Economic Development, Institutions and Trust

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This version: May 3, 2004

Abstract

Economists increasingly recognize institutions and generalized trust as key determinants of differences in economic performance and development of regions and nations. This paper describes the microeconomic foundations of the concept of social capital. It describes the emergence of trust and the problems that emerge when linking trust to macroeconomic performance indicators. We argue that although the importance of trust in explaining growth and productivity differences is evident, an at least equally important question is how trust emerges. Combining the microeconomic strands of research that focus on the latter question with macroeconomic questions focusing on economic performance can provide important new insights.

JEL codes: D23, O1

Keywords: trust, institutions, economic development

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1. New Governance Systems

The 'invisible hand' in economics prompts a permanent drive towards more efficiency in a competitive market, reflected inter alia in mass production in relation to labour specialisation, or industrial districts in relation to flexible specialisation. Several theoretical frameworks have been developed to map out the industrial and market implications of a given economic system, such as the technological, the institutional, the industrial-organisational and the evolutionary approach (see also Sabel and Zeitlin, 1985 and You, 1995). In all cases, a decisive factor for successful performance of an economic system has been 'good governance' (not only in the form of the public sector, but also reflected in municipal and paternalistic modes of control). The history of economic development in many regions of our world witnesses a variety of policy or control systems and managerial arrangements that are often culture-specific and geographically determined. For example, the emergence of public-private water management boards ('waterschappen') in the Netherlands is the result of a long-lasting struggle of centuries against the water threats in the 'low countries'.

Currently, we observe new forms of decision-making agencies in our ICT age, such as virtual and network organisations, which seem to become a substitute for fordist institutional constellations. Learning and – in relation to embeddedness – control play a key role in these new economic arrangements (see also Raub and Weesie, 1993). In these new conceptual frameworks, trust relationships between different actors are essential. For example, Granovetter (1985) calls attention for the question in how far a trustor can adjust his expectations on the behaviour of a trustee on the basis of past experience. Networks are then information mechanisms that serve to reduce uncertainty regarding the behaviour of other agents. In addition, networks call for tailor-made institutional support systems, such as clustered control structures, bilateral pricing strategies, etc. (see Hagen and Choe, 1998).

All such new modes of governance configurations lead to an unprecedented variety in the appearance and functioning of economic systems, in which social, cultural, geographical and institutional factors are essential ingredients. As a consequence, we observe a high degree of heterogeneity in regional economic development. To account for this variation across nations or regions we need to go beyond neoclassically oriented growth theories.

Empirical research in economics increasingly recognises the decisive importance of institutions and policy mechanisms as background variables for productivity and productivity growth. Hall and Jones (1999) label these factors as social infrastructure. Good governance has often been identified as the main concept in these investigations (Olson, 1996). In many

economic analytical frameworks, property rights enforcement, an autonomous state and sound macroeconomic policies are seen as a *conditio sine qua non*. This approach is only partially satisfactory, however. The emergence of good policies or good governance is usually not sufficiently addressed. Most notably, the critical question is: why do some countries or regions fail to install good policies and why do other countries or regions fail to perform well in spite of good governance? For recent investigations into the spatial variation of institutional and organizational features, and the implications for regional development, we refer to, for example, Lambooy, 1997 and 2002; Lambooy and Boschma, 2001, and Boschma et al., 2002.

Recently, macroeconomic research on growth has also started paying attention to the effects of social structure and social relations on economic performance. This has led to a revival of interest in 'old' institutional and evolutionary approaches to institutional change, which focus on culture and informal, social norm systems (see, for example, Hodgson, 1998). Much of the literature appears to be clustered around the concept of social capital and one of its main constituents, namely interpersonal trust. In this chapter, we present an overview of the concepts 'social capital' and 'trust', as well as their link to productivity and development. We will also illustrate the main theoretical and empirical questions that remain to be answered in future research.

This chapter is organised as follows. In section 2, we present the basic argument for the importance of cooperative behaviour in economic life, and the resulting pivotal role for social capital. Section 3 shifts the focus from a general notion of social capital to trust as its operationalization. A synthesis of the insights from research into the emergence of interpersonal trust is the aim of the next section, after which section 5 intends to transfer trust from 'microeconomic' networks to a macroeconomic setting. We stress the possibility of negative consequences of network-based trust for macroeconomic performance, and the relation between the generalisation of interpersonal trust and formal institutions, imposed and enforced by the state. In this way we return to our central questions of the emergence and effect of good governance. Section 6 presents concluding remarks and suggests some questions that remain to be answered.

2. Social Capital and Trust in Economic Transactions

People engage in economic transactions, because these are beneficial for all parties. The benefits of specialisation and trade are well-established pillars in traditional economics. Still, the quid-pro-quo inherent in any (market) transaction is by no means automatic. When we

adopt the postulate of economic man, who decides purely on the basis of self-regarding considerations, the Hobbesian problem of order arises (Granovetter, 1985; Ostrom, 2000). Free-riding, theft, malfeasance and other conflicts will arise when given a chance, not only in collective services but also in markets. Market transactions can be considered to embody elements of prisoner's dilemma games, because cooperative behaviour is involved. The solution of neo-classical economics to this problem of order has been the assumption of perfectly competitive markets. Close social relations between transacting parties that might lead to misuse and fraud do generally not occur in atomistic markets. Agents interact at arm's length and can only successfully realise a transaction at the market price. Malfeasance will not pay-off and prevention of theft merely requires effective property rights, which are easily defined given the assumptions of perfect insight and atomistic, one-dimensional transactions. In other words, the invisible hand of the price mechanism cannot be tampered with.

However, economic transactions cannot be completely captured by the atomistic model of perfect competition. In a setting of imperfectly competitive markets, imperfect insight, uncertainty and asset specificity, in which many transactions are conducted over time and repeated with some frequency, cooperative behaviour matters. Granovetter (1985) argues that under such circumstances the discipline of competition is insufficient to safeguard mutual interests in transactions. We need additional theory to explain cooperative outcomes and good economic performance – or the lack thereof – amongst different societies.

