust people have in other inhabitants of their own country. Although there seems to be no theoretical ground for assuming a direct relationship between the extent to which people trust their own countrymen and international trade it appears that this variable is correlated to trust in inhabitants of other countries; probably, it can be seen as a form of a basic level of trust in foreigners. We calculated correlation coefficients between this indicator for trust and the two indicators for informal trust (‘informal mutual trust’ and ‘informal average trust’) of respectively 0.78 and 0.67 for 1996. In order to compute the variable, we took the results from the WVS held in the years 1995-1997. If a country was not included in that sample, we took the results from the WVS held in 1990-1993. Only two countries, Luxembourg and Greece, were absent in both surveys.

Table 6.3.5. Estimation results for gravity equations explaining bilateral trade flows using a random effects model^a

Dependent: value of bilateral trade.

	(1)	(2)	(3)
Distance	-1.01 (0.10)	-0.77 (0.08)	-0.93 (0.15)
GDP	0.67 (0.05)	0.92 (0.04)	0.89 (0.06)
GDP per capita	-0.70 (0.05)	-1.10 (0.04)	-0.85 (0.08)
Land area	-0.02 (0.05)	0.02 (0.04)	-0.03 (0.06)
Landlocked	-0.91 (0.09)	-0.22 (0.08)	-0.56 (0.12)
Island	0.90 (0.25)	0.38 (0.20)	
Common border	0.41 (0.20)	0.39 (0.17)	0.27 (0.19)
Common language	1.17 (0.23)	0.16 (0.19)	0.02 (0.18)
Formal trust		0.44 (0.10)	0.06 (0.10)
Informal mutual trust			0.27 (0.04)
Informal average trust		1.09 (0.04)	
Year	1993-1999	1993-1999	1993-1999
Number of obs.	1800	1800	627
R2 within	0.48	0.50	0.55
R2 between	0.63	0.87	0.95
R2 overall	0.60	0.86	0.95
Method	RE GLS	RE GLS	RE GLS

^a Standard errors robust to country-pair clustering recorded in parentheses. Intercept and year controls not reported.

Table 6.3.6 shows the estimation results for 1996, the period 1993-1999 and two subperiods of three years. The coefficient value for ‘formal trust’ varies between 0.28 and 0.61 and the coefficient value for ‘informal mutual trust’ varies between 0.13 and 0.33. This is rather in line with the sizes of the coefficients found in the simple OLS estimates. However, the coefficient for ‘informal average trust’ is relatively high, ranging from 1.03 to 1.66. This is clearly larger than the OLS results. Hausman tests on endogeneity suggest that both indicators for informal trust are indeed endogenous, both in 1996 and for the seven-year period 1993-1999, with an exception for ‘informal mutual trust’ in 1993-1999. This (mixed) result means that we have to be very careful in interpreting the estimation results of the OLS and random effects estimations. Therefore, we prefer the IV estimation results, although it is remarkable to notice that the IV estimation results for the coefficients of the informal trust variables are

close to or even higher than the OLS and RE estimation results.⁸ A similar resemblance with the OLS results can be found in the dynamics of trust and trade. The indicators for informal trust are higher in 1996 and the period after, than in the period before 1996, and there seems to be a trade-off between formal trust and informal trust.

Table 6.3.6. Estimation results for gravity equations explaining bilateral trade flows using 2SLS^a

Dependent: value of bilateral trade.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Distance	-0.69 (0.10)	-0.73 (0.14)	-0.75 (0.13)	-0.78 (0.15)	-0.74 (0.12)	-0.74 (0.11)	-0.87 (0.13)	-0.64 (0.11)
GDP	0.91 (0.07)	0.83 (0.06)	0.72 (0.07)	0.84 (0.07)	1.08 (0.14)	0.98 (0.05)	0.92 (0.09)	0.97 (0.05)
GDP per capita	-0.70 (0.43)	-0.47 (0.20)	0.20 (0.29)	-0.65 (0.24)	1.75 (1.05)	-1.31 (0.23)	-0.68 (0.62)	-1.37 (0.24)
Land area		-0.03 (0.05)	-0.01 (0.05)	-0.03 (0.06)		-0.02 (0.05)	0.01 (0.06)	-0.04 (0.05)
Landlocked		-0.46 (0.08)	-0.42 (0.08)	-0.53 (0.09)		-0.17 (0.11)	-0.14 (0.11)	-0.15 (0.11)
Island						0.37 (0.27)	0.51 (0.27)	0.24 (0.27)
Common border		0.15 (0.17)	0.10 (0.16)	0.11 (0.19)		0.34 (0.23)	0.29 (0.25)	0.35 (0.21)
Common language		0.05 (0.21)	-0.01 (0.19)	0.09 (0.21)		0.05 (0.23)	0.01 (0.21)	0.04 (0.22)
Formal trust	0.39 (0.15)	0.32 (0.08)	0.43 (0.08)	0.28 (0.08)	0.61 (0.16)	0.52 (0.13)	0.54 (0.13)	0.52 (0.12)
Informal mutual trust	0.33 (0.09)	0.22 (0.06)	0.13 (0.07)	0.23 (0.08)				
Informal average trust					1.66 (0.68)	1.37 (0.19)	1.03 (0.38)	1.42 (0.23)
Year	1996	1993-1999	1993-1995	1997-1999	1996	1993-1999	1993-1995	1997-1999
Number of obs.	66	498	198	234	210	1577	630	737
R2	0.94	0.96	0.97	0.95	0.80	0.83	0.88	0.80
Method	IV(2SLS)	IV(2SLS)	IV(2SLS)	IV(2SLS)	IV(2SLS)	IV(2SLS)	IV(2SLS)	IV(2SLS)

^a Standard errors robust to country-pair clustering recorded in parentheses. Intercept and year controls not reported. Instrumented: informal average trust / informal mutual trust. Instruments: WVS trust and all exogenous variables.

6.4 Concluding remarks

Our empirical investigation above shows that both indicators for formal trust and informal trust obtain significant and positive coefficient values and contribute to a substantial extent to the explanation of bilateral trade flows. Our extensive analysis of alternative specifications and estimation methods suggests that these estimation results are quite robust indeed, and that causality runs from trust to trade (although we cannot exclude some recursive causality from trade to trust). The results are also robust when possible outliers like Japan and the United States (both at a large distance from Europe, the US are an exceptionally big country in our

⁸ Although it might be counterintuitive that the IV-estimates for the supposed endogenous variable are higher than the OLS-estimates, it is not an exceptional result; see for example the literature on education and earnings where IV-estimates are commonly found to be higher than OLS-estimates (Card 1999).

data set) are removed from the data set (as we found in estimations not reported here). It is interesting to note that we find such substantial influence of the two types of trust on trade flows, considering the fact that the countries in our dataset, especially the EU-countries, are all more or less highly developed, share many similar cultural characteristics and have closed many bilateral and multilateral legal agreements. It would not surprise us if the results would be even much stronger, when we would have availed of a dataset including a greater variety of countries, less developed and/or with a less strong Western orientation.

