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Staff Paper

THE APPLICATION OF SOCIAL CAPITAL IN UNDERSTANDING ECONOMIC DEVELOPMENT

by

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The Application of Social Capital in Understanding Economic Development

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ABSTRACT

This paper briefly examines how social capital affects overall economic growth processes and individual firm development, both positively and negatively, in low- and middle-income countries. The paper discusses how the concept of social capital is related to simple economic growth models and to the analysis of economic networks these countries. The degree to which social capital can substitute for or complement other forms of capital investment is examined. The paper concludes with suggestions for future research and policy analysis by agricultural economists in this area.

Keywords: social capital, economic development, marketing networks

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The Application of Social Capital in Understanding Economic Development

John M. Staatz

"Even western bankers recognise social capital: for they know the value of a smile when they receive a customer, and they recognise the worth of the 'old school tie network.' More recently, economists are coming to realise that there cannot be durable development nor economic growth without good governance. Bankers and economists would be wrong to neglect social capital." Poulton and ag Youssouf, p.15

"Social capital is a . . . force for good (although it can also be a force for inertia, protecting inefficiency, or worse)." Ibid., p. 197

Agricultural economists working on issues of economic development in low-income countries have had a bifurcated approach to dealing with notions related to social capital. Until recently, formal economic growth models have ignored social capital, with its role generally lumped with unexplained residual after "conventional" inputs are taken into account.[1] The failure of such models to explain the diversity of growth paths followed by different countries have led some (e.g., Morris and Adelman; Hirchman) to argue that economics lacks any truly explanatory models of economic development. Neoclassical economists' rediscovery in recent years of the role of institutions and transaction costs in the development process can be seen as one attempt to begin to address this critique by treating, albeit indirectly, the role of social capital in economic development.

Although formal growth models generally ignore social capital, agricultural economists working at a more micro level have frequently incorporated notions related to social capital into their work. Micro-level analyses (e.g., of marketing networks) often look at the role of social relations in influencing firm success and economic coordination. Projects and programs (e.g., group lending schemes) are often designed in a way that attempts to use social capital to increase their chances of success.

This paper offers some observations on how social capital is related to overall economic growth processes in low- and middle-income countries and how it affects individual firm development, both positively and negatively, in those economies. The paper then raises a few questions about what these observations imply for the research and policy advising work of agricultural economists. The paper makes no pretense of being comprehensive; and in the spirit of an

[1]Except to the extent that social capital is correlated with the conventional inputs, in which case the effect of social capital is erroneously attributed to the other inputs.

organized symposium, it intends more to raise issues for discussion than offer definitive conclusions. It draws ideas from papers and discussions at a recent conference on social capital held at Michigan State University, but all the misinterpretations are my own.

Defining Social Capital

The Social Capital Interest Group (SCIG, p.2) at Michigan State University has defined social capital as:

> *...the potential benefits, advantages, and preferential treatment resulting from one person or group's sympathy and sense of obligation toward another person or group. Social capital also includes the potential benefits, advantages, and preferential treatment that originate from one person's sympathy and sense of obligation toward his or her idealized self.*

The SCIG goes on to note that "social capital is owned by the object of feelings of sympathy and obligation" (p. 3). In other words, social capital represents a person's claim on the resources of others who feel sympathy and obligation toward her or him.[2] In this sense, social capital has some of the characteristics of a debt for the person extending it to others. Yet in contrast to many other types of debt, feelings of sympathy or obligation are often reciprocated in various social groups, leading to a web of reciprocal obligations. As we will see below, this mutually extended debt (or credit) acts to increase the "liquidity" of social interaction, thereby expanding economic activity, much like an expansion of the money supply.[3]

Schmid and Robinson and Siles argue that social capital has many of the characteristics of other types of capital: it is a stock, from which a flow of services can be extracted; it can be augmented through investment; it may depreciate without regular reinvestment or use; and it can be a substitute for or a complement to other factors of production. We will examine below some of these characteristics as they relate to economic development.

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[2]Social capital towards one's idealized self is more commonly referred to as conscience. Conscience thus has a claim on an individual's resources--i.e., it influences behavior by "claiming" that resources be spent in a way that is consistent with the norms of the idealized self.