Several explanations have been provided in economic theory for the occurrence of successful cooperative outcomes. These all point to factors that we have identified above as part of the social infrastructure. The first solution has been offered by new institutional economics. Formal institutional arrangements are invoked to solve complex contractual problems and reach cooperative outcomes. A second solution tries to underpin the emergence of, in particular, social norms from concrete social relations or networks. Although both approaches have a different focus, the lines of demarcation are not as strong as they are purported to be. We will argue that formal rules may complement social norms, rather than substitute for them. We will focus on this second type of solution, and discuss the role of formal institutions within the framework that results.

Social capital is an important concept in the literature on social relations. Often dated back to Loury and Bourdieu (for example, 1986), social capital has become a rather elastic concept. Portes (1998) notes an emerging consensus towards the formulation of a definition. He defines social capital as "…the ability of actors to secure benefits by virtue of membership

in social networks or other social structures." Hence, it is the ability of people to work together for common purposes. Portes stresses the importance of identifying social capital as ability rather than as the resources that follow from the use of networks. The latter practice, which is regularly found in the literature, can lead to tautological reasoning.

The definition above is conceptually neat, but does not offer much help for exploratory analysis. In this light, Knack and Keefer (1997), quoting Solow, argue that 'if social capital is to be more than a "buzzword" its stock "should somehow be measurable, even inexactly", but "measurement seems very far away"'. Efforts have been made, however, to assess the critical dimensions or origins of social capital and at least to suggest operational proxies. Paldam and Svendsen (1999) choose to focus on the density of trust as a definition of social capital, determining how easily people work together. The relevance of trust is best acknowledged, according to them, by the fact that its level differs across societies and in time. However, trust is a factor that causes social capital and determines its extent, rather than the equivalent of social capital. Still, focusing on trust is a sensible choice. In comparison to the overarching concept of social capital, variables such as trust can be operationalised more easily into a proxy that is measurable across survey respondents. For example, Knack and Keefer (1997) have used indices from the World Values Surveys to represent interpersonal trust and a related variable for civic norms.[2]

3. The Impact of Trust on Economic Performance

Besides the advantage of its more concrete and measurable nature, trust seems the binding factor in successful cooperative behaviour. As we have argued, explaining cooperative outcomes is crucial for explaining divergence in economic performance. Many authors have emphasized the central position of trust in their analysis of cooperative behaviour and social relations (for example, Fukuyama, 1995; Granovetter, 1985; Coleman, 1988) and its implications for economic performance (for example, Olson, 1982; Landes, 1998). Let us briefly consider some of their statements. Granovetter refers to Hobbes in saying that 'conflict-free social and economic transactions depend on trust and the absence of malfeasance' (p. 484). Ostrom (2000, p. 144) reminds us that 'most contractual relationships –

[2] The specific question asked to respondents to assess the level of interpersonal trust was: "Generally speaking, would you say that most people can be trusted, or that you can't be too careful in dealing with people?" The indicator Knack and Keefer constructed from the responses is 'the percentage of respondents in each nation replying "most people can be trusted" (after deleting the "don't know" responses).'

whether for private or public goods – have at least an element of this basic structure of trying to assure mutual trust', since if trust were lacking '[both] players will end up with lower payoffs than if they had been able to trust and cooperate'. Knack and Keefer (1997, p. 1252) cite Arrow, who strongly advocated the link between social capital and economic performance: "Virtually every commercial transaction has within itself an element of trust, certainly […] (when) […] conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence".

The mechanisms along which trust can affect economic performance can be classified in two categories. The first category builds on the notion that trust can lower *transaction costs*. High trust reduces, for example, the resources spent on contractual safeguards, litigation and protection from violations of property rights. Furthermore, if trust is low, the activities of firms and entrepreneurs may be biased towards monitoring and enforcement of contractual obligations, rather than towards adapting to changing opportunities. Complete control of the present, predictable situation is preferred to innovation into risky, uncertain new situations for which confidence in spontaneous cooperative behaviour is necessary. Finally, a healthy level of trust reduces the need for formal institutions to safeguard abidance by transactional agreements. The second category emphasises *government performance* and the *quality of economic policy*. In more trusting societies government officials may likewise be seen as more trustworthy. As an effect, policy announcements will be seen as more credible, thus sorting more effect in the sense of reducing perceived uncertainty and increasing perceived stability. This should induce more substantial investment, both in physical and human capital that is meant to be optimal over the long run. Trust can also be related to all kinds of increased associational involvement, including the level and character of political participation (Putnam, 1993). Active participation and voice of citizens potentially improve government performance and the quality of (economic) policies.

The arguments so far rely heavily on the intuitively appealing idea that the circumstances shaped by trust enhance economic performance by promoting cooperative behaviour. The argument is often supported with case-study evidence from underdeveloped, traditional economies, or not-so-recent historical situations. Still, the literature also uses the concepts to explain contemporary differences in performance across time and across countries of both developed and developing world (for example, Fukuyama, 1995; Knack and Keefer, 1997). To provide a more solid ground for including trust in cross-country comparisons, we

need to explore the development of trust and the relation between social capital and formal institutions. After having done that we can return to the links between trust and macroeconomic performance and assess the empirical evidence at hand.

4. The Genesis of Trust

Coleman (1988) and Paldam and Svendsen (1999) essentially define trust as *the mutual expectation within a group or community of cooperative behaviour, which is based on shared social norms, such as reciprocity and reliability*. The question for the rationale of trust is twofold. First, why should it arise and second how does it evolve? We refer to two approaches to answer the first question. To begin with, one may postulate that people are moral beings, with underlying values that propagate trustworthiness and hence validate the rationality of trusting one's fellow citizens. The second view stresses the potential mutual advantages of deviating from narrow norms of selfish short-run optimization (Paldam and Svendsen, 1999).

Although the first view has been criticized as an over-socialized interpretation of human interaction, with people being over-sensitive to moral acceptance by others (Granovetter, 1985), we argue that both solutions to the why-question are necessary and complementary. This view is taken by Coleman (1988) who attempts to reconcile rational individual motivations (an engine of action, in his words) with the importance of social structure. Trust and trustworthy behaviour are only rational if the benefits of malfeasance are somehow checked. For this, we need effective social norms to evolve, which bind the acceptability of behaviour. Knack and Keefer (1997, p. 1254) state that these norms of civic cooperation 'act as constraints on narrow self-interest' and 'alter the costs and benefits of cooperating and defecting in prisoner's dilemmas'.