How do these findings relate to the mystery of the missing trade? For different periods and for different estimation methods, the estimated coefficient values for formal trust cluster around 0.40, with a highest value of 0.61 and a lowest of 0.16. In almost all specifications this coefficient value is highly significant. A coefficient value of 0.40 means that country-pairs which have a similar origin of their legal systems trade almost 50 percent more with each other than other country-pairs. For the coefficient of mutual informal trust we found values in the range of 0.16 to 0.33. When we take a coefficient value of 0.20 it means that a rise in mutual trust by one standard deviation leads to an increase in trade of almost 40 percent. This effect is even higher when we take the alternative indicator for informal trust, 'informal average trust'. From a theoretical perspective this indicator is less informative than 'informal mutual trust' because it is based on average instead of bilateral trust, but from an empirical perspective it is more informative because it can be used in estimates for a broader range of countries. Here we found a somewhat larger range of coefficient values in our specifications with a lowest value of 0.22 and a highest of 1.66. A value of 0.70, which is almost in the middle of this range, would imply a rise in bilateral trade of more than 100 percent when 'informal average trust' would be enhanced by one standard deviation. The combined effects of formal and informal trust described above add up to a 90-150 percent change in bilateral trade.

In order to provide some more insight in the order of magnitude of the influence of trust on bilateral trade flows, we compare, by way of a concrete albeit extreme example, the country-pair Germany-Greece with Denmark-Sweden. Denmark-Sweden is the country-pair with the best trust relationship in our dataset, whereas the trust between Germany and Greece is the lowest in the dataset. Our estimation results indicate that trust problems between Germany and Greece are responsible for "missing trade" between these countries in the order of some 216 percent of the actual value of bilateral trade. Germany and Greece do not share a legal system like Denmark and Sweden do (accounting for 49 percent) and their mutual informal trust is much lower than between Denmark and Sweden (accounting for 167 percent). It does, by the way, not imply that there are no trust problems between Denmark and Sweden. Although their mutual informal trust is rather high, there is still ample room for a rise that would further enhance bilateral trade between these countries. The similar origin of the legal systems in these two Scandinavian countries does not guarantee the exclusion of all possible legal controversies. Clearly, case study evidence and a detailed analysis of legal and cultural differences is needed in order to derive more sophisticated indicators for both formal and informal trust. It would provide us with further evidence on the main empirical finding of this chapter, namely that a considerable part of missing trade can be attributed to a relative lack of trust. More mutual trust between nations and traders would lead to lower transaction costs and would, therefore enhance trade and welfare.

Obviously, trust formation in trade relationships brings about positive externalities. Therefore, trust between countries partly has the character of a public good. Although our findings are largely based on a static analysis, they strongly suggest that government agencies for trade promotion should be alert on mitigating transaction costs that come forth out of trust problems

(also see WRR 2003a). This implies policies that ease the settlement of international legal disputes, that encourage reputation building, that increase the traders' knowledge of other cultures, that strengthen the traders' capabilities to speak foreign languages and that promote the formation of international networks, for example by smoothing the regulation on visas for international students and employees. These policy implications require special attention in this era of globalisation and the developments in information and communication technologies. In fact, globalisation and the ICT-revolution enhance the possibilities to trade with faraway foreign countries by diminishing tariff barriers, transport costs and communication costs, which undoubtedly leads to a surge in trust problems. Especially reputations become more important as information about past performances will be available to a larger public through the Internet. ICT can, however, never form a true replacement for all personal contacts. Face to face contact will remain essential to develop mutual trust and keep the trade going.

6.5 *Annex. Data sources and definitions.*

6.5.1 Datasets

For the data on trust between countries, ‘informal mutual trust’ and ‘informal average trust’, we used:

Melich, A.
European Commission * Brussels, Belgium
Eurobarometer 46.0 1996 [computer file]
Amsterdam, Steinmetz-archieff (P1337)

For the data on trust within countries, “WVS trust”, we used:

Inglehart, Ronald, et al.
World Values Surveys 1990-1993 and 1995-1997 [computer file]
Amsterdam, Steinmetz-archieff

For all other data, we used:

the dataset constructed by Rose (2002), which can be found at his website:
<http://faculty.haas.berkeley.edu/arose/>

6.5.2 Definitions.

Table A6.5.1. Explanation of variables used in the gravity equation

Value of bilateral trade	Log value of bilateral trade in real \$
Distance	Log of distance
GDP	Log of product of real GDPs
GDP per capita	Log of product of real GDPs per capita
Land area	Log of product of land areas
Landlocked	Number of countries that are landlocked (0/1/2)
Island	Number of countries that are an island (0/1/2)
Common border	1 if countries share a land border
Common language	1 for common language
Formal trust	1 for common legal system
Informal mutual trust	Product of mutual trust (only for the 15 EU-countries)
Informal average trust	Product of average trust in the countries (for all 25 countries)
WVS trust	Product of WVS trust (for 23 countries)

Table A6.5.2. Summary statistics of informal mutual trust and informal average trust

	Year	Observations	Mean	Standard deviation	Minimum	Maximum
Informal mutual trust	1996	78	7.53	1.71	5.04	12.21
Informal mutual trust	1993-1999	627	7.58	1.65	5.04	12.21
Informal average trust	1996	231	6.90	1.07	4.08	8.97
Informal average trust	1993-1999	1800	6.90	1.09	3.68	8.97

Table A6.5.3. Countries in the dataset

Country	EU-member	Dataset 93-99?	WVS session	Origin of legal system
Austria	Yes	Full period	1990-1993	German
Belgium	Yes	1997-1999	1990-1993	French
Czech Republic	No	Full period	1990-1993	Former socialist
Denmark	Yes	Full period	1990-1993	Scandinavian
Finland	Yes	Full period	1995-1997	Scandinavian
France	Yes	Full period	1990-1993	French
Germany	Yes	Full period	1995-1997	German
Greece	Yes	Full period	Na	French
Hungary	No	Full period	1990-1993	Former socialist
Ireland	Yes	Full period	1990-1993	English
Italy	Yes	Full period	1990-1993	French
Japan	No	Full period	1995-1997	German
Luxembourg	Yes	1997-1999	Na	French
Netherlands	Yes	Full period	1990-1993	French
Norway	No	Full period	1995-1997	Scandinavian
Poland	No	Full period	1995-1997	Former socialist
Portugal	Yes	Full period	1990-1993	French
Russia	No	1998-1999	1995-1997	Former socialist
Slovak Republic	No	Full period	1990-1993	Former socialist
Spain	Yes	Full period	1995-1997	French
Sweden	Yes	Full period	1995-1997	Scandinavian
Switzerland	No	Full period	1995-1997	German
Turkey	No	Full period	1995-1997	French
United Kingdom	Yes	Full period	1995-1997	English
United States	No	Full period	1995-1997	English

Chapter 7

Conclusion

7.1 *Summary*

This dissertation studies the effects of trust on economic co-operation between individual persons and/or organisations. The investigation of trust starts with the intuition that trust enhances economic co-operation, which enables further labour division and increasing returns to scale, thus leading to positive economic welfare effects. These intuitive claims about trust and its presumed economic effects are examined in three ways: from the perspective of social capital in chapter 2, from a conceptual perspective in chapter 3, and with use of three case studies in the chapters 4, 5 and 6. This section summarises the main findings with attention for the four related sub-problems (as stated in paragraph 1.2): (i) the concept of trust (what is trust?), (ii) the causes of trust (what are the sources of trust?; how does trust develop?), (iii) the economic consequences of trust (what are the effects of trust on economic performance?), and (iv) the measurement of trust (how can trust be measured?).

