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"Thought Paper": The Role of Social Capital in Frontier Capital Markets

#4: "Social Capital and Economic Development"

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"[Social Capital is] the web of social relationships that influence individual behavior and thereby affects economic growth", Karen Pennar: *Business Week*, Dec. 15, 1997

This paper is the fourth of a series of "thought papers" addressing social capital published by the Network Science Center at West Point. As our research teams conduct their analyses, certain findings and insights arise that may not be directly related to the research question at hand but, we believe, are important to both the academic and policy communities. This particular series of "thought papers" will address insights concerning social capital and its role economic development issues.

The Network Science Center at West Point has been involved in ongoing research exploring the network topologies of Capital Markets in Frontier Capital Markets. Frontier Markets are essentially a subset of Emerging Markets with lower market capitalization and liquidity. This term was coined in 1992 by the International Finance Corporation. Our team's research has involved extensive data collection efforts including numerous interviews with financial leaders and innovators in these emerging economies.

During the course of this data collection and the subsequent analysis, the research team has identified additional topics that we believe are ripe for analysis. We believe that addressing these research topics is vital to understanding and devising potential innovations in economic development.

Throughout the course of our interviews with key actors and organizations within our networks of interest, it became apparent to the research team that the key individuals' social networks were amazingly powerful and influential. The team was aware of the concept of social capital and thought that it would be important to explore this concept in more depth and to further determine how to incorporate this concept more fully into our network analysis.

Literature Review of Social Capital and Economic Development

On the micro-level, social capital according to Putnam (1993), is defined as the structural features of community life (such as individual networks and households) as well as the shared norms and values which "produce" benefits for the entire community (Grootaert & van Bastelaer 2002:2).

With the inclusion of hierarchical organizations and the consideration of interaction within and between such organizations, James Coleman (1990) introduces a meso-level scope to social capital. For him, as well, social capital includes the structural aspects (networks, hierarchy, and power structures) as well as the "motivation for action" of agents that have the ability to create beneficial as well as detrimental outcomes (Grootaert & van Bastelaer 2002:2).

The macro-level view of social capital additionally encompasses formalized institutions like the attributes of the government, law and its institutions, as well as civil and political liberties that enable collective action for the benefit of a smaller social entity, like a community or a household (Grootaert & van Bastelaer 2002:3, Knack 2002:41). The social capital on the level of society entails shared norms, values (which may also include Schmid's "socio-emotional goods" such as sympathy, regard, love, and care (Schmid 2003:718)), and customary informal social networks enabling individuals to cooperate (Knack 2002: 41).

All three levels emphasize structure and cognitive processes as the two constituents of social capital. Social networks - whatever their scope - enable the distribution of resources, whereas shared norms, values, beliefs, and trust among network members facilitate this process. The structural aspect of social capital therefore

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refers to the observable, tangible individual and his social networks, the institutions and organizations he plays a role in. Cognitive social capital on the other hand describes predispositions of interaction between these social entities, such as trust, common culture and customs (e.g. shared values, norms). It is this internal aspect of social capital, which lies within the individual's perceptions, which can only be measured indirectly (Krishna & Uphoff 2002:87f.).

Empirical Findings on the Economic Impact of Social Capital

Past empirical studies have analyzed particular aspects of economic development, such as performance and effects of development projects (Krishna & Uphoff 2002, Isham & Kähkönen 2002, Gugerty & Kremer 2002), trade (Fafchamps & Minten 2002), voluntary engagement on the communal level (Pargal et al. 2002), and the founding of groups amongst the poor for the purpose of improving their situation (Bebbington & Carrol 2002).

Some studies have analyzed the impact of immigration, and the subsequent modification to an existing social network, on trade. For example, Gould (1994) finds that immigration into the United States increases exports to the country of origin while another study determined that immigration increases imports from the country of origin as well (Rauch 1995:8). Curtin (1984) and Kotkin (1992) also establish that immigrants play important roles in international trade. In one case, the immigrant's connection to those in his country of origin solves the trust problem, while in the other; his new position provides him with access to profitable information (Rauch 1995:8f).

Others have looked at the creation and transformation of social capital and its effect on social cohesion (Colletta & Cullen 2002) and conflict along social lines (Bates & Yackovlev 2002). The authors of these studies have individually and pragmatically defined social capital to ease its measurement in their respective context (Grootaert & van Bastelaer 2002:341). The interpretation of the results found social capital to be imperative for a number of aspects of human life and economic development around the world.