Both trust and trustworthiness are based on moral valuation as well as objective valuation of cooperation as an instrument to obtain economic payoffs. In other words, as Nooteboom (2001) remarks, both internal and external values matter in the cost-benefit considerations of investment in cooperative norms and trust. But how do norms arise and generate interpersonal trust? On the one hand, you have to be able to expect that trustworthy behaviour is beneficial for each agent whom you deal with: the present value of rewards from cooperative behaviour should outweigh the benefits of defecting. This determines the extent of trust you will have in others. On the other hand, you yourself must be trustworthy. Only then will cooperative behaviour persist.

Ostrom (2000) offers a compelling analysis of the evolution of social norms and

spontaneous cooperative behaviour that closely parallels this idea. She starts from a setting in which the presence of internal value towards social norms has evolved to some extent. The pervasive advantages of cooperation that existed in early human history serve to motivate such a situation. This evolutionary argument motivates the development of social norms as *shared understandings about actions that are obligatory, permitted, or forbidden* (Ostrom, 2000). Subsequently, she advocates an 'indirect evolutionary approach' to explain the surprising extent of cooperative behaviour in micro-evidence on collective action problems in both field- and experimental research.

Central to this approach is the adaptation of individual behaviour in the presence of social norms, through experience and learning. In such circumstances, the use and effectiveness of a cooperative norm within a group of people may grow in strength, which yields trust and, consequently, promotes self-enforceable cooperative behaviour. How does this process operate? As we saw before, both expectations towards others' actions and own behaviour depend partly on external (economic) payoffs to cooperation over time, but *also* on internal values that some people attribute to fairness and honesty. One without the other will not suffice. Without internal values, trust would be irrational, if the pure economic payoff to defection exceeds the payoff to cooperation, whatever the other agents decide, preventing a social norm from developing. This would, in a prisoner's game setting, lead to the non-cooperative and socially inefficient Nash equilibrium. Internal values shared by part of the population are needed to alter the payoff structure for other players. The *a priori* trustworthy players will value the outcomes of cooperative behaviour above the value of outcomes in which *they* themselves defect (Henrich et al., 2001; Ostrom, 2000). Their valuation of cooperation helps to explain the evolution of trust, because they at least enter the market with intent to cooperate. They set a cooperative norm and can be trusted. High relative external values of cooperative outcomes are necessary to incite others to contemplate cooperation. If the economic payoff to cooperation is lower than to theft, cooperation will not be likely to sustain over time. Given that those people without internal value towards cooperation will defect, trustworthy players will increasingly abstain from cooperation too. In the end, they are *conditional* cooperators (Ostrom, 2000).

What determines whether the cooperative norm will be adopted and grow in strength, thus reinforcing cooperative outcomes, or that cooperative behaviour will decline because 'rational egoists' take advantage by appropriating quasi rents in the process? Ostrom points at the importance of contextual factors to alter external (or objective) payoffs of cooperation and

defection, and to incite the adoption of norm-reflecting internal values: 'We need to understand how institutional, cultural, and biophysical contexts affect the types of individuals who are recruited into and leave particular types of collective action situations, the kind of information […] available about past actions, and how individuals can […] change structural variables so as to enhance the probabilities of norm-using types being involved and growing in strength over time' (Ostrom, 2000; p. 154). Generally speaking, context refers to several important factors of social structure that have been highlighted earlier by Coleman (1988) and Granovetter (1985). Besides specific external background factors such as uncertainty, much of the context in which social relations occur has to do with the design of social structure. For effective norms to develop, a social structure has to succeed in making information available internally on behaviour and on opportunities for collective gain. The former involves setting up monitoring rules that alter the external payoff structure for all players by enabling collective punishment when norms are not abided by. The latter is put forward in Rauch (2001) as a factor that motivates and strengthens social structures for collective action. Coleman captures these aspects of information and effective monitoring in two related design aspects of social structure: closure and appropriability. Closure essentially refers to the existence of sufficient mutual ties within a relevant group of people to ensure the existence of an *effective* social norm, which supports persistent cooperation. Because of the existence of social norms and repeated interaction within the group, tightly knit social relations evolve that generate a common background and understanding between the group's members. Closure generates trust that generalizes the social relations between members. In a way, the organization is fungible, and appropriable for other beneficial purposes (Coleman, p. 109; Portes, p. 6). Investment and cooperative participation in such a network of relations thus becomes more profitable in the presence of closure and appropriability.

Granovetter (1985) further emphasizes the focus on such networks of social relations. He criticized the atomistic view of human behaviour in both the undersocialized model of 'homo economicus' and the oversocialized model of exogenously instilled generalized morality. Instead, like Ostrom, he argues for the importance of social context and history in shaping 'concrete, ongoing systems of social relations […] (in which actors') attempts at purposive action are embedded' (Granovetter, op. cit., p. 487). He then explicitly states that these structures of personal relations (networks) generate trust and discourage malfeasance. Using networks, people base trust on information about past behaviour that indicates whether a particular agent can be expected to deal honestly with them. This information most reliably

follows from own personal relations with the individuals in question or from trusted informants' experiences. Concrete networks facilitate this kind of concrete information, whereas formal institutions and organizations would only help to provide information on reputation as 'a generalized commodity' (p. 490).

The discussion of the role of networks in international trade by Rauch (2001) further clarifies the network concept. A network can be defined as *a group of agents that pursue repeated, enduring exchange relations with one another* (Podolny and Page, cited in Rauch, 2001, p. 1179). This definition conforms closely to the ideas of Coleman in which cooperative norms evolve best in tightly knit, closed groups. A second definition, from an earlier article by Granovetter, defines a network as *a set of actors who know each others' relevant characteristics or can learn them through referral* (cit. in Rauch, 2001). This definition better suits the description by Granovetter mentioned above. The latter type of network is also contained in the former, thus giving rise to the identification of "strong ties" for the former type of network and "weak ties" for the latter structure of personal relations.

The network design is an effective and efficient social structure in a particular situation where collective investment in mutual trust is called for. As Ostrom (2000, p. 152) puts it, 'conditional cooperation and mutual monitoring reinforce one another, *especially in regimes where the rules are designed to reduce monitoring costs*. Over time, further adherence to shared norms evolves and high levels of cooperation are achieved without the need to engage in very close and costly monitoring to enforce rule conformance' (italics added).