With respect to sub-problem (i) ‘the concept of trust’, trust is regarded as the ‘willingness to permit the decisions of others to influence your welfare’ in this dissertation. There will only be a willingness to let other people influence your welfare, when there is the expectation that these other people will not harm your welfare. Because the behaviour of other people is inherently uncertain, to trust another person means that one accepts the vulnerability to the possible opportunistic behaviour of other people. Both the competency and the intention of the other with respect to the co-operation are crucial elements with regard to the emergence of trust at the bilateral level, but have to be analysed together with the external conditions in which they operate.

Chapter 2 investigates trust in relation to the concept of social capital, to the other social capital elements network participation and norms of civic co-operation, and to religion. An overview of the macroeconomic empirical literature shows that generalised, interpersonal trust is associated with economic performance at country level, but that this association is stronger for the less-developed countries than for the developed Western countries. The links between network participation and economic performance at the macro level are much weaker, probably as a result of opposing Putnam and Olson effects. The Putnam effect is that networks generate norms of generalised reciprocity and trustworthiness that spill over to activities outside the network, and that people learn specific skills, e.g. how to organise a meeting, that are also useful in other parts of the society, e.g. in the field of political participation. The Olson effect is that networks become distributional coalitions that foster their special interests to the detriment of the common interest of society. With regard to norms of civic co-operation and generalised reciprocity, the macroeconomic literature shows a positive link between these norms and economic performance, but the measurement of these civic norms is not without problems. The measure is highly susceptible to socially accepted

answers and specific circumstances, which makes its validity questionable. The macro research findings on religion and economic performance are ambiguous and not convincing. This implies that generalised, interpersonal trust seems to be the most plausible link between social capital and economic performance, although even this link is not completely unambiguous at the macro level.

At the micro level, the chapter investigates the relations between trust, civic participation, political participation, norms, and religion. A general finding is that active network participation contributes to higher interpersonal trust. Especially active memberships of churches and religious organisations and of leisure organisations in the fields of sports and culture are beneficial to the emergence of trust. However, a perverse Olson effect on trust appears with regard to political parties, environmental organisations and professional organisations. In these special interest organisations, the trust of the active participants is lower than the trust of the passive members. With regard to religion, it appears that religious people are very active social capitalists. Especially the indicators for religious connectedness (being an active member, attending church regularly) are positively related to trust, civic involvement, volunteering, political participation and civic virtues. This implies that network participation is a major source of interpersonal trust.

A third theme in this chapter is the measurement of social capital and trust (sub-problem (iv) 'the measurement of trust'). In essence, there are three ways of measuring trust and (other elements of) social capital: with game experiments that measure actual behaviour, with surveys that ask people about their trust and trustworthiness attitudes, and with help of Putnam's instrument, i.e. the density of voluntary organisations in a region. The level of social capital in the Netherlands is high in an international perspective and shows, in general, no indications of decline. It is even the reverse, the general trend is upward.

Chapter 3 examines the creation and maintenance of trust in contingent bilateral relationships, which provides an answer to sub-problem (ii) 'the causes of trust'. Trust between individuals emerges as the product of relational and rational considerations that are influenced by formal and informal institutions. A trust typology is developed with two dimensions: the foundation of trust (from formal to informal) and the level of trust (from individual to institutional). This typology orders the four types of influences on the creation of trust and their underlying trust mechanisms: (i) instrumental influences, related to the 'homo economicus' view of mankind, which build trust through performance mechanisms (e.g. hostages) and pre-commitment mechanisms (e.g. specific investments); (ii) social influences, stemming from the idea that trust is relational product, which foster trust as a result of basic trust, satisficing mechanisms (e.g. typecasting), tolerance mechanisms (e.g. habituation), informalisation mechanisms (e.g. identification) and distortion mechanisms (e.g. cognitive dissonance); (iii) system influences, originating from formal collectivities, which create trust with use of accountability mechanisms (e.g. by the legal system) and reputation mechanisms (by networks); and (iv) normative influences, related to cultural trust norms and communities, which raise trust through social control mechanisms, social sanction mechanisms (e.g. social exclusion) and status mechanisms (e.g. pride). This typological distinction is only for analytical purposes. In reality, the various trust mechanisms are closely interrelated. For example, legal systems and forms of normative power appear to be closely connected to each other, and the extent to which legal systems respect the autonomy of bilateral contracts strongly influences the interpersonal trust on the individual level. Thus, the influences on the creation of trust form a complex amalgam of interrelated personal and institutional, and formal and informal trust mechanisms of which the precise interaction cannot be stated. Therefore, a contingency approach of trust is proposed, which takes account of this complexity of trust influences, and

aims to make the number of factors manageable per research context by excluding trust mechanisms in a reasoned way.

Chapter 4 presents the first case study of trust, which involves the social-economic policy preparation in the Netherlands over the period 1980-2000. It analyses how trust developed between the players in the Dutch institutional framework. Instrumental, social, normative and system aspects all play a role. Normative influences can be recognised in the Dutch (trust) culture that is favourable to co-operation and consensus, possibly descending from a joint fight against the water and (later) against foreign competition. A clear system influence comes from the specific legislation on collective labour agreements, which provides incentives for employers and employees to behave co-operatively, both at central, industry and single firm levels. Most important however, is the framework of institutionalised contacts between the government, the social partners, DNB, CBS, CPB and the advisory boards. The frequent interactions with a lot of face-to-face contacts, at formal and informal occasions, and with a relatively small group of people, imply an active participation in networks, in which information is exchanged, reputations are formed (instrumental influences) and social bonds can develop (social influences). This all contributes to the formation of mutual trust between the main players in the field of social-economic policy preparation.

The high mutual trust between economic policy makers resulted in better macroeconomic policies and performance in two ways. First, the high trust enabled the prevention of hold-up problems in the wage-setting process at the individual level between employee and employer, because it allowed for the delegation of the task of adjusting contracts to aggregate shocks to corporatist organisations. Second, the high trust led to co-operative long-term views on the economic problems, which provided societal and political support for drastic policy measures, such as the policy of wage moderation in combination with the promise of employers to invest in employment, the attempts to make the labour market more flexible, and the reforms in social security. In these ways, the institutional framework transformed interpersonal and interorganisational trust at the micro level to positive macroeconomic effects.

Chapter 5 offers the second case-study of trust, involving co-ethnic employment, i.e. the over-representation of workers of the same ethnic group within ethnic minority firms. Strong social networks and related high within-group trust constitute the major reasons for co-ethnic employment by lowering information and co-ordination costs. These costs are related to management and search problems. The management problems involve a principal agent problem between the manager and his personnel, which potentially leads to high monitoring costs, and a bonding problem, which might result in a suboptimal level of specific investments. In this context, the ethnic network can be seen as a trust creating device based on social control, social sanction, status and reputation mechanisms, which enables managers to economise on the transaction costs that are related to management problems. The ethnic network also lowers the information costs that are associated with the search process. Through the network, reliable information about vacancies and the quality of applicants can be easily transferred, which implies a lowering of the search costs. In this way, social networks and high within-group trust lead, in the short run, to more jobs for employees, easy access to labour for ethnic minority firms, strengthening of the group values and norms, and less unemployment and social security problems for society. In short, co-ethnic employment is a mechanism through which trust leads to better economic performance.