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Additionally, researchers have demonstrated that social capital can impact development and conservation (Krishna & Uphoff 2002), improve economic performance to decrease transaction costs, increase profits, and provide financial security in dire times (Fafchamps & Minten 2002, Bebbington & Carroll 2002:273) as well as encourage investment (Isham & Kähkönen 2002, Bates & Yackovlev 2002:329). Social capital may also substitute for insufficient formalized structures that ensure market efficiency (Fafchamps & Minten 2002, Colletta & Cullen 2002, Knack & Keefer 1997:1284), limit free-riding on public goods and services, and smooth the flow of information between social units (Isham & Kähkönen 2002). It can also aid in the emergence of new markets by creating new social relations and in accessing and managing innovation (Bebbington & Carroll 2002:273).

On the other hand, evidence of social capital's negative effects like rent-seeking, free-riding and increasing the disadvantage of those who most need it is empirically shown in Gugerty and Kremer's study on development assistance (Gugerty & Kremer 2002). The horrendous effects of social capital are illustrated by Colletta and Cullen in their study on the Rwandan genocide, where social networks were used to encourage, motivate, and direct mass killings leaving communities and families destroyed (Colletta & Cullen 2002). Paradoxically, the violence also fostered strong bonds amongst victims and perpetrators respectively (Colletta & Cullen 2002:297). Interestingly, Bates and Yackovlev (2002) found that ethnicity promotes economic development, but also may instigate violence under certain circumstances (Bates & Yackovlev 2002:330).

Reducing Poverty by Utilizing Social Capital

Since the poor face relatively low opportunity costs in establishing and maintaining social contacts and social capital can substitute for private capital, they also stand to gain the most from memberships in clubs and other associations (Collier 2002:37ff, Knack 2002:64). It could be expected that fostering social capital can aid in poverty reduction (Grootaert 1999, Narayan & Pritchett 1999, Knack 2002:64) and

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indeed: with increased diversity in their social relations, the welfare of the poor experiences improvement (Woolcock & Narayan 2000:232). But the tendency of social relations to homogeneity leaves the poor with limited potential access to social resources much different from their own (Collier 2002:38). This is especially true for the distribution of information, because knowledgeable people tend to have larger, constantly growing networks due to their search for more information. They also tend to gain more information from every contact, which leaves them with little incentive and resources to converse with less informed people (Collier 2002:38). On the other hand, Kapila (2006) found that the lack of access to information hinders the formation of social capital even for educated people in a Kenyan study (Kapila 2006:29).

Other possible constraints on the formation and diversity of social capital were found to be both gender and ethnicity (Kapila 2006:26, Collier 2002:37). Furthermore, attempts to reduce the free-rider problem, by utilizing collective action, puts the poor at a disadvantage. It is often not possible for them to build a reputation on repeated transactions, which is necessary in order to assist in the appreciation of public goods (Collier 2002:38). When considering safety and security, the poor tend depend on collective social sanctions the most. While wealthier people can acquire private security, for example, people with less access to capital rely on the public provision of these items (Collier 2002:38).

Policies that secure property rights and effective contract enforcement prove to have ambiguous impact on reducing poverty: on one hand, they aid in reproducing the existing economic inequality, while on the other, they promote egalitarian effects and facilitate social mobility (de Soto 1989, Knack 2002:65). Still, on the level of national government, Olson (1994) attributes poverty to the lobbying and rent-seeking behavior of groups that puts non-members to disadvantage (Knack 2002:65).

Social capital appears to be an ambivalent tool when utilized to alleviate poverty. Although the poor have the incentives as well as the non-material resources to join different social networks, access to diverse social resources is blocked off. And although dependent on the provision of public goods and social rules and norms, they often cannot put forth the material resources they need to not be categorized as free riders.

Elements of Social Capital Impacting Economic Development

As concluded by Putnam in his seminal study on participation and performance in Italian communities, interpersonal social ties (even exceeding the immediate social environment and extending to society in general) and trust appear to limit transaction costs (Knack 2002:55, 60) and improve economic performance (Hjerppe 1998:I, Knack & Keefer 1997:1252). This generalized trust is also associated with stronger confidence in government institutions (Knack & Keefer 1997:1279, Knack 2002:57ff) and appears to correlate positively with better subjective ratings of government efficiency, corruption, and infrastructure quality (La Porta et al. 1997, Knack & Keefer 1997, Knack 2002:57ff) – all factors, which influence economic performance.