In short, networks generate trust and consequently reduce the transaction costs of interaction. Paldam and Svendsen (1999) stress the importance of trust (following from effective social norms) for self-enforced cooperative behaviour. Agreements to a large extent need only be informal, which significantly 'lowers the level of transaction costs, eventually giving significant benefits to everybody'. Portes (1998, p. 6) emphasizes the importance of closure and strong norms to facilitate transactions 'without recourse to cumbersome legal contracts'. A notable finding in an experimental context is that networks generating endogenous cooperative behaviour tend to be crowded out when an external authority imposes formal institutions and 'third party' monitoring to substitute for internal rules – i.e., social norms (Ostrom, p. 147). Because external rules of the game enforce cooperation without leading to the spontaneous formation of internal norms, reinforcement of cooperative behaviour by moral effects and mutual monitoring does not arise. Self-enforced cooperative behaviour that has an endogenous rationale does not unfold. As a result, cooperation enforced

by exogenously imposed formal institutions can dissolve easily. The transaction costs of persistent cooperative behaviour are accordingly higher in this case.

The analysis of the genesis of trust that was illustrated in this section leads to valuable insight in the nature of interpersonal trust. The importance of both moral value and objective payoffs for persistent cooperative behaviour illustrates that trustworthiness in itself is not an internalized value, but a behavioural norm. Trust, which is based on the credibility of this norm of trustworthiness, is not only based on internalized moral virtues, but is most of all a rational calculation within the context of a specific network. Some actors may attach value to fairness or honesty, and these internal values may indeed spread to other participants in successful collaboration (see, for example, Bowles, 1998 on endogeneity of preferences). However, even pure egoists will expect cooperative behaviour and find it in their interest to spontaneously reciprocate on these expectations. In a suitable context they will trust and act trustworthily, which is in complete contrast to the predictions of standard atomistic economic theory.

Yet, the question remains when and why the context is just right for trust and effective norms to arise spontaneously. If we do not address this question more fully in future research (cf. Ostrom, 2000, p. 154), we keep running the risk of committing a fallacy pointed out by Portes (1998). When voluntary cooperative behaviour occurs, it is scientifically not sufficient to attribute this to effective norms and high levels of trust. In this case we would end up re-labelling the issue to be explained: if we see voluntary cooperative outcomes, trust must have pre-existed. In such a reasoning trust becomes both cause and effect. The identification of closure and appropriability that affect payoffs in a network context *is*, however, a step ahead in explaining cooperative behaviour on a specific micro scale. The problem re-enters, however, when we try to relate trust to macroeconomic performance.

5. From Networks to Performance

5.1 The Generalization of Trust

Often, social capital and trust are interpreted as a feature of collectivities or nations instead of as a feature in networks. The authors that focus on the macroeconomic effects of trust all emphasize such generalized trust (Fukuyama, 1995; Knack and Keefer, 1997). But in this way, social capital, or trust, easily becomes an all-encompassing factor that ‘leads to positive outcomes […] and […] is inferred from the same outcomes’ (Portes, 1998, p. 19). The

problem is impelling because the leap from a network explanation of interpersonal trust to a nation-wide ease of cooperation remains to be explained. Simply starting with good economic performance and to reduce this to the beneficial effects of civic norms and trust 'turns out to be an explanation that is a logical corollary of the effect to be explained' (Portes, 1998, footnote 8). To prevent as much as possible that the use of social capital or trust as an explanatory factor for macroeconomic performance becomes a tautology, an explanation for the generalization of network outcomes to the societal level is needed.

A promising potential explanation for the generalization of trust from networks can be found in the concept of weak ties. If exchange transactions are not too much embedded in (extended) kinship relations, the scope and nature of a network will promote investment in new trade opportunities. The focus of such an open network is on information about the expected trustworthiness of existing and new transactors, without explicitly seeking narrowly repeated interaction and morally tight relations. There is a trade-off involved in choosing to focus on weak ties and openness. Information on trustworthiness will be less detailed and up-to-date than in the case of relatively tight and small networks based on strong ties. Still, Ostrom argues that even noisy information on player-type can help sustain cooperative behaviour. Moreover, the expected payoffs of cooperative behaviour in an open network may be higher over time, because it is more flexible towards extending its activities to new markets - both geographically and in terms of activities (cf. Rauch, 2001, in particular on the role of information provision on market opportunities within business group networks).

How does openness of networks fit in when the feature of closure is emphasized as important for the development of norms and trust? Openness to new partners and opportunities does not contradict the closure aspect of networks. Closure only refers to the circularity of ties within a network. Even weak ties have this central feature. Their purpose is to generalize access to information about the characteristics of all partners by referral mechanisms that build on closure. Furthermore, since weak ties rely on knowledge of players' characteristics (Rauch, 2001, p. 1184) rather than on the specific pattern of interaction itself (as strong ties do), their fungibility and appropriability for other purposes, new entrants and new activities is larger. This promotes the generalization of trust from a specific context to the level of interaction with comparative strangers.

The leap to transactions with comparative strangers may not be as big as it seems. Forsgren and Johanson (cited in Rauch, 2001, p. 1179) claim that 'markets are more or less stable networks of business relationships'. Even comparative strangers have to abide by the

norms of the network that they enter, if they want to be successful and benefit from expanding trade opportunities over time. In itself, the incentive structure ex-ante generates expectations of reciprocative behaviour, which is equivalent to generalized trust.

Fukuyama (1995) can also be argued to indicate the importance of openness for the development of generalized trust. Akin to the network view, he stresses the importance for economic performance of the ability to form organizations. He distinguishes two possible sources of trust that support the formation of economic organizations. The most natural cornerstone for organization is the (extended) family. Such kinship bonds are rather close, strong ties. The second form of trust is spontaneous sociability, or generalized trust: the ability of strangers to trust one another and work together (Fukuyama, 1995a). Spontaneous sociability coincides with weak ties and open networks.