However, the same high within-group trust might have a detrimental effect on welfare in the long run. Co-ethnic employment might form an obstacle to the social and economic emancipation of ethnic minority groups. It generates disincentives for individual group members to acquire general skills, because their culture-specific skills enable them to find a

co-ethnic job. However, this increases their vulnerability for labour market disruptions. Co-ethnic employment hinders the development of ethnic minority firms, because their scope (with regard to suppliers, customers, and employees) stays narrowly focused on their own ethnic group, which hinders the development of small family firms to larger scale firms. Furthermore, co-ethnic employment fosters the danger of the ethnic trap and stimulates the emergence of an ethnic minority enclave economy; both would imply isolation from instead of integration in the society of the ethnic minority group. Thus, the chapter showed that social networks and (within-group) trust can both have positive and negative externalities.

Chapter 6 investigates the relations between trade, trust and transaction costs. Trust problems in international trade lead to transaction costs related to contact (search costs related to suppliers, quality of the product, reliability of the trading partner et cetera), to contract (agreeing on a legal contract), and to control (monitoring and enforcing the agreement). Enhancing trust between trading partners results in a reduction of transaction costs, and therefore in an increase of trade. Given that trade leads to higher economic growth, this forms the third example, after the labour market oriented examples of chapter 4 and 5, of a specific mechanism through which interpersonal trust influences economic performance.

This hypothesis is tested with use of a gravity equation for 25 countries to which indicators of formal trust and of informal trust are added. Both types of trust influences have substantial effects on the volume of trade, thus corroborating the hypothesis. The magnitude of the effects is rather high, especially when we take in consideration that the countries in the used dataset are rather similar; they are mostly highly developed countries, share many cultural characteristics and have closed many bilateral and multilateral legal agreements (especially the EU-countries). A second conclusion is that there are indications that the causal relation runs from trust to trade. Moreover, although the indicators of both formal and informal trust are positively and statistically significantly related to the volume of bilateral trade, there seems to be a trade-off between the two. Over time, the influence of informal trust rises, while the influence of formal trust declines.

7.2 Discussion

7.2.1 A free lunch? – the trade-offs of trust

The dissertation started with the intuitive claim that trust enhances economic co-operation, which enables further labour division and increasing returns to scale, thus leading to positive economic welfare effects. In the chapters, several mechanisms are distinguished that buttress this claim, thus giving an answer to sub-problem (iii) ‘the economic consequences of trust’.

(i) Trust is closely related to associational activity, to volunteering, and to political participation (chapter 2). (ii) The combination of mutual trust between the foremen of government and social partners, with mutual trust between the individual members (of labour unions and employer organisations) and their representatives at the central negotiations leads to co-operative long-term views on the economic problems, which provides ample societal and political support for drastic policy measures (chapter 4). (iii) Social network based trust enables co-ethnic firms to economise on the transaction costs of monitoring, bonding and searching (chapter 5). (iv) A higher formal and informal trust between trading countries lowers the transaction costs of contact, contract and control, and increases the volume of bilateral trade flows (chapter 6). At first sight, all these mechanisms point to an unequivocal positive link between trust and economic performance. Trust forms a co-ordination mechanism for all kinds of economic co-operation and especially the more informal types of trust provide co-ordination of behaviour at low (transaction) costs. However, this clear

positive relation between trust and economic performance is hard to reconcile with the results of the macro-economic empirical research in which this link is, least to say, ambiguous, especially with regard to advanced economies.

How can this discrepancy be explained? Part of the ‘disappointing’ outcomes of the macro empirical research can be addressed as a problem of too many institutional differences between countries and too little observations (the number of countries is strictly limited) to control for these differences, which leads to spurious results. Furthermore, there is an aggregation problem when micro level data of generalised trust are aggregated to country level averages. It is highly questionable, especially with regard to large countries, to measure country level trust by averaging the high and low trust levels of the various regions of the country. A third explanation is that the macro-economic research is right: there is no unequivocal positive link between trust and economic performance.

The last explanation is the most plausible. Trust is not without costs itself. If trust would be an ‘asset’ with positive externalities but without costs, the core tenets of the neo-classical economics – people respond to incentives and in equilibrium are the returns equalised across different activities – would predict that demand for trust would be indefinite, that the production would try to cope with this demand, but that an equilibrium would never be reached. In practice, however, trust is limited. There is no one hundred percent trust in real life. Apparently, there are costs involved and equilibria with finite levels of trust are reached in which the marginal costs and marginal benefits of trust are equal.

What are the costs of trust? With regard to the creation of formal types of trust, the answer is relatively simple. The creation and maintenance of collective systems of law and order incur substantial costs. In the first place, these are financial costs (payment of the police officers, the judges, the politicians, the lawyers, et cetera), but also the non-financial costs, such as lack of privacy and the idea of living in a police state, do not weigh up against the benefits of enhanced formal trust.

A different kind of trade-off occurs with regard to informal trust. Co-ordination with use of informal trust involves dense and closed social networks in which learning and control lead to effective social control and social sanction mechanisms. A higher density and closure of networks leads to higher informal trust, but it enlarges the distance to other networks. It is the trade-off between bonding and bridging social capital. Higher within-group trust leads to a lower between-groups trust. This trade-off can also be seen as a trade-off between static and dynamic efficiency. In a static situation, it is profitable to strengthen the ties with your transaction partners and thus to increase the within-group informal trust. This strategy lowers your transaction costs of co-operation in the short term. However, the same strategy worsens your long term perspectives, because it impedes the creation of links with new transaction partners from outside your existing, closed network (i.e. you miss potentially beneficial business opportunities), and it impedes new institutional developments (why would you pay attention to institutional, co-ordination facilitating inventions when informal trust already accounts for that?).

These trade-offs between the benefits and costs of trust are not only distinguishable in the macro-economic empirical results, but also in the examples mentioned above. (i) Trust is related to civic and political involvement, but associational activity can also have negative ‘Olson’ consequences for society, when associations let their special interests prevail above the common societal interest. In the Netherlands, it even appears that the active members of most types of voluntary organisations are less trusting than the passive members, and sometimes even less trusting than non-members. Also in the Netherlands, the relatively orthodox Protestants are less trusting than Catholics and atheists. These are both examples in which group behaviour – that in principle results in positive ‘Putnam’ effects of enhanced norms of reciprocity and trustworthiness – leads to high within-group trust, but low

generalised trust, and thus has negative external effects. (ii) High trust between the Dutch employer and employee federations enables an effective dealing with social co-ordination dilemmas in the field of labour market policies. Both federations are large enough to be considered ‘encompassing organisations’, which would imply that their special interests overlap the common interest. However, it appears that these federations abused this within-group trust by co-operating in using the disability scheme as a ‘dump’ for relatively unproductive employees, of which the costs are born by society at large. (iii) High informal trust between co-ethnic employers and employees enables them to economise on management and search costs. At the same time, the social ties that are responsible for this high informal trust hinder the social-economic emancipation of the individual members of ethnic minority groups and hinder the growth of ethnic minority firms, because they enlarge the distance with other parts of society. This impedes integration and fosters the ethnic trap. (iv) Trust lowers transaction costs and enhances international trade. The general trade-offs apply. Higher formal trust leads to higher financial consequences. Higher informal trust implies the danger of rigid business networks, which miss business opportunities with outsiders and neglect institutional innovations. The case of the Maghribis traders who were ‘defeated’ by the innovative Genoese traders is exemplary.