[3]Production within a farm household illustrates how social capital can substitute for credit (working capital). Family members work without explicit wages, agreeing to share the output of the household. If the household head had to rely instead on outside hired labor, she/he would have much greater need for working capital. Reciprocal labor exchange, also common in developing countries, offers another illustration of this point.

Social Capital and the Theory of Economic Growth

Much of the received wisdom of development economics is based on Adam Smith's observation that the wealth of a nation grows through specialization and trade. In standard economic texts, this is often portrayed as a process of increasingly anonymous exchange, as the economy evolves from one in which individuals' economic positions are dictated by tradition and exchange is highly personalized, to systems where effective demand and mass markets guide how people spend their time and energies. (Breimyer has referred to the latter as "the heroic age of markets.") Yet as Robison has pointed out, Smith's vision of economic specialization and trade, outlined in *Wealth of Nations* presupposes a basic social contract (which Smith discussed in *The Theory of Moral Sentiments*) in which individuals have enough mutual empathy to allow the specialization and trade to take place.[4]

Robison and Siles illustrate theoretically the importance of social capital to economic growth by showing how increasing antipathy among groups in an economy quickly drives the economy away from large-scale production based on specialization and trade toward autarkic household production. As the number of groups in an economy who refuse to trade with one another increases, the number of potential trades in the economy decreases exponentially, rapidly precluding the types of roundabout, specialized production that typifies high-income, industrial economies. These authors go on to illustrate how including feelings of sympathy for one another in a simple model of exchange reduces transactions costs (thus broadening the market), leads to greater internalization of externalities, and voluntary investment in high-exclusion-cost ("public") goods. Broadening the scope of the market, capturing external economies of scale, and investment in "public" goods are frequently cited as basic elements in any successful economic growth strategy. These theoretical findings thus suggest that social capital should be included as a critical element in any attempt to model economic growth and to develop policies to spur it.

Everyday empirical observations confirm these theoretical implications. Unfortunately, most of our observations are of situations where the rapid destruction of social capital leads an economy to regress toward subsistence (e.g., wartime Bosnia, Somalia). One exception is Poulton and ag Youssouf's fascinating analysis of how a strategy of investing in social capital helped lead to a

[4]The notion that economic development involves movement towards increasingly anonymous markets ignores the growth over the last 30 years of niche markets and strategic alliances among various economic entities. Operating in such personalized markets (which are increasingly important for developing countries) requires developing the social capital needed to participate in international networks of contracting.

peaceful settlement of the recent rebellion in northern Mali and the reestablishment of an economy based on exchange between the region's herders and farmers.[5]

A major shift in the development literature over the past 15 years has been the renewed emphasis on the role of institutions in development (Staatz and Eicher). In some ways, this attention to the importance of institutions implicitly addresses issues of social capital. Institutions are "rules of the game," ways of structuring human interdependence. The literature on institutions and development (e.g., North, Hayami, Stiglitz) offers insights into how these rules affect transaction costs, patterns of production and exchange, and hence the speed and distribution of economic growth. The types of institutions that arise in a society are a function of its level and distribution of social capital. Yet to date, there have been few efforts in the development literature to link explicitly insights from the institutionalist literature on development with notions of social capital. The main exception has been the analysis of the role of networks in economic development, which we examine next.

Social Capital and Networks

Social capital is often manifested as networks among economic agents. The analysis of how such networks foster firm growth and economic coordination is the area in which the analysis of the role of social capital in economic development is most advanced. This literature draws on a rich tradition in sociology (e.g., Busch), economic anthropology (e.g., Hill), economic demography (e.g., Todaro), political science (e.g., DeSoto) and marketing economics (e.g., Jaffee) to examine how feelings of sympathy and obligation among members of networks, based on kinship, gender, geographic origin, old school ties, and other bases reduce transaction costs and hence increase the probability of individuals and communities achieving economic success. The most obvious example is that of networks of ethnic minorities engaged in trade (Jaffee). Better information flows and informal means of contract enforcement within the group often give such minorities distinct advantages in trade, particularly in settings where the formal institutions governing commerce are weak or are enforced arbitrarily.