Fukuyama argues that – based on a comparison of cultures – a trade-off seems to exist between the strength of family ties and the strength of spontaneous sociability (the strength of 'weak' ties, that is). He motivates this trade-off by the claim that the emergence of spontaneous sociability is inhibited in cultures that emphasize kinship relations above all. He states that spontaneous sociability depends on 'a prior sense of moral community, that is, an unwritten set of ethical rules or norms that serve as the basis of social trust'. A moral community emerges habitually from civil society and is rooted in nonrational factors such as culture, religion and tradition. Like Putnam (1993), Fukuyama ascribes a large role to society's intermediate associations, varying from private business organizations, private schools and literary clubs to Bible study groups and choral societies. Although his argument appears to suffer from tautological reasoning (cf. Portes, 1998) and an oversocialized view of social norms (cf. Granovetter, 1985), the link to intentional and rational network constellations and an 'openness explanation' for generalized trust can be made. Cultures that build their norms and networks mostly on family bonds are likely to be less open. Correspondingly, less civil activity will ensue. As a result of a lack of experience in interacting with strangers, moral community will not arise and reliance on this type of interaction will remain low. Not surprisingly, generalized trust (spontaneous sociability) will not be widely prevalent.

Following our discussion in section 4, it is clear that Fukuyama's 'moral community' should not be seen as merely exogenous generalized morality. Yet, part of it starts with internal moral valuation. The endogeneity of preferences to social structure (Bowles, 1998) implies that moral valuation can grow intentionally in a network constellation and can even

evolve to have an independent staying power. Thus, if participation in civil society has positive effects on internalization of cooperative norms, Putnam's and Fukuyama's seemingly oversocialized faith in the appropriability of experience in intermediate associations for economic interaction may not be inaccurate. Henrich et al. (2001) provide empirical support for the ex-post context- independence of social norms. The results of their field experiments into the existence of cooperative values suggest that a wide diversity of norms exists between different cultural groups, which seem to be persistent to standardization of the context. People consistently follow their pre-existing norms in an experimental context, characterized by anonymity and the absence of mechanisms for collective sanctioning.

5.2 Negative aspects of Trust in a Network

Up to now we have worked from the assumption that trust within specific networks is a socially beneficial asset. Networks, however, can often have negative implications for macroeconomic performance. They may create a type of trust that does not promote generalized trust, but rather undermines it, either inadvertently or intentionally. One example of networks that can turn out to have negative effects for economic performance is a family or parochial-based network. As Fukuyama illustrates, family ties indeed create kinship trust at the expense of generalized trust.

Both Granovetter and Portes acknowledge the scientific importance of explicitly dealing with the negative aspects of network constellations. To prevent the analysis of social capital from falling within the bounds of moralizing statements rather than serious sociological research, Portes says, we must not present networks and collective sanctions as unmixed blessings (p. 15). We can distinguish two negative effects of network structures that are especially relevant for macroeconomic performance (cf. Portes, 1998, p. 15). To begin with, networks can intentionally serve to foster a partial interest at the exclusion of others. Furthermore, networks, and the normative structure they create, give rise to beneficial opportunities for internal free-riders, or constrain strategies of behaviour to redistributing the resources controlled by the network.

The former source of scepticism towards economic networks has a long history in economic theory. Knack and Keefer (1997) refer to its modern roots in Olson (1982). His proposition is that networks often act as special interest groups or lobbies that narrowly seek preferential treatment at disproportionate cost to society. This view comes into conflict with the positive role ascribed to civil society networks (associations) in generalizing trust, by

Putnam and Fukuyama.

Second, networks based on strong parochial moral community (Rauch, 2001, p. 1181) may become inward looking when community or group closure is unduly emphasized at the cost of – rather than combined with – openness towards new opportunities and members. In such a circumstance, success and cooperative norms are not measured against the standard of economic accumulation and expansion of resources, but instead in terms of internal assistance and obligation within a static environment of fixed resources. This gives excessive power to the hierarchy of community relations and puts accordingly high pressure on the opportunities for entrepreneurial success. This type of privileged access to the resources of fellow members within the group stifles competition on the basis of own achievement. It leads to downward levelling norms (see Portes, 1998, p. 16).

Berry (1989) gives a convincing illustration of how redistributional rentseeking both within and between groups leads to inbred stagnation. She emphasizes the role of social institutions (social norms) regarding access to productive resources, for the strategies of resource use and the perpetuation of the agricultural crisis in many African economies. During the transition from traditional tribal society, through colonial rule, to independence, cost saving 'indirect rule' by the colonial authorities to a large extent led to the survival of traditional kinship and community based polities, and their extension into higher levels of governance. As a result, both in productive enterprise and state governance, access to resources still depends heavily on strong community-based social relations. Berry (1989, p. 46) summarizes the effects of this type of social organization on economic activity as follows: 'Strategies of production and accumulation are directed towards establishing or strengthening social relations, which in turn affect the terms on which people gain access to resources'. The 'perpetuation of access via social identity leads to further investment in (social) institutions as potential channels of access' (Berry, 1989, p. 51). This proliferation of social claims for access distracts resources away from productive investment and into *redistribution*.

Fukuyama (1995) and Knack and Keefer (1997) identify patronage and rentseeking with low generalized trust. When interactions become locked-in in a social structure characterized by parochial vested interests and patrimonial channels of access to resources, the political and economic sphere will be dominated by nepotist rentseeking, stagnating productivity and potential social conflict. The question that remains is whether we can identify factors that determine when networks are conducive to economic performance by generating sufficient generalized trust. We may argue that strong ties of repeated interaction are more

likely to be associated with possible rentseeking. However, even weak ties (for example, indirect referral of opportunities to access resources) may go together with excessive emphasis on redistribution and, thus, economic stagnation. Inclusive networks usually start from strong group ties, but the competitive incentive to increase the relative size of any such network may render the ties somewhat weaker. This, nevertheless, does not affect their redistributional intentions. For now, we can refer to some key proximate factors behind the effects of networks on the generalization (or lack thereof) of trust. They are whether the moral community is linked to parochial or family ties or to broader community cooperation (cf. Fukuyama, 1995) and whether accompanying social norms emphasize open venturing or consolidation.