The conclusion is threefold. First, there is no free lunch with regard to trust. Trust involves both benefits and costs, which have to be weighed against each other. Second, empirical research on the macro level is subject to important methodological problems of aggregation. The effects of trust on economic performance should be studied on intermediate levels which give insight into the precise mechanisms through which trust between persons transforms into economic effects. Third, as was already stated in chapter 1, the neo-classical economics provides a methodological framework that is in essence ‘created’ to analyse the trade-offs between costs and benefits. In this respect, the basic tenets of neo-classical economics are suitable tools to understand and study the phenomenon of trust; economic scientists should therefore not refrain from doing so.

7.2.2 The future of trust – dynamics of the trade-offs

In several parts of the dissertation, a change in trust or its underlying mechanisms is noted. In chapter 6, it is shown that the importance of formal trust with respect to international trade declines during the 1990s, while the relevance of informal trust increases. Three possible reasons are given. First, it could be that the level of informal trust has risen for some exogenous reason, and has crowded-out the need for formal trust. Second, it could be that the differences between the legal systems become less pregnant, for example because of legal harmonisation in the EU. Third, it could be that the composition of the trade switches from relatively homogeneous to relatively more differentiated goods, which increases the contracting and verification problems related to formal trust, thus increasing the ‘demand’ for informal trust mechanisms. Probably, the change can be best explained by a combination of the three reasons. Technological advance in Information and Communication Technologies (ICT) and individualisation may be the underlying trends. ICT lowers the costs of learning and control. With help of modern communication systems, the span of social control can be extended to a larger network, which implies a change in the trade-off between bonding and bridging social capital: the gap declines. The importance of informal trust compared to the importance of formal trust rises as a consequence of this development. The trend of individualisation leads to a higher demand of more heterogeneous, individualised products. Together, these trends raise the importance of informal trust as a ‘competitive advantage’ in the realm of international trade.

A same kind of competitive advantage with regard to informal trust can be seen in the production and services sector. In the more advanced economies, the amount of ‘professionals’ and ‘knowledge workers’ is rising. An inherent characteristic of this kind of idiosyncratic work is that the effort and quality of production are hard to measure in an objective manner. Hierarchical forms of co-ordination are therefore less useful to tackle the related principal agent problems. Therefore, co-ordination of this type of specialised work implies the use of ‘soft’, informal trust mechanisms. This leads for example to ‘flat’ organisations with a minimum of hierarchical layers and to strengthened attention for ‘team spirit’ and ‘identification with the company’, which are fostered by Friday afternoon drinks, survival weekends, dinners, and joint sporting paid by the company. In this way, the monitoring problems are mitigated by a rise in informal trust. Companies (and countries) that dispose of a high ‘stock’ of informal trust thus have a competitive advantage in providing relatively more advanced and idiosyncratic products and services.

However, the ‘active building’ of informal trust in companies might have a perverse effect on the level of generalised trust in a country. In the first place, there is the usual trade-off when high within-company trust deters generalised trust. In the second place, there may be an indirect effect: work related activities reduce the time of the employees for participation in other (voluntary) organisations. This can be related to the finding of chapter 2, in which it was shown that there is a switch from memberships of secondary to the less time-intensive, tertiary organisations. Of course, this change is also a result of the fact that membership of tertiary organisations and virtual communities are easier to combine with modern, individualised lifestyles than the ‘old’, secondary forms of network participation. Nevertheless, it might be another indication of the trade-off between high within-group trust and generalised trust.

7.2.3 Policy implications

The findings in this dissertation provide many suggestions for governmental action in the field of the creation and maintenance of trust. For example, with respect to international trade, the analysis of chapter 6 strongly suggests that government agencies for trade promotion should be alert on mitigating transaction costs that come forth out of trust problems. Some specific proposals for appropriate policies in this field are policies that ease the settlement of international legal disputes, that encourage reputation building, that increase the traders’ knowledge of other cultures, that strengthen the traders’ capabilities to speak foreign languages and that promote the formation of international networks.

A more general focus comes from the conclusion in the section above: the level of informal trust in a country is getting increasingly important in advanced economies. Informal norms of trust and trustworthiness have positive external effects, especially when they are of the generalised kind. However, due to their external effects, people have a tendency to ‘underinvest’ in the creation of these norms, because just part of the benefits but all of the costs accrue to the investing individuals. This public good aspect of norms forms, in principle, a reason for government interference.

However, it is difficult for governments to stimulate the creation of ‘good’ informal norms actively. The governmental policy tools are formal by nature and may crowd-out informal rules. Strict formal control of certain behaviour with use of fines, for example with regard to neglecting speed limits on highways or avoiding fares in public transport, take away the ‘normative’ aspect of the ‘wrong’ behaviour. The decision to behave trustworthily (or not) becomes a rational calculation – in which the chance of being caught is weighted against the benefits of the obtrusion – instead of an ethical issue. The intrinsic motivation to behave well (resulting from feelings of guilt and shame or a desire to behave in a good way) is replaced by

extrinsic motivations (the rational calculation of material benefits and costs). In this way, formal control takes away the feeling that people have an own responsibility to behave well. Another aspect of informal norms is that they take a much longer time to develop than to decay: trust comes on foot, but leaves on horseback. This asymmetry in creation and destruction combined with the crowding-out effect of formal norms imply that government policies in this realm must be very cautious in not deterring the existing informal norms.

Instead of focusing on the norms directly, the government could also look at the structures in which the norms are created. In general, this could provide an incentive for governments to stimulate participation of people in voluntary networks. Again, the best the government can do is not to harm the existing social structures of the societal midfield. The danger of perverse Olson effects looms, when the government gets too much (financially) involved in the creation and support of voluntary organisations. Somewhat worrisome is the finding that, especially in the Netherlands, there are many types of organisations that reduce instead of increase the level of generalised trust among its active members. This is an indication that many of these organisations are already caught in the Olson trap. Another aspect of network participation that might be worrying is the trend from memberships of secondary to tertiary organisations. For the Netherlands, it is troublesome that the church is on the one hand of the main organisations in which trust is created but on the other hand one of the organisations that sees the strongest decline in membership rates.

The case of the Dutch Miracle shows the importance of mutual trust between the main policymakers in the field of social-economic (labour market) policies. This case is also an example of the common wisdom that trust comes on foot, but leaves on horseback. It is hard to create trust, which is also shown by the examples of Japan and Germany. Close relations between government and social partners in Japan did not result in an effective dealing with the macro-economic problems. Also in Germany, which is a high-trust country, proposals from the government to come to a 'polder model'-like consensus with employer and employee federations did not succeed. Apparently, it is hard to create mutual trust, even when a good example is given by a neighbour country and when the problems in the economy are recognised by all parties involved. In this perspective, it is remarkable to see the eagerness with which Dutch government officials and union leaders are now tearing down the building of consensus based policy concertation that proved so valuable in the last decades. A resemblance with the eagerness and even joy of the German and French soldiers just before the War in 1914 to start fighting each other comes to the mind. The Dutch government and union leaders would be wise to cancel their war and start talking again. Only a pessimist would deny that there is more that unites them than divides them.