Interestingly, economic performance improves with higher levels of generalized trust, but decreases with high levels of trust in kin-ties (La Porta et al. 1997, Knack 2002:57ff, Woolcock & Narayan 2000:233). Strong horizontal ties risk fostering particularized interest that puts non-members at a disadvantage (Woolcock & Narayan 2000:230). Not only extreme trust in family-members to expense of trust in strangers, but also an overly high level of involvement in groups paradoxically brings about decreased productivity growth in high-income countries (Helliwell 1996, Knack 2002:59).

Two theories focus on the effect particularized trust has on the society as a whole: Olson (1982) attributes tendencies to rent-seeking and growth-impairment to strong in-group ties, whereas Putnam (1993) claims that trust learned in non-hierarchical organizations will extend towards benefitting society in general (Knack 2002:60). In trying to resolve this conflict, Knack and Keefer found in their empirical research, no significant correlation between group-memberships and growth (Knack & Keefer 1997:1272), but a negative significant correlation with investment rates (Hjerrpe 1998:19, Knack & Keefer 1997:1252, Knack 2002:60). Hjerrpe (1998) establishes in his research that high levels of trust are strongly and positively correlated with higher incomes (with the notable exception of China, where the existing high levels of trust do not coexist with relatively high levels of income; Hjerrpe 1998:14ff).

Fukuyama (1995) shows the importance of trust for economic growth by substantiating that the lack of generalized trust curbs the supply of capital and qualified personnel on the macro-economic level (Knack 2002:56f). His division of countries into "high-trust" and "low-trust" countries is based on variations of trust and "spontaneous sociability" and his finding that higher trust societies (e.g. USA, Germany, and Japan) have better results in implementing economic innovations on the organizational level and demonstrate more flexibility in adjusting to environmental changes than their low-trust counterparts (e.g. France, Italy, China, North Korea) (Knack 2002:56f). The effect of trust on economic growth is thereby more significant in poorer countries, which suggests that trust makes up for lacking governmental institutions and less developed financial markets (Knack & Keefer 1997:1284, Zak & Knack 2001, Knack 2002:58).

These findings promise that trust - the possibility to rely on the ability to enter contracts with confidence – is a medium to economic prosperity. How then, is it possible to foster trust? The characteristics of higher trust societies include stronger formal institutions and homogeneity regarding wealth and income inequality, but also ethnic diversity and institutionalized discrimination (Knack 2002:59). Income and land inequality impact a society's economy and its growth: countries with high income inequality were found to default more often on sovereign debt (Berg & Sachs 1988). Economic inequality was also found to correlate positively with poor growth rates especially due to the increase in the uncertainty of property rights (Zak & Knack 2001, Knack 2002:62), which are significantly related to economic growth (Squire 1993, Knack 2002:65).

Other factors positively correlated to economic growth are level of education, trade intensity, and property rates (Knack 2002:66). Research on ethnic diversity indicates that an ethnically heterogeneous society is detrimental to economic performance: ethnic heterogeneity is associated with slow economic growth (Easterly & Levine 1997, Knack 2002:61ff), the polarization of preferences for public goods and the resulting hindrance of their provision, the tendency of competition in rent-seeking and the increased possibility of economic discrimination along ethnic lines (Knack 2002:60ff).

Much effort was concentrated on understanding the relationship between social capital in the form of trust and inter-group conflict. It appears that in many cases the relative size of the groups constituting the respective society may tip the scale towards conflict: civil war thus appears most likely in countries where competing ethnic groups are of relatively medium size (Collier 1998) possibly because polarization is greatest in societies with fewer equally sized competing groups (Horowitz 1985; Knack 2002:63). The detrimental effects ethnic heterogeneity appears to have on economic performance are held to be due to inefficient policies, intense black market activities, high levels of corruption, poor public education services, uncertainty of property rights, and poor physical, institutional, and financial infrastructures (Knack 2002:61ff). Collier (1998) proposes that ethnically heterogeneous countries fare better in democratic environments. This conclusion is based on his analysis of ninety-four ethnically diverse countries. Additionally, it has been demonstrated that countries limit political freedom more than others inhibit economic growth (Knack 2002:63).