All in all, the spectrum of theoretical considerations clarifies that it would be too easy simply to transpose trust within specific networks to generalized trust in random transactions. Just ascribing trust and social capital to individual people and adding up to the societal level, as Paldam and Svendsen (1999) do, is theoretically unsatisfactory. We have seen that the origin of interpersonal trust has to be sought in deliberate, purposeful networks of social relations. But, as Granovetter (1985, p. 491) admits, the 'embeddedness position' is 'less sweeping' than its under- and oversocialized alternatives as solution to the problems of general order in economic life. 'Networks of social relations penetrate irregularly in different sectors of economic life, thus allowing for what we already know: distrust, opportunism and disorder are by no means absent'. Moreover, he recognizes that 'while social relations may indeed often be a necessary condition for trust and trustworthy behaviour, they are not sufficient to guarantee these and may even provide occasion and means for malfeasance and conflict on a scale larger than in their absence'. This means that we have to keep searching for ultimate explanatory factors to solve the problems concerning cooperative behaviour and economic performance more fully. Although the answers provided by theory may appear inconclusive, the approach followed is to be preferred over more decisive and normative under- or oversocialized statements of exogenously generalized morality and self-fulfilling formal institutional prophecies, which are more prone to the Portes-critique.

Let us now turn to the relation between the formal institutional framework and generalized trust. Sometimes, close ties and networks appear a constraint rather than a condition for the generation of general interpersonal trust. Should we prefer paucity of ties after all, or is there some way for the central public authorities to foster the 'right' ties?

5.3 The Role of Formal Institutions

At first sight, market competition appears to foster a situation in which ties are not close and oligarchic, but rather impersonal and directed towards objective payoffs. Indeed, sufficiently competitive markets are a necessary condition for desirable cooperative behaviour between economic partners up- and downstream in a commodity chain, or towards consumers. Excessive market power may, after all, lead to or coincide with specific interests and unproductive rentseeking, fostering the wrong type of ties, networks and cooperation. However, as we saw before, markets are no guarantee for cooperative behaviour and good macroeconomic performance in real-world economies. Even competitive, atomistic markets may not suffice. Some form of closure is also needed to enforce conformance to cooperative norms.

An example may serve to illustrate this. Caballero and Hammour (1996) describe a situation in which investment levels and growth in the economy are lower than socially optimal. They capture a realistic feature of the dynamic process of production and investment in market economies. In part of the economy, some part of the investment made by a firm is specifically tied to labour in production. Labour is non-specific and has an opt-out to employment in the 'non-specific' sector or to unemployment benefits. As a result, the production factor capital cannot appropriate all of its ex-ante opportunity costs. This so-called asset specificity creates a hold-up problem in investment, which leads to a lower growth rate of the economy (for example, Grout, 1984; Van der Ploeg, 1987). This *atomistic* situation of relations between owners of units of capital and individual labourers can be analysed using the tools from *network* theory. A cooperative norm is not likely to arise in the market relation described above, since there is no closure. Eventually, when capital and labour enter a transaction relation, the latter can defect on such a norm by ex-post appropriating part of capital's ex-ante reward (often labelled as quasi-rents). Defecting cooperative 'agreements' is in the best interest of labour, whatever capital chooses to do, although the cooperative outcome is socially preferable. We have a classical prisoner's dilemma situation in a setting of impersonal ties.

To reach the preferable cooperative outcome would require investment in some effort to close the system. Producers in a market could merge in a network, perhaps together with labourers, in an attempt to develop an internal social norm, mutual monitoring and collective punishment. From a theoretical point of view, such effective norms may be difficult to develop in an atomistic market (cf. Olson, 1965). Moreover, they could evolve into a lobby for

the redistributional interest of a sector as a whole, against other industries. Alternatively, the Hobbesian alternative for generating a generalized incentive to cooperate in the market is to install a public authority (the state) that enforces formal institutions.[3] Knack and Keefer (1997, p. 1279) quote Hardin: 'In a Hobbesian view […] trust is underwritten by a strong government to enforce contracts and to punish theft.' He even goes as far as to argue that government regulation is indispensable for the generalization of trust: 'Without such a government, cooperation would be nearly impossible and trust would be irrational'. Formal institutions aim to reach external closure of social relations. Instead of closure through spontaneous networks with 'sufficient ties' (Portes, 1998), closure is imposed externally by 'third party' enforcement of cooperative behaviour.

As we have seen before, there is a tension between external rules and social norms (Ostrom, 2000). What is the relation between formal institutions and generalized trust? Can formal institutions substitute for or complement network-induced trust? On the one hand, formal institutions may be necessary for a widespread generalization of trust and dynamic efficiency in a complex market economy. Strong impartial formal institutions induce more confident use of weak ties that are based on impersonal, objective payoffs. They promote generalized trust, since enforcement of cooperation in economic behaviour is no longer dependent on strong community ties. In this way, as Rauch (2001, p. 1184) concludes, formal institutions substitute for network ties as well as influence the way networks operate. They help to rationalize generalized trust and motivate closed networks to open up.

Greif (1994) is more drastic when he emphasizes the importance of a *lack* of ties in generating a need for the development of formal institutions. These institutions supported the openness of organizations towards new opportunities in trade and towards new members. Expansion and specialization thrive more in societies characterized by a lack of ties and by well-developed formal institutions that strengthen trust. Greif thus identifies formal institutions as essential for a good dynamic performance of economies and sees (strong) ties and networks as inefficient in the long run.

On the other hand, Ostrom (2000) pointed out that external involvement in cooperative

[3] As it turns out, formal institutions, like contracts, are an imperfect solution for the problem. In real life, complete contracts are impossible and transaction costs of contracting complex situations can quickly become prohibitive. This points to the need for a combination of internal norms and formal rules to ensure cooperative behaviour. Social norms succeed in lowering transaction costs by promoting self-enforcement through either strong or weak ties; formal institutions can safeguard against rentseeking and may help to overcome the collective action problem of forming ties by reducing uncertainty. Although desirable, this complementarity is not as straightforward in practice.

dilemmas tends to crowd out social norms and the development of internal values, acting as an imperfect, more costly substitute for self-enforcing trust. Endogenous closure, after all, cannot be created on the basis of formal institutions and will even be prevented from emerging. This led Granovetter (1985, p. 489) to conclude that '(formal institutions) do not produce trust, but instead are a functional substitute for it' and 'institutional arrangements alone could not entirely stem force or fraud'. If we stick to the egoist nature of 'homo economicus', constrained by formal rules only, we should expect continuous large scale attempts to circumvent these rules. This would yield a vicious circle of an ever-increasing level of transaction costs, with progressively more complex rule systems and monitoring practices. In reality, we see both tendencies of loophole search and self-reinforcing cooperative behaviour. For the latter to dominate, effective social norms and voluntary networks with weak ties appear to be as indispensable as strong, impartial formal institutions. Hence, for the emergence of generalized trust, state regulation somehow should blend with or complement spontaneous cooperative norms. How should the advantages of both norms and external rules be accomplished without the latter crowding out the former?