7.2.4 Suggestions for further research

Several small, specific questions result from the research in this dissertation. Why do active members in Dutch voluntary organisations have such a low tendency to trust? Why do Dutch Protestants have such a low tendency to trust? What are the effects for trust of the change between secondary and tertiary network participation? Can we measure the new and virtual forms of network participation and their effects? Does the creation of work related informal trust lead to positive or negative external effects on generalised trust? Why is the polder model not copied by other countries? Why is it difficult to sustain a long-term view on the common interest when there is no sense of urgency? What is the optimum in the trade-off between formal and informal trust? At which point does co-ethnic employment lead to integration problems? How can governments foster trust?

The more general suggestion for further research rises from the conclusion above, that the empirical research on trust and its economic effects on the macro level is troubled by important methodological problems of aggregation. The research on this relationship should therefore focus on the intermediate mechanisms through which interpersonal trust affects economic performance. This dissertation has researched this still largely unexplored field of the relation between micro level trust (and its theoretical background) and macro level empirical results (including the role of institutions, external effects and the implications for government policies). In this field, there are ample opportunities for further research.

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Samenvatting (Summary in Dutch)

De economische effecten van vertrouwen Theorie en empirisch bewijs

Dit proefschrift onderzoekt de effecten van vertrouwen op economische samenwerking tussen individuele personen en/of organisaties. Het onderzoek gaat uit van de intuïtieve veronderstellingen dat vertrouwen essentieel is voor de totstandkoming van economisch samenwerking, dat economische samenwerking vereist is om de vruchten te kunnen plukken van arbeidsdeling en schaalvoordelen, en dat vertrouwen dus nauw samenhangt met maatschappelijke economische welvaart. Economische samenwerking wordt hierbij breed opgevat. Het omvat alle vormen van vrijwillige ruil (ruil van arbeid, kapitaal, ideeën, et cetera). In dit verband is vertrouwen gedefinieerd als de 'bereidheid om toe te staan dat besluiten van anderen jouw persoonlijke welvaart beïnvloeden'. 'Anderen' verwerven de mogelijkheid om 'jouw welvaart te beïnvloeden', wanneer je een samenwerking met ze aangaat. Het doel van een samenwerking met een andere partij is om er iets mee te winnen; anders zou je die samenwerking niet vrijwillig aangaan. Tegelijkertijd creëert die samenwerking echter ook een gevaar, omdat de andere partij misbruik van de samenwerking zou kunnen maken. Wanneer men een vrijwillige ruiltransactie aangaat, verwacht men dus er iets bij te winnen, maar men accepteert op het zelfde moment het risico dat het eigen belang wordt geschaad. Met andere woorden, men vertrouwt de andere partij zich zodanig te gedragen dat het eigen belang wordt gediend (in plaats van geschaad) met het aangaan van de samenwerking.

Het element van onzekerheid is bij vertrouwen van essentieel belang. Het gedrag van andere mensen in de toekomst is onzeker. Als mensen vertrouwen geven, gedragen ze zich echter alsof zij de toekomst kennen. Vertrouwen transformeert de onzekerheid daarmee in risico. De vertrouwengevers nemen de risico's voor lief die de onvoorspelbaarheid van het gedrag van anderen met zich meebrengt. Dit risico is tweezijdig: de 'gok' om de ander te vertrouwen kan goed of slecht uitpakken. In vertrouwenssituaties geldt in het algemeen, dat beantwoord vertrouwen meer oplevert dan niet vertrouwen (positief risico), maar dat misbruik van vertrouwen meer schade veroorzaakt dan beantwoord vertrouwen aan opbrengsten genereert (negatief risico). Wanneer een economische samenwerking goed verloopt, levert dit voor beide partijen een winst op, die niet gerealiseerd zou zijn als ze wegens gebrek aan vertrouwen van de zaak hadden afgezien. Wanneer de andere partij zich echter onbetrouwbaar gedraagt, kan de schade aanzienlijk zijn. De gok nemen om de ander te vertrouwen, betekent dus dat men de bereidheid heeft aanvaard om zich bloot te stellen aan de mogelijkheid van opportunistisch gedrag door anderen.

De veronderstellingen over het verband tussen vertrouwen en de daaraan mogelijk gerelateerde welvaartsvoordelen worden op drie wijzen onderzocht: allereerst vanuit het perspectief van sociaal kapitaal in hoofdstuk 2, vanuit een conceptueel perspectief in hoofdstuk 3, en aan de hand van drie praktijkstudies in de hoofdstukken 4, 5 en 6.

Hoofdstuk 2 benadert vertrouwen in relatie met het concept sociaal kapitaal. Hierbij wordt de definitie van Putnam gebruikt, die sociaal kapitaal opgebouwd ziet uit drie elementen: vertrouwen, netwerken en normen. Naast netwerken en normen wordt ook religie in de beschouwing betrokken, omdat zij een aantal belangrijke kenmerken gemeen heeft met sociaal kapitaal en er wellicht zelfs deel van uitmaakt. Bovendien biedt de analyse van religie de mogelijkheid een onderscheid te maken tussen de invloed van structurele en normatieve aspecten van sociaal kapitaal.

De macro-economische empirische literatuur toont een positief verband tussen de mate van vertrouwen en economische welvaart, maar dit verband is voornamelijk relevant voor ontwikkelingslanden en nauwelijks voor geavanceerde Westerse landen. Een macro-economisch verband tussen network participatie en economische welvaart lijkt vrijwel niet te bestaan, mogelijk als gevolg van elkaar tegenwerkende Putnam en Olson effecten van netwerken. Het Putnam effect houdt in dat participatie in netwerken leidt tot positieve externe effecten. Ten eerste zijn netwerken de bron van algemene normen van wederkerigheid en betrouwbaarheid, en ten tweede leren mensen bepaalde vaardigheden aan in netwerken (bijvoorbeeld hoe efficiënt te vergaderen of in het openbaar te spreken) die ook nuttig zijn in andere delen van de maatschappij (bijvoorbeeld met betrekking tot politieke participatie). Het Olson effect betreft de mogelijk negatieve externe effecten die uitgaan van netwerk participatie. Volgens deze redenering verworden netwerken als snel tot ‘verdelende’ groeperingen die hun eigen belang voorop stellen ten koste van het algemeen maatschappelijk belang. Met betrekking tot de normen van ‘goed burgerschap’ wordt in de macro-economische empirische literatuur een positief verband gevonden met economische welvaart, maar de maatstaf voor deze normen van burgerzin is discutabel. Hij is sterk gevoelig voor de neiging van mensen sociaal wenselijke antwoorden te produceren en voor de specifieke feitelijke omstandigheden, wat grote vraagtekens plaatst bij de validiteit van deze maatstaf. De macro-economische onderzoeksresultaten met betrekking tot het verband tussen religie en economische voorspoed zijn verdeeld en niet overtuigend. De conclusie is dat algemeen vertrouwen de meest waarschijnlijke link tussen sociaal kapitaal en economische welvaart lijkt te zijn, hoewel zelfs deze relatie niet onomstotelijk is aangetoond.