Studies of the effects of social capital on firms' success in low and middle income countries have examined both intra-firm and inter-firm networks. In both types of networks, feelings of sympathy and obligation among members act as a catalyst to promote synergies of resource use through teamwork. In particular, social capital induces individuals to share their human capital with others in the network. Hence, the payoff to both an individuals' and a firm's investment in

[5]The Malian president who helped negotiate the peace, Alpha Oumar Konaré, is a former professor of anthropology. Poulton and ag Youssouf describe how he drew upon his understanding of traditional social capital ties in Mali to allow various elements of civil society work to build a consensus for peace. After reading Poulton and ag Youssouf's account of the peace negotiations, one is left wondering if the result would have been the same had Konaré been trained as a neoclassical economist who had never heard of social capital.

human capital depends on the level of social capital within the network. Similarly, social capital can lead to broader sharing of physical capital, as in the case where lenders use reputation and group guarantees as forms of collateral.

Barr and Woolcock both emphasize the importance of distinguishing between two types of networks: those that are more local and emphasize what Woolcock calls "intra-group ties" and those that link firms or individuals to a wider global set of correspondents ("extra-group networks.") The more local networks primarily serve to help manage risk (through reciprocal lending, provision of certain collective goods, and sharing information on the reliability of trading partners). The more global networks link firms to a broader set of information regarding market opportunities and new technologies. Barr found, in her analysis of Ghanaian firms, that smaller firms, primarily concerned with day-to-day survival, depended more on the local networks, while larger, growth-oriented firms relied more on the global networks.

Networks, particularly those based on ethnic links, often arise when other formal mechanisms to facilitate trade are missing (e.g., reliable third-party enforcement of contracts through the court system). The networks thus act as substitutes for the more formal mechanisms that reduce transaction costs. What is frequently overlooked, however, is that lack of such formal mechanisms itself reflects the existence of social capital within other networks, those in which key government decision makers participate. In many countries, particularly those where the governing elite is small and shares common links (ethnicity, old school ties, marriage), it is frequently difficult for those who are in charge of enforcing the formal rules of the state to resist requests for favorable treatment from those in their network. (How can I, as director of the customs service, ignore requests for help from those with whom I socialize every day, particularly when they have helped me out in the past?) In such cases, those outside the network that includes the key government decision makers need to create their own networks as a substitute for a more impartial official system. Networks and the more formal institutions are thus mutually interdependent, leading Woolcock to conclude that "the fortunes of formal institutions and community groups cannot adequately be understood apart from one another."

Part of the process of successful economic development involves broadening who is included in the "official" network of formal trade-facilitating mechanisms. As this broadening occurs, informal trade networks and more formal arrangements may increasingly complement each other, as the existence of formal mechanisms (e.g., court adjudication) may encourage firms to resolve disputes more quickly through informal means. Developing a better understanding of the potential complementarities and substitutability between formal and informal mechanisms might lead to the design of more productive formal mechanisms.

While the literature often stresses how social capital, as expressed through networks, can help individuals, firms, and communities in developing countries succeed, social capital can also constrain growth, both at the level of the firm and of the broader economy. At the firm level, since social capital represents a claim on the resources of others, the "debt service" associated with social capital frequently hinders capital accumulation and firm growth. This is particularly

true in local, intra-group networks. Pressures to employ relatives and distribute earnings to friends and kin put heavy demands on entrepreneurs in many countries and may explain why some of the most successful entrepreneurs are migrants who have escaped some of the claims of their kinship networks (Hill).

In many countries, the social obligations of a successful business person to support friends and relatives impose heavy costs. Yet the fiscal code in these countries (often based on the code of a former colonial power) frequently does not recognize such obligations as legitimate business costs. Such lack of recognition may discourage many firms from entering the formal sector, which would subject them to an income-tax code that does not recognize such costs as legitimate, in spite of other advantages that might accrue to the firm from operating more openly (Dembélé).

At the national level, one of the major disadvantages of networks is the animosity they create toward members of the network by those outside of it. Network members frequently face charges of being clannish, secretive, or worse. Jealousies about their success often translate into scapegoating and violence, particularly in periods of economic crisis (witness the recent sacking of ethnic Chinese establishments in Indonesia).