Paldam and Svendsen (1999) refer to this as the basic policy dilemma of social capital (viz. trust). Concluding their paper they say: 'Social capital is self enforcement and thus contrary to third party enforcement. Attempts by third parties – as public authorities – to enforce social capital may thus be counterproductive'. Some researchers argue that the state cannot do much to complement social norms positively and that trying to substitute for spontaneous trust will be unsuccessful and potentially detrimental. Fukuyama (1995a) advocates that, 'while state power can effectively undermine civil society […], it is much less able to promote strong bonds of special solidarity or the moral fabric that underlies community'. This conclusion reflects the tendency in Fukuyama (1995) and Putnam (1993) to rely on (an oversocialized) generalized morality to explain generalized trust. Fukuyama's main conclusion on generalized trust is that the lack or abundance of it is determined by cultural factors. Somehow, civic virtues determined by the level and character of civil, associational activity, as opposed to the reliance on family ties, translate into cooperative behaviour in the economy and the democracy. This process, according to Putnam, could take centuries to mature. Similarly, Paldam and Svendsen (1999) state that 'it appears that social capital is rarely produced in a deliberate way. At present, we hardly know how it is produced – it comes about through activities with another purpose'.

The analysis in Berry (1989) suggests the relevance of situations in which the cultural

context determines whether there is scope for beneficial institutional changes, either of formal effective rules or of social norms. Traditional societies in which cultural values have been instilled intentionally into the cooperative norms of production and distribution can be resistant to changes in the economic or political context. In an era of global industrialization and newly found independence, vested interests stepped into the space opened by these changes. Today, rentseeking and stagnation characterize these developing countries. Khan (1991) refers to *transition costs* as the costs of resistance to institutional change imposed on society by the vested socio-economic interests. The size of transition costs is determined by the effectiveness of cultural norms, the changing of which constitutes a new collective action problem. In Khan's analysis, only a strong state can overcome a situation in which the traditional ruling elite and its socio-economic system of norms prevent socially beneficial changes in norms to arise, and break the paradoxical situation in which formal rules are ineffective in changing behaviour.

This already suggests there is more to be said about generalization of trust and the role of government regulation. But we must do so cautiously. Rather than outright statist theory, we have to take account of the importance of explaining the emergence of spontaneous trust in providing guidance for state regulation. The gap between micro network theory and sweeping stories of general interpersonal trust can be filled more satisfactorily. Ostrom (2000) made it clear that the rationalization of cooperative behaviour does not only have to rely on exogenously internalised values. She stressed the centrality of the external, non-cultural, economic values of cooperation and its interrelation with internal values in the genesis of effective norms and trust. Furthermore, the possible negative effects of network ties also add an element of their own to the dynamics of generalizing trust. Too much emphasis on civil society might lead the state to retreat from its responsibilities. The temptation for government to wash its hands in innocence regarding economic failure cannot be denied. The state need only refer to the lack of moral community, or deduce from poor macroeconomic performance a seeming disappearance of civic virtues, to relegate stagnation to factors outside its own realm of influence (cf. Portes, 1998, p. 19). A more balanced view recognizes that the state is able to contribute to the emergence of general trust, while it can also break down social and economic cohesion.

Certainly, the state can obstruct cost-efficient cooperative behaviour if it tries to substitute endogenous social norms (or the lack thereof) with overly specific, intrusive state engineering of cooperative behaviour. A historical example can be found in the massive

communist experiments of the twentieth century (some of them continuing up to date). In these societies, the role of strong community ties was substituted by a strong dependence on the state bureaucracy. Instead of impartial regulator, the state became the predominant party in the socio-economic sphere. The authoritarian or totalitarian regimes tried to determine what people should do, with whom and even where they should live. Not surprisingly, payoff structures with respect to cooperative behaviour became totally dependent on the strength and involvement of the state. This undermined the development of effective social norms and internal values and did not provide a focus on openness of economic activity. As a result, the level of spontaneous cooperation and generalized trust was low.

A weak or soft state, however, will also fail to provide the required complementary regulation for cooperative behaviour. A soft state acts to conserve vested interests. Depending on the context, a soft state may lack autonomy and become a governance tool that extends the influence of a ruling oligarchic elite. Alternatively, in a highly unstable, polarized context, it may fail to set an impartial, consistent standard of regulation in a continuous attempt to satisfy the wishes of competing interests. A soft state thus tends to promote or enforce spontaneous cooperation that takes the form of rentseeking. As a result, the level of generalized trust will be low and cooperative ties will be relatively conservative and closed. A weak state attempts to set an autonomous regulative stance, but fails to enforce these rules sufficiently when challenged. Ostrom (2000, p. 147) describes the consequences of weak intrusiveness: '..the mild degree of external monitoring discourages the formation of social norms, while also making it attractive […] to deceive and defect'. She even argues that state intrusion without strong monitoring and sanctioning would be 'the worst of all worlds'. A weak state leads to the discouragement of weak ties and general cooperation. Consequently, parochial ties gain importance, which leads to the possibility of unproductive rentseeking. Moreover, if strong kinship, ethnic or civil ties are absent, the inconsistency and uncertainty of a weak state may lead to a breakdown of cooperation as such. A fragmented society (cf. Fukuyama, 1995a) with low generalized trust will be the result.