Op het micro niveau onderzoekt het hoofdstuk de relaties tussen vertrouwen, sociale participatie, politieke participatie, normen en religie. Een algemene conclusie is dat actieve leden van verenigingen – dit zijn degenen die vrijwilligerswerk doen in verenigingsverband – en passieve leden meer vertrouwen hebben in andere mensen dan niet-leden. Met name het actief lidmaatschap van kerken en religieuze organisaties, van sportverenigingen en van culturele verenigingen gaat samen met een hoger vertrouwen. Dit vormt een bevestiging van het Putnam effect. Het perverse Olson effect is echter ook zichtbaar, maar dan bij de leden van politieke partijen, milieuverenigingen en beroepsverenigingen. In deze belangenorganisaties is het vertrouwen van de actieve leden zelfs lager dan dat van de passieve leden. Met betrekking tot religie wordt geconcludeerd, dat religieuze mensen zeer actieve ‘sociaal kapitalisten’ zijn. De indicatoren voor de structurele elementen van religie (verbonden met actief lidmaatschap en regelmatig kerkbezoek) geven hierbij een duidelijker positief verband aan met vertrouwen, sociale participatie, vrijwilligerswerk, politieke participatie en goed burgerschap dan de indicatoren voor de normatieve elementen (verbonden met geloofsleer en geloofsethiek). Voornamelijk het netwerkelement is dus een belangrijke bron van vertrouwen.

Ten slotte wordt getracht in het hoofdstuk het niveau van sociale kapitaal in Nederland te meten. In een internationale vergelijking blijkt Nederland samen met de Scandinavische landen te behoren tot de landen met het hoogste sociale kapitaal. Bovendien worden geen aanwijzingen gevonden dat het sociaal kapitaal dalende is. Integendeel, de algemene trend is stijgend.

Hoofdstuk 3 onderzoekt het ontstaan en voortbestaan van vertrouwen in bilaterale samenwerkingsverbanden. Vertrouwen tussen individuen ontstaat als het gevolg van zowel rationele als relationele overwegingen die worden beïnvloed door formele en informele instituties. Er wordt een vertrouwenstypologie ontwikkeld met twee dimensies: de grondslag van vertrouwen (van formeel naar informeel) en het vertrouwensniveau (van individueel naar institutioneel). Deze typologie ordent de vier verschillende typen invloeden op het ontstaan van vertrouwen en de onderliggende vertrouwensmechanismen: (i) instrumentele vertrouwensinvloeden, gerelateerd aan het ‘homo economicus’ perspectief op menselijk gedrag, die vertrouwen opbouwen door middel van prestatiemechanismen (bijv. met behulp van bonussen en gijzelaars) en zelfbeperkingsmechanismen (bijv. specifieke investeringen); (ii) sociale vertrouwensinvloeden, voortkomend uit de gedachte dat vertrouwen een relationeel product is, die vertrouwen opwekken als een gevolg van basisvertrouwen, ‘satisficing’-mechanismen (bijv. door het ontwikkelen van een vertrouwensheuristiek), tolerantiemechanismen (bijv. gewoontevorming), informaliseringsmechanismen (bijv. door wederzijdse identificatie) en vertekeningmechanismen (bijv. cognitieve dissonantie); (iii) systemische vertrouwensinvloeden, ontspringend uit formele instituties, die vertrouwen creëren met behulp van aansprakelijkheidsmechanismen (bijv. het rechtssysteem) en reputatiemechanismen (via netwerken); en (iv) normatieve invloeden op vertrouwen, gerelateerd aan culturele vertrouwensnormen en gemeenschappen, die vertrouwen genereren door middel van sociale controle en sanctie mechanismen (bijv. sociale uitsluiting) en status mechanismen (bijv. trots).

Dit onderscheid in vier typen vertrouwensinvloeden is van zuiver analytische aard. In de praktijk zijn de verschillende vertrouwensmechanismen sterk met elkaar verweven. Rechtssystemen en vormen van normatieve macht blijken bijvoorbeeld nauw met elkaar samen te hangen, en de mate waarin rechtssystemen de autonomie van bilateraal afgesloten contacten respecteren beïnvloedt in niet geringe mate de aard van het vertrouwen op individueel niveau. Gezien het grote aantal mechanismen dat het ontstaan van vertrouwen kan beïnvloeden en de nog grotere combinatie van samenhangen die zich daarbij voor kunnen doen, wordt een contingentiebenadering van vertrouwen voorgesteld die de complexiteit van invloeden op het bestaan van vertrouwen als uitgangspunt neemt. De veronderstelling bij deze benadering is dat de precieze samenhang tussen de invloeden op het ontstaan van vertrouwen op voorhand niet als een algemene wetmatigheid is aan te geven. Per onderzoeksobject of onderzoekscontext moet derhalve het aantal factoren hanteerbaar worden gemaakt door op beredeneerde wijze vertrouwensmechanismen of zelfs complete invloedssferen uit te sluiten.

Hoofdstuk 4 bevat de eerste casestudy van vertrouwen. Het betreft het systeem van beleidsvoorbereiding op sociaal-economisch gebied in Nederland tussen 1980 en 2000. Dit systeem staat bekend onder de benaming ‘polder model’. Het hoofdstuk analyseert hoe vertrouwen ontstond tussen de belangrijkste deelnemers aan dit proces van beleidsvoorbereiding en hoe dit wederzijds vertrouwen de oplossing van sociaal-economische problemen vergemakkelijkte. Bij het ontstaan van vertrouwen spelen zowel instrumentele, sociale, normatieve als systemische aspecten een rol. Normatieve vertrouwensinvloeden kunnen worden herkend in de Nederlandse (vertrouwens)cultuur die gericht is op samenwerking en consensusvorming, mogelijk als gevolg van de noodzaak van een gezamenlijke strijd tegen het water en, in latere tijden, tegen buitenlandse concurrentie. Een systemische vertrouwensinvloed is kenbaar in de wet op de CAO, die prikkels verleent aan zowel werkgevers en werknemers om zich coöperatief op te stellen op het niveau van het centraal overleg, maar ook op individueel en bedrijfstakniveau. Voor de vorming van vertrouwen is evenwel nog het meest belangrijks het kader van geïnstitutionaliseerde

contacten tussen de regering, de sociale partners, de centrale bank, CBS, CPB en de adviesorganen. De frequente interactie met veel 'face-to-face'-contact, op formele en informele bijeenkomsten, en met een beperkt aantal mensen impliceert een zeer actieve netwerkparticipatie, waarin informatie snel wordt uitgewisseld, reputaties worden gevormd (instrumentele invloeden) en sociale banden worden opgebouwd (sociale invloeden). Al deze verschillende invloeden leidden tot het ontstaan van een hoge mate van wederzijds vertrouwen tussen de belangrijkste voormannen in het beleidsveld van de sociaal-economische politiek.

Het hoge wederzijds vertrouwen vertaalde zich op tweeërlei wijze in beter macro-economisch beleid en economisch welvaren. Ten eerste vormde het hoge vertrouwen een rem op het ontstaan van 'hold-up'-problemen in het loonvormingsproces op het individuele niveau tussen werkgever en werknemer, omdat het vertrouwen het mogelijk maakte de beslissing over de loonaanpassing met betrekking tot externe schokken te delegeren aan de corporatistische organisaties. Ten tweede resulteerde het hoge vertrouwen in een consensus beleid van samenwerking met een lange termijn visie op de aanpak van de economische problemen. Hierdoor ontstond maatschappelijk en politiek draagvlak voor harde beleidsmaatregelen, zoals een langdurige periode van loonmatiging die werd gecombineerd met de werkgeversbelofte te investeren in werkgelegenheid, flexibilisering van de arbeidsmarkt en ingrijpende bezuinigingen in de sociale zekerheid. Het polder model werkte op deze wijze als een mechanisme dat vertrouwen tussen personen en organisaties op het micro niveau omzette in positieve gevolgen voor de economie op het macro niveau.