A basic challenge in the development process is thus how to broaden the ties of social capital (thereby widening the scope for exchange) without losing the advantages of tight coordination characteristic of smaller networks. Hartango discusses this challenge in light of the distinction made in the Indonesian language between the concepts of the “inclusive we” and the “exclusive we.” Many of the effects of social capital on firm development depend on which conception of the group is more prevalent. The “exclusive we” may foster inter-group trade and reduce transaction costs, but risks alienation of those who are not included in the “we” group, which may ultimately hurt the firm and the economy as a whole if the economy’s growth is based on nepotism and favoritism that hinder international competitiveness. The “inclusive we” may foster broader participation, but may be weaker in inducing close coordination of group action. Yet a basic challenge of nation-building (and the large-scale, roundabout production that is characteristic of a national or international economy) is to broaden the concept of who is "in."

Implications for Agricultural Economists

What does the foregoing imply for agricultural economists interested in understanding economic development in low- and middle-income countries and helping develop policies and programs to foster it?

Understanding the Role of Social Capital

The first implication is simply that we need to recognize more explicitly the role that social capital plays in the development process and try to account for it in our analyses. To date, most of the work by agricultural economists, sociologists, anthropologists, and demographers on the role of social capital in economic development has examined the importance of networks as variables that

explain the degree of economic success of firms, migrants, and individual entrepreneurs. Much less work has been done at the national or macro-level of investments in social capital on the pattern of economic growth and income distribution. Some work along this line has been done in the U.S. (Robison and Siles) and at the village level in India (Narayan). Yet the implications of such work for the design of economic policies could be very significant (e.g., the details of how structural adjustment programs are designed, including how the burdens of adjustment are shared across the population). Much work lies ahead in defining appropriate proxies for social capital and trying to carry out cross-sectional or longitudinal studies at the national level to isolate its impact on various indicators of economic performance.

A second implication is that drawing on ties of social capital to foster development projects can be a double-edged sword. For example, we may conclude that programs would be more successful if they worked within existing social networks. This is the logic, for example, of designing group lending schemes that take advantage of social capital within the group to increase repayment rates. While there may be significant scope for increasing the effectiveness of development efforts by working through existing social networks, the danger is that working exclusively with such groups may aggravate social tensions between groups if one network is viewed by others as being unjustly favored.

Can We Increase Social Capital?

It is an article of faith among those who have adopted the term social capital that social capital can be augmented through investment. But in reality, we know little about the production function for social capital. A few studies (e.g., Hyden) have examined factors that strengthen the networks or lead to their decline, and the subsequent impacts on firm success. What we do know is that social capital is easier to develop in response to external threats than internal challenges; witness the great mobilization of economic activity that takes place in response to a popular war. Governmental attempts to create a peacetime "big push" of investment in social capital in response to internal challenges face the problem of convincing people that these challenges are the "moral equivalent of war," which is remarkably difficult to do, as Jimmy Carter learned.

We are thus left with the challenge of how to induce more incremental investments in social capital. A strategic question, similar to that regarding investments in other types of capital in low- and middle-income countries, is what should be the mix of public and private initiatives in this effort? For example, to what extent should public education systems design programs to foster sympathy among different economic, social, and ethnic strata of the population? Given the resentments that arise from heavy-handed social engineering in some countries, one may be tempted to argue that investments in social capital should be left to private individuals and voluntary associations. At a minimum, there is a need to move away from the approach still prevalent in many countries that requires all voluntary civic organizations to register with the government, thus creating a barrier to entry to new producers of social capital.

Yet, there are plenty of examples throughout history of voluntary associations building social capital among their members at the expense of others (e.g., Hitler's brown-shirts; the KKK). So what collective limits should be put on types of investments in social capital permitted in society, and which types of social capital should be publicly supported or "subsidized"? Each society struggles to find an appropriate "investment code" for social capital, and then create incentives to induce investments consistent with that code. This is analogous to the public role setting the basic rules under which a "free market" operates.[6] Agricultural economists need to be engaged in this debate with our colleagues from the other social sciences. Our analytic framework may offer particular insights into the economic characteristics of social capital and how it can substitute for or complement other types of investment necessary to foster economic development.

[6]Poulton and ag Youssouf describe this as the role of the state in "creating space" for civil society to build social capital.

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