Although state intervention can obstruct the formation of general trust and is sometimes ineffective in correcting less desirable forms of spontaneous cooperation, the government can have a positive role. Vested interests are not imperturbable. Kikuchi and Hayami (1999) show that external developments in technology may trigger institutional transformation in a traditional society, contrary to the alternative findings by Berry (1989). Technological change, entering from abroad, acts as an external shock to the payoff structure

of alternative forms of cooperation. As Khan (1991) argues, this may eventually lower transition costs and the effective barriers to institutional change. Restrictive cultural norms may loosen in result, as cooperative structures are evolving towards investment in weak, generalized market ties and general cooperative norms. The state can have a positive role by accommodating beneficial cooperative norms. Important for achieving complementary formal institutions is the strong autonomy of the state. Moreover, the type of intervention should be general regulation and provision of public goods rather than specific intervention. The state should not substitute for the market mechanism, collectivizing and controlling access to resources. Moreover, the function of formal rules is not to substitute for generalized trust, but rather to encourage spontaneous cooperation and contribute to the generalization of norms and trust. Designing formal institutions as substitutes can lead to specific engineering of cooperation and crowd out effective norms. For example, promoting the involvement in civil associations by giving financial incentives may have exactly the opposite effect from that desired: rentseeking instead of civic virtue and general trust. Ostrom concludes that, in any case, 'it is possible that past policy initiatives to encourage collective action that were based primarily on externally changing payoff structures for rational egoists may have been misdirected – and perhaps even crowded out the formation of social norms […]'. The recipe for successful formal institutions includes the following requirements: formal institutions should reflect impartial (i.e., neutral) authority and stimulate decentralized authority in specific norms of cooperative behaviour. Complementing and 'increasing the authority of individuals to devise their own rules may well result in processes that allow social norms to evolve and thereby increase the probability of individuals better solving collective action problems' (Ostrom, p. 154).

In the end, the interplay between social norms and formal institutions in the emergence of generalized trust seems to depend on a set of context variables. We may classify within this set variables such as the extent of social polarization in society, the level of state autonomy (measured by the quality of formal institutions) and the level of civil activity. Whereas network design, such as closure and appropriability, help to explain the micro-emergence of network-specific trust, these general context variables are ultimately important for the payoffs of generalized cooperative behaviour and of investment in network building. For example, social polarization and ethno-religic homogeneity are important factors in determining the extent of uncertainty with respect to the security of property against 'third party' confiscation. The level of general trust is, after all, not only dependent on the expected norm-abidance of

direct partners in transactions. Either by direct conflict or indirect taxation, competition for the redistribution of resources in a rentseeking process will lower the security of property and the level of trust with respect to the expected benefits of any economic transaction.

6. Concluding Remarks

The search for the ultimate causes for divergent economic performance has led us to consider the importance of social infrastructure: policy, governance and social norms. This chapter presented an overview of theory and evidence on the role of norms and trust for economic performance. Over the past decades, much progress has been made in research on the emergence of cooperative norms, trust and self-enforcing agreements on a micro or meso level, emphasizing the importance of a specific structure of social relations: networks and their design aspects (see Granovetter, 1985; Coleman, 1988; Ostrom, 2000; Henrich, 2001; Rauch, 2001). Extrapolation to the importance of trust for the general level of cooperative behaviour and economic performance in society as a whole, is a natural next step (see Putnam, 1993; Greif, 1994; Fukuyama, 1995).

The analysis of the generalization of effective norms and trust is still under construction. The search for key general contextual factors is promising and points at factors such as social polarization, associational involvement and the quality of formal institutions. Yet, analysis of generalized trust and the role of formal institutions are in risk of becoming just a restatement of the cooperative dilemmas to be explained. The context variables that we have identified admittedly contribute to a sound cause-and-effect analysis. But, more has to be done to formally develop a closed simultaneous system to explain the causal chains between spontaneous cooperative action, effective norms, generalized trust and economic performance. Contextual factors influence the structure of expected payoffs to cooperation and, consequently, in some way set the chain in motion. However, during the process, emerging trust and effective norms also influence the payoff structure. The ex-post identifiable payoffs are endogenous themselves. Also, context variables themselves are interdependent. Social polarization affects civil activities and the quality of governance and vice versa.

In the end, we have to identify in more detail which external factors determine the direction in which the payoff structure develops, and whether they can be influenced politically by ‘the development of public policies that enhance socially beneficial, cooperative behaviour based in part on social norms’ (Ostrom, 2000, p. 154). A complementary role for formal institutions in fostering and promoting self-enforced agreements is possible, but does

not follow self-evidently from state interventionism.

The primacy of social structure, if mostly exogenously generated or lacking, may even put into doubt whether government can effectively reform policy and formal institutions to foster successful development in countries that have failed so far. This is also highlighted in the literature that stresses the role of geographic factors in explaining the variation of income (for example, Gallup et al., 1999). In any case, this paper has shown that social structure is not as exogenous as the above statements suggest. Deliberate investment in cooperative norms can emerge with objective economic gains in sight. The government can positively influence expected payoffs to cooperation. Our list of contextual variables suggests that a diverse spectrum of government regulation could be beneficial, varying from traditional statist intervention to reduce income and land inequality, to neo-liberal impartial and autonomous governance, to ensure property rights and reduce uncertainty. But, as Fine (2001) argues, political economy is underrepresented in the literature on social capital. Insight in the regularities that govern how transition costs of social and political change follow from the interaction between government autonomy and societal interest groups is needed.

As of yet, Portes (1998, p. 21) argues that social capital theory has not succeeded in providing a persuasive answer on the question how and when network outcomes generalize positively. Similarly, Durlauf (2002) argues that as of yet the empirical literature that aims at understanding macroeconomic phenomena on the basis of some form of generalized trust suffers from conceptual problems, lack of theoretical guidance, lack of attention for potential reverse causality, and lack of attention for potential parameter heterogeneity.[4] Some of the cornerstones for this explanation have been laid out in this paper, in the emphasis on network design (for example, openness and closure; appropriability), context, and the relation between formal rules and social norms, introduced by various authors. To improve our theoretical insights and gain reliable empirical assessments, future analyses should try to establish 'some controls for directionality' of causation (Portes, p. 21) in order to disentangle and clarify cause-and-effect sequences. In any case, if trust proves to be a crucial factor behind the observed differences in economic performance, building, fostering and supporting society's capacity for cooperation will be no less difficult for policymakers than any other, or otherwise motivated, development strategy available. Neither can policymakers withdraw from their

[4] See, for example, Knack and Keefer (1997) and Putnam (2000) for attempts to empirically analyze macroeconomic phenomena with trust as explanatory variable. The extent of robustness of this literature is illustrated in Beugelsdijk et al. (2004).

responsibilities and regard the importance of social structure as justification for a deterministic view on development potential. Social capital is neither a ready remedy for major social problems, nor does it legitimate the state merely to shift responsibility for, and funding of its construction to civil society.

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