Policy Implications: Investing in Social Capital

Due to its intangibility the development or utilization of social capital is not a standard objective of development policies. Empirical studies have shown that increasing levels of social capital fosters economic development. It not only improves economic performance and development outcomes (Krishna & Uphoff 2002:85), and thus reduces poverty rates (Squire 1993), but it also benefits the poor more than the rich (Knack 2002:70ff). Research also reveals that social capital at least does not aggravate income inequality.

These studies also reveal that social capital is found in many different forms (internal dynamics of a community, influential individuals) and in various amounts. These aspects are very difficult to influence and stimulate by external intervention.

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Nevertheless, projects promise to be successful in affecting social capital positively, when certain considerations are taken: non-divertible program inputs, projects addressing local and regional organizations and institutions, as well as the adjustment of political structures on the macro-level (e.g. changing how elections are run) (Grootaert & Bastelaer 2002:347ff). Utilizing existing social resources and strong common interest, projects should phase out gradually transferring responsibilities (Bebbington & Carroll 2002:274).

High levels of social capital are correlated with high levels of trust and the likelihood of individuals participating in grass root organizations, partaking in decision-making processes, increase in information distributing media, and the perception that laws are “clear” and “fair” and enforced (Krishna & Uphoff 2002:107f, Hjerrpe 1998:11). In Kenya, the disconnection between private sector organizations and community leads to the blockage of social resources on both ends (Kapila 2006:31). In alignment with Putnam’s argument, (1993, 1995) social capital was shown to aid organizational efforts in communal projects (Knack 2002:56; Pargal et al. 2002:204). The stimulation and reinforcement of structural social capital may encourage trust and cooperation, emphasize social identity and enhance reciprocity. Its interplay with local and national governments cannot only improve democracy on the national level (Knack 2002:55), but also lead to more inclusive and responsive forms of regional government and increased influence on initiatives on the national level (Bebbington & Carroll 2002:273).

Increased responsiveness of the political elite can help to open up a community for innovation (Kapila 2006:30). In return, the authorities can aid local projects by distributing information about its work and successes (Pargal et al. 2002:205). Governments can also nurture social capital by providing economic security through rules and laws enforcing contracts, securing property and guaranteeing personal security, civil liberties, and bureaucratic integrity (Knack 2002:41) and thus earning credibility, which has a positive impact on economic performance itself (Hjerrpe 1998:13).

It is on this level that policies on bridging social divides on the basis of ethnicity, race, religion, social class, and gender can be instigated (Woolcock & Narayan

2000:236). Helliwell and Putnam (1995) found that the performance of regional governments significantly affect economic growth (Knack 2002:56, Hjerrpe 1998:12).

Narayan (1999) developed a grid that classifies the relationship between the state and bridging social capital (social capital that enables cooperation between groups, communities, and governments), where different levels of state functionality correspond to either low or high levels of bridging social capital. Weak states accordingly are prone to either coping or conflict depending on the associated level of bridging social capital. Strong states on the other end of the state capability spectrum range on a spectrum between exclusion (which is a form of latent conflict) and social and economic wellbeing depending on the level of connectedness of the various social units (Woolcock & Narayan 2000:237). The implication for policymakers and researchers is clear: before deciding on project designs it is necessary to identify the extent of social relations between groups, communities, and authorities in order to develop strategies that utilize positive social capital (trust, cooperation, institutional efficiency) to counter negative social capital (Woolcock & Narayan 2000:238).

Successful development and conservation projects were determined to be attributed to pre-existing high levels of social capital (Pargal et al. 2002:205) and longstanding external relationships (Grootaert & Bastelaer 2002:347). The cooperation fosters transparency in participating organizations, which also stand to gain impact they would not have alone. Such a profitable strong, external relationship comes at the price of flexibility, dedication, as well as sensitivity (Bebbington & Carroll 2002:276). In development aid programs it seems vital to success to get the beneficiaries substantially involved right from the start (Hjerrpe 1998:11). All in all, past empirical research leaves us with the conclusion that taking social capital into account and assessing it in the beginning stages of a project can lower the costs, facilitate progression, and increase the possibility of success (Grootaert & Bastelaer 2002:347ff).

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The Way Ahead

Our analysis of previous studies confirms our premise that social capital needs to taken into consideration and quantification is vitally important when attempting to understand the networks involved in economics especially when analyzing economic development. Our research team has completed a “pilot” social capital data collection project and our next paper will include an analysis of this data, present some initial findings, and we will discuss challenges inherent in this type of data collection and analysis.

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