Hoofdstuk 5 bevat de tweede casestudy van vertrouwen. Deze is gericht op co-etnische werkgelegenheid. Met co-etnische werkgelegenheid wordt het verschijnsel aangeduid dat in bedrijven met een eigenaar die tot een etnische minderheid behoort disproportioneel veel werknemers werken met dezelfde etnische achtergrond als die van de eigenaar. Sterke sociale netwerken en een samenhangend hoog vertrouwen binnen de groep zijn de belangrijkste redenen van co-etnische werkgelegenheid, omdat zij de informatie- en coördinatiekosten verlagen die gerelateerd zijn aan management- en zoekproblemen. De management problemen worden gekenmerkt door een principaal agent probleem en een bindingsprobleem. Het principaal agent probleem houdt in dat de principaal (de manager) andere belangen heeft dan de agent (de werknemer), terwijl de productie en inzet van de werknemer niet altijd goed te meten zijn. Het bindingsprobleem houdt in dat relatiespecifieke investeringen slechts renderen over langere tijd, terwijl op voorhand de verdeling van de overwinsten en de duur van de relatie niet kunnen worden vastgelegd. Met betrekking tot deze problemen werkt het etnische netwerk als een vertrouwen creërend mechanisme op basis van sociale controle, sociale sancties, status en reputatiemechanismen. Als gevolg kunnen co-etnische managers besparen op de transactiekosten die gerelateerd zijn aan de management problemen. Het etnische netwerk verlaagt tevens de informatiekosten die optreden in het zoekproces. Via het netwerk kan snel en betrouwbaar informatie over vacatures en kwaliteit van sollicitanten worden verspreid. Op deze manier resulteren sociale netwerken en het hoge groepsvertrouwen op de korte termijn tot meer banen voor etnische werknemers, een eenvoudige toegang tot de arbeidsmarkt voor etnische minderheid bedrijven, versterking van de normen van de etnische minderheidsgroep, en een verminderd beroep op socialezekerheidsregelingen voor de maatschappij. Kortom, co-etnische werkgelegenheid vormt een mechanisme dat vertrouwen transformeert in betere economische prestaties.

Hetzelfde hoge groepsvertrouwen heeft echter verscheidene negatieve welvaartseffecten op de lange termijn. Co-etnische werkgelegenheid kan een rem vormen op de sociale en economische emancipatie van etnische minderheid groepen. Het veroorzaakt namelijk negatieve prikkels voor de individuele groepsleden om algemene vaardigheden te verwerven,

omdat hun cultuurspecifieke vaardigheden hen al in staat stellen een co-etnische baan te vinden. Dit verzwakt echter hun weerbaarheid voor verstoringen op de arbeidsmarkt. Co-etnische werkgelegenheid remt de ontwikkeling en groei van etnische minderheid bedrijven, omdat de blik van deze bedrijven (met betrekking tot leveranciers, klanten en werknemers) beperkt blijft tot de eigen etnische groep. Dit vermindert de kans dat kleinschalige familiebedrijven zich ontwikkelen tot grote ondernemingen. Verder vergroot co-etnische werkgelegenheid het gevaar van de etnische val en het ontstaan van enclave economieën; beide leiden tot isolatie in plaats van integratie van de etnische minderheid groep in de samenleving. De conclusie van dit hoofdstuk is dat sociale netwerken en (groeps)vertrouwen zowel positieve als negatieve externaliteiten met zich mee brengen.

Hoofdstuk 6 onderzoekt de relaties tussen handel, vertrouwen en transactiekosten. Vertrouwensproblemen in de internationale handel leiden tot transactiekosten die gerelateerd zijn aan het tot stand brengen van het contact (zoekkosten in verband met het vinden van een leverancier, kwaliteit van het product, betrouwbaarheid van de transactiepartner, et cetera), aan het vervaardigen van het contract (overeenstemming bereiken over de juridische afspraken) en aan het controleren van de afspraken (nagaan of aan de verplichtingen wordt voldaan en het afdwingen daarvan). Het vergroten van het wederzijds vertrouwen tussen handelspartners reduceert de transactiekosten en leidt tot een toename in de handelsstromen. Gegeven de veronderstelling dat handel bevorderlijk is voor de economische groei, vormt dit een derde mechanisme, naast de arbeidsmarkt georiënteerde voorbeelden van hoofdstuk 4 en 5, waarin vertrouwen tot effecten op de economie leidt.

Deze hypothese is empirisch getest met behulp van een graviteitsvergelijking voor 25 landen. Een basis graviteitsvergelijking 'verklaart' het volume van de bilaterale handelsstromen aan de hand van de afstand tussen twee landen en de grootte van de landen. Aan dit basismodel zijn indicatoren voor formeel en informeel vertrouwen toegevoegd. In lijn met de hypothese blijken beide typen vertrouwensinvloeden substantiële effecten op het handelsvolume te hebben. De omvang van de effecten van vertrouwen op de handelsstromen is opmerkelijk hoog, zeker als in ogenschouw wordt genomen dat de landen in de gebruikte dataset sterk op elkaar lijken. Het zijn grotendeels geavanceerde economieën met veel gedeelde culturele karakteristieken en onderling zijn veelvuldig bilaterale en multilaterale wets- en handelsverdragen gesloten. Een tweede gegeven dat uit het empirisch onderzoek voortkomt, is dat er indicaties zijn dat de causale relatie van vertrouwen naar handel loopt. Een laatste opmerkelijke bevinding is dat, hoewel de indicator voor zowel formeel als voor informeel vertrouwen positief en statistisch significant gerelateerd is aan de hoogte van de bilaterale handelsstromen, er een afruil lijkt plaats te vinden tussen formeel en informeel vertrouwen. Over de tijd heen neemt de invloed van informeel vertrouwen toe op de verklaring van handelsstromen, terwijl de invloed van formeel vertrouwen afneemt.

Het laatste hoofdstuk brengt de inzichten van de verschillende beschouwingen bij elkaar. De belangrijkste conclusie is dat vertrouwen geen fenomeen is dat enkel positieve externaliteiten in zich bergt. Er zijn zowel baten als kosten aan vertrouwen verbonden, die tegen elkaar moeten worden afgewogen om tot een optimaal niveau van vertrouwen te komen. De kosten van formele vormen van vertrouwen liggen in het opzetten en onderhouden van een juridisch systeem. De kosten van informele vormen van vertrouwen liggen in de afruil tussen enerzijds vertrouwen tussen groepsleden en anderzijds vertrouwen tussen groepsleden en niet-groepsleden. Een sterker groepsvertrouwen vergroot de efficiëntie van het economisch handelen binnen de groep, maar leidt tot minder contact en een lager vertrouwen in niet-groepsleden, wat een negatieve uitwerking heeft op het economisch welvaren.

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