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## **An essay on social capital: Looking for the fire behind the smoke**

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**Abstract:** *Social capital is defined as the density of trust. It is related to production by a key hypothesis: social capital determines how easily people work together. An easy-to-use proxy (Putnam's Instrument) is the density of voluntary organizations. Social capital might be a new production factor to be added to human and physical capital, or it might enter as a reduction in transaction or monitoring costs. Direct and indirect ways to measure social capital are discussed. The critical question is whether social capital can be changed. That is, can self enforcement replace third party enforcement? We consider how much harm totalitarian regimes do to social capital when they expand their scope of area of control.*

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This essay has three aims: (A1) To sharpen a vague concept into something well defined and measurable at the micro level, and to discuss how it might be aggregated to the macro level. (A2) To show that social capital is a potentially powerful tool at both levels. Finally, we discuss the crucial policy question: (A3) How can social capital be built? That is, how can the national and international authorities induce people to trust each other and work together voluntarily? In particular, how is it possible to reward this kind of behavior in transition economies where the need for economic growth is critical? We deal with the three aims in a gradually more speculative manner:

(A1) Sections 2 and 3<sup>1)</sup> discuss how the concept of social capital should be defined and measured. Here our aim is to be fairly concrete. At present measurement consists of unsystematic bits and pieces of evidence from many sources using different definitions, and from studies using different macro-proxies. This does allow us to speculate as we will do especially in (A3), but there is still a long way to go before these speculations can be systematically confirmed.

(A2) Section 2 presents three alternative approaches to building social capital into theory - showing that it might play an important role. We have to limit ourselves to sketch potential roles and models. Basically, we discuss how a social capital variable might fit into formal theory, and what types of questions it may be able to answer. We show that social capital can enter in various ways and potentially answer important questions. Whether social capital will in fact live up to its potential is an empirical matter.

(A3) Section 4 on social capital building discusses the *basic policy dilemma* of social capital. It is *self-enforcement* contrary to *third-party enforcement*. Governments and international organizations are third parties. They may aim at increasing social capital, but their interference might do more harm than good to social capital. Here we are still less concrete and mainly argue from examples, where we “guess”, what the evidence might have been, if social capital had been measured. The last of our examples considers the slowness of the transition from socialism after 1989.

We have presented this paper to several audiences and discussed it with many colleagues. Inevitably, we have been met with the following comment: “Oh yes, but this was already discussed in the ZZ-literature, though with another name and a slightly different slant”. Each time ZZ has been different. The family of social-capital-like concepts is large, and the reference list could easily be increased. However, a lot is still vague.<sup>2)</sup> There is (too) much “smoke” smelling of something like social capital. The promise of social capital is that there is at least some “fire” behind the smoke.

## 1. Making sense of a family of concepts

Many definitions of social capital have been proposed. We believe that the trust-definition in Table 1 is the most basic. It bases the concept on a simple micro concept, which may be aggregated to the macro level. Social capital is (potentially) important economically for the reason given as the key hypothesis in the second line of the table. The key hypothesis might not be true, or might be a necessary condition only. The table also lists a practical instrument that may be a proxy for social capital. If it works, social capital becomes a simple matter to measure compared to many other statistics routinely published.

Table 1. Our definition of social capital,  $\Omega$ , a key hypothesis and the operational proxy,  $\Pi$

<p><b>Definition <math>\Omega</math>:</b> The density of trust existing within a group. The group might be extended to the whole of the society.</p>
<p><b>Key hypothesis:</b> <math>\Omega</math> determines how easily people work together.</p>
<p><b>Proxy <math>\Pi</math>:</b> The density of voluntary organizations in the society. The proxy will be referred to as <i>Putnam's Instrument</i>.</p>

Note: Some prefer to reverse the definition and key hypothesis. It is precisely because the two items are so closely related that social capital appears promising. Putnam defines social capital as social network.

It is important to stress two limitations right from the start:

- (L1) Little *systematic quantitative* evidence is available on social capital. This is rapidly changing.<sup>3)</sup> But we are still into speculation and conjectures - thus the term "essay" in the title. However, much is known on seemingly relevant matters allowing us to suggest how a theory may be built.
- (L2) Social capital might be relevant for the development of the arts, religion and culture in general - our modest aim is to discuss social capital only to the extent it is *relevant for production*.

One part of the literature deals with the impact of social-capital-like macro proxies. Some of the more successful are proxies for the lack of social capital as the crime rate (Fukuyama, 1995a). Others are proxies for the "degree of civic mindedness" (Knack & Keefer, 1997). These results are promising, but more theory-close measures are needed for creating a sound base for a social capital theory, as will be argued in section 3.1.

### 2.1 Some members of the social capital family

The term "social capital" was probably introduced - in our sense - by the sociologist James Coleman in 1988.<sup>4)</sup> Later the same term was used by several political scientists - notably Putnam (1993) and Fukuyama (1995). Similar concepts are also found in economics, though mostly with different names.<sup>5)</sup> However, it is clearly attractive to have a concept termed social capital. It is a bit like the name everybody uses for his favorite uncle - unfortunately different people have different uncles.

Coleman defined social capital as "the ability of people to work together for common purposes in groups and organizations". (Coleman, 1988; p95). Voluntary cooperation is *self enforced*, contrary to cooperation *enforced by third parties*. The ability to cooperate voluntarily depends on the degree to which communities share norms and values and are able to subordinate individual interests to those of the group. Behind shared values is *trust* - the concept used by Fukuyama (1995a & b) and - in an ambitious attempt to build a formal "economic" theory - by Dasgupta (1998). Table 2 covers a set of similar concepts with

different names in other parts of economic and management theory and from other social sciences.

Table 2. Theories closely related to social capital

<b>Management:</b> Theories dealing with <b>goodwill</b> . The investment-like costs of building goodwill. Its value as a factor of production. It can be lost quickly.
<b>Macro policy-making:</b> Theories dealing with <b>credibility</b> . The investment-like costs of its accumulation. Its value for improvement of the efficiency of policy-making, especially as regards monetary policy and exchange rate management. It can be lost quickly.
<b>Game theory:</b> Theories dealing with processes to uphold <b>cooperative</b> solutions, when they are not the equilibrium of the game. That is, side payments, tit-for-tat strategies in repeated games and third part enforcement.
<b>Anthropology, psychology:</b> Theories dealing with the development of <b>group norms</b> . How they emerge and change.

On the micro level trust is the *mutual expectation* that arises within a community of regular, cooperative behavior, based on commonly shared norms. In this way, acceptable behavior is disciplined by reinforcing encounters in game situations. Social norms can be based on *religious or justice values*, but they also cover *secular norms like professional standards and codes of behavior*. Norms are created and transmitted through *cultural mechanisms*. The (nebulous) word “*culture*” itself suggests that the ethical rules by which people live are nurtured through repetition, tradition, and example. Many different theories recognize the advantages - also for the individual - in deviating from narrow norms of short-run maximization. Firms for example protect their goodwill as an asset.

Some social scientists (eg, Lewin, 1991) see such cases as *the* key deviation from the *economic man model*, ie, *the* explanation why the “narrow” economic model is false. This is surely misleading. The key point is precisely that the said behavior is an advantage for the individual, and hence it should be included in any reasonable textbook on the economic man model (that is, microeconomics), though not in the first chapter. Table 2 lists theories rationalizing this behavior.<sup>6)</sup>

Everything listed in Table 2 should not be included in our definition, but only something that influences the “ease of cooperation” at the micro level. The key idea is that the causal factor is the level of *trust* in the society, and that this level differs from one society to another as well as over time.

We have hence argued for Table 1. We have a *definition* of  $\Omega$  (from Fukuyama, Dasgupta and others), a *key hypothesis* (from Coleman) suggesting why  $\Omega$  matters, and an *operational proxy* - Putnam’s Instrument, II - allowing us to imagine that something close to  $\Omega$  can be measured.

## 2.2 Family roots: social contract, third party enforcement and transaction costs

While the term social capital is new, the underlying ideas go back to a long way in the social sciences.

The importance of shared values and a social contract was already emphasized by Rousseau (1762). With a compressed version of his own words: People are not originally “corrupted” and have a “good will”, but it is often “deceived”. Therefore, the original life in nature was harmonic and peaceful. The problem is that people have been removed from the “state of nature”. (see Rousseau, 1993:203).<sup>7)</sup>

Max Weber (1904) also emphasized the importance of culture. Here, trust grew out of religious beliefs. For example, the early puritans developed shared values that glorified hard work, thrift and honesty. These values were instrumental to the accumulation of capital and capitalism.

In stark contrast to Rousseau's optimist view of human nature stands the pessimist view of Hobbes (1651) who offers the reverse solution: third party enforcement. Because even the weakest member in society is capable of killing the strongest, a social contract is needed. This contract is enforced by the totalitarian king "Leviathan", who protects people from one another. If there were no common power to restrain individuals - by laws and law-enforcement - every man would constantly be open to violent invasion of his life and property.

Mancur Olson (1965) - and most of the public choice literature - starts the analysis of group behavior from a pessimist view of human nature. If the risk of detection (and the cost of punishment) is lower than the benefits of committing a crime, then a person will commit the crime. So in the absence of police and court systems (with only low risk of detection and punishment), anarchy will prevail.

Because trust assures that another individual will not take advantage of you even if he might derive economic benefit, self-enforcement is possible. Even if it pays to commit a crime, or free-ride or ignore the rules in a contract, fewer people will do it in the presence of trust (Putnam, 1993: 173). A high level of trust lowers the level of transaction costs, eventually giving significant benefits to everybody. An informal agreement is thereby accomplished where the only sanction is that of social ostracism.<sup>8)</sup>

## 2. Three alternative approaches: Production, transaction and monitoring

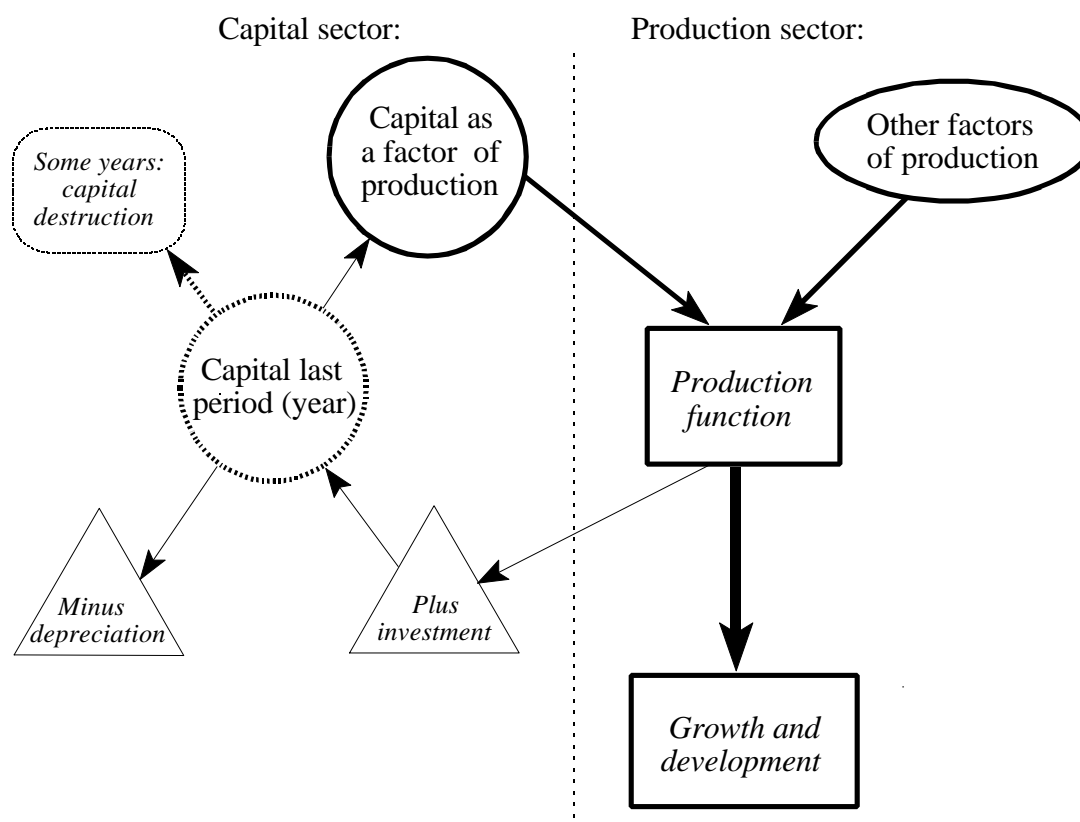
The purpose of this section is to present three approaches that give different formulations and a different theory-building strategy. The term social *capital* suggests that  $\Omega$  is capital like any other capital, as discussed in subsection 2.1. This leads to a *production function* approach. It is also possible that  $\Omega$  is a factor that determines *transaction costs*. This suggests a different formulation. The two formulations are contrasted in subsection 2.2, while 2.3 discusses the idea that  $\Omega$  concerns *monitoring costs*. For some purposes, it makes no sense to distinguish between transaction and monitoring costs. However, when it comes to theory-building there is a crucial difference, as we will see. The three approaches are used to sketch a few possible lines of theory-building. It is probably not fruitful to go too far in either of the three directions without a more solid empirical basis.

### 2.1 The idea that social capital is capital

It is easy to see why the idea that  $\Omega$  is capital has a nice ring to it. The marriage between "social" and "capital" is politically appealing. And, then you have physical capital, human capital and social capital.<sup>9)</sup> The key hypothesis of Table 1 further suggests that  $\Omega$  is a variable that furthers production.

For a concept to be *capital* it has to be a stock in a *stock-flow* context, as drawn on Figure 1. Flows - as production - are marked in *italic*. Some flows are accumulated - invested - and hereby become a stock, ie, capital, marked with normal text. That is, in the long run the stock is endogenous. In the short run the stock becomes (almost fully) exogenous (predetermined). Also, capital can be used and even destroyed. Physical capital can be destroyed by, eg, bombs and earthquakes, However, capital can also become redundant by a technological breakthrough or a change in tastes. The reader will see that these characteristics apply to physical capital, and to human capital. They also apply to financial capital - and, in fact - to goodwill and credibility in the theories listed in Table 2.

Figure 1. The logic of any »capital« as production factor.



The question is if they apply to social capital. Casual observation suggests that social capital does accumulate and decumulate as capital, and that it can also be destroyed. One can also argue that it is a factor of production. The weak link is the way it is “produced”. Physical capital is produced by the investment industry. In most cases it is easy to see what is going on here, though the line dividing consumption and investment is a thin one. In the same way human capital is produced by the education sector. But, it appears that social capital is rarely produced in a deliberate way.<sup>10)</sup> At present, we hardly know how it is produced - it comes about through activities with another purpose. Social capital thus a positive externality (see Collier, 1998). Here much study is required.

Development agencies frequently spend money under such heads as “*institution building*” (see 4.3). These expenditures might be seen as deliberate attempts to build social capital. Also, attempts have been made to build cooperative movements (see 4.1). When such efforts succeed, they do build social capital, but the process is at best slow. A rural saving banks system may take several decades to develop. In its turn it may then lead to other systems, but then we are speaking of half a century.<sup>11)</sup>

Putnam (1993) goes further and argues that social capital building is a *process lasting centuries*. He observed a large gap between the social capital of North and South of Italy in the 1980s. One of his main points is that this gap was caused by the emergence of the North Italian city-states and the centralized Neapolitan Kingdom in the South from the 11<sup>th</sup> to the 14<sup>th</sup> century. If this is true, the annual flows must be infinitesimal relative to the stock. It is thus far-fetched to speak of a capital. We should rather treat  $\Omega$  as an *exogenous background variable*, like language and climate.

### 22I.2 Is $\Omega$ a factor of production or a transaction costs factor?

Assume that we have a measure  $Q \approx \Omega$ . The next question is: How should  $Q$  relate to production,  $Y$ ? We can use either the production function approach or the transaction approach.

The production-function approach sees  $Y$  as a function of labor,  $L$ , physical capital,  $K$ , human capital,  $H$ , and technical progress, indicated as a time index  $t$  on  $F$ . It is written as:

$$Y = F_t(K, L, H) \quad (1)$$

The term “capital” in the concept of social capital suggests that  $Q$  (and hence  $\Omega$ ) should enter as a production factor like  $K$  and  $H$ . That means:

$$Y = F_t(K, L, H, Q), \text{ where } \partial Y / \partial Q > 0, \text{ and } \partial^2 Y / \partial Q^2 < 0. \quad (2)$$

The transaction cost approach sees  $\Omega$  as a factor affecting *transaction cost*. Here  $Q$  should be *proportional to the number of transactions*, and hence to  $Y$ . The parallel would here be to the transaction-part of the money demand relation. It suggests formulation (3).<sup>12)</sup>

$$Y = (Q)F_t(K, L, H), \text{ where } \partial Y / \partial Q > 0. \quad (3)$$

Formulation (3) points to the simple possibility that  $\Omega$  is a scaling function for production. Maybe a linear approximation - where  $(Q) \approx cQ$ , where  $c$  is constant - could work.<sup>13)</sup> In such a simple world  $Q$  and  $Y$  would be proportional. If social capital grows by 10%, so does production. If formulation (3) is the proper one, it does not matter if  $\Omega$  is “capital”.

### 2.3 Social capital as a monitoring cost factor

Social capital is self-monitoring. It may hence be seen as a factor reducing monitoring costs. This is easy to formulate in the language of game theory: Social capital might be treated as the background factor (trust) that determines the amount of free riding in certain well-defined games, for a given amount of third-part enforcement. Note that this approach is close to the definition of  $\Omega$  in Table 1.

In the prisoner’s dilemma game, cooperation is an advantage to the players, but the uncoordinated actions of the players lead to an inferior Nash-equilibrium. When the two players know the situation in advance, they are likely to make an agreement to cooperate. If they trust one another, self-monitoring works. When both doubt the other, the game ends in the Nash-equilibrium. Here a third party is needed to punish the player(s) who fail to be trustworthy. Obviously it is expensive to employ a third party to “monitor” the game and ensure that the two players do not free ride. The more social capital (trust) the players have, the less monitoring is necessary. Hence monitoring costs are reduced.

Many studies analyze the amount of free riding actually occurring - both in actual cases and in experiments. It appears that the cooperative solution occurs much more often than predicted by rationality.<sup>14)</sup> We hence suggest that a connection as given in equation (4) exists between the frequency of cooperative - trusting - plays,  $\beta$ , in prisoners’ dilemma games, and social capital,  $\Omega$ , at any given level of third-party enforcement,  $E$ :

$$\beta = (\Omega, E), \text{ where } \partial \beta / \partial \Omega > 0 \text{ and } \partial \beta / \partial E > 0. \quad (4)$$

This approach suggests that one could perhaps develop a technique analyzing  $\Omega$  by the methods of experimental economics, by studying how often people - in a group - play the cooperative solution in

certain well-defined prisoner's dilemma games. We shall return to this possibility in section 3

The game theory approach raises the possibility that the process of social capital building has the character of a repeated game with learning. Such games are likely to have one or a few equilibria, giving a simple underlying *quasi-static* structure to the theory. That is, the process may cause  $\Omega$  to converge to one or a couple of  $\Omega$ 's, precisely as suggested by Putnam's Northern and Southern equilibrium.

It is too early to conclude which of the three theoretical approaches is the superior one - as of now all three seems promising. Moreover, we do not have actual numbers available - without numbers, hunches and theories remain smoke.

### 3. Measuring social capital: the micro and the macro level

Many of the most used concepts in the (social) sciences have been developed in an interactive process where theory has helped developing measurement, and measurement has led to empirical knowledge that has been crucial for the development of theory, etc. Subsection 3.1 looks at the minimum conditions for a measure of social capital to be useful step in the process. We consider three methods for measuring social capital. The experimental method is given a few words only. We then turn to two sampling methods. Subsection 3.2 discusses some joint problems and the aggregation problem. Subsection 3.3 looks at a direct measure of  $\Omega$  based on a loan question, while 3 considers Putnam's Instrument, II. Subsection 3.5 contains a few remarks on the newest attempts of measurement.

#### 3.1 A minimalistic approach: How much do we need to begin?

Table 3 gives the minimum conditions a useful proxy,  $Q$ , for social capital should meet. The three conditions of the table can be met better. That is, if  $Q_1$  and  $Q_2$  both satisfy the minimum conditions, we may demonstrate that  $Q_1$  or  $Q_2$  or some composite  $Q_3 = f(Q_1, Q_2)$  better satisfy the conditions.

Table 3. The three minimum conditions for a measure  $Q$  for social capital  $\Omega$

A.	$Q$ should be relevant for production.
B.	$Q$ should be different from what we already measure.
C.	$Q$ should be theoretically linked to $\Omega$ .

Hence, if we can find one  $Q_1$  that satisfies the minimum conditions of Table 3, we have a *useful* starting point. Any theoretical or practical advance in our understanding of  $\Omega$  can then be used to improve  $Q$ . Condition A was already discussed - as (L1) - in section 1, but the other two conditions are new.

*Re B: different:* Several macro studies build up a macro proxy for social capital from aggregations of existing "social macro indicators" for human capital, democracy, good governance, political stability, gender relations, the crime rate, etc. Other studies use the same indicators without terming them social capital. If social capital contains nothing that we do not use already, we hardly need the concept. The promise of social capital is that it is something different, which is connected to economic development in a way we understand. So we need a measure that is sufficiently close to the definition to start with. If this measure can then be shown to correlate with existing "social" macro indicators, we will have obtained a new insight, but the starting point cannot be the macro proxy.



*Re C: operational:* Many economic variables have been refined and developed so that they are measurable and organizations collect and process the data. Maybe the same will eventually happen to social capital. However, before anybody would want to start on such a process, it needs to be demonstrated that at least one proxy - Q - matters for production. Hence, we need a simple proxy from which to start our quest.

Section 2.3 above suggests a possible experimental method to measure social capital. This is by studies revealing how often people cooperate in prisoners' dilemma games. One could imagine that experimental techniques developed so that it becomes possible to put an experimental lab on a van, drive into a location and start running a set of experiments with a sample of the local population. After n experiments the estimate of  $\Omega$  stabilizes on the screen, and that is it - the van can drive to the next location. This might be no further into the future than the methods discussed in 3.3 and 4.<sup>15)</sup>

In our judgement, sampling methods - to which we now turn - are more likely to be useful.

### 3.2 Measurement by sampling individual social capitals. Areas, groups and the national level

The next two subsections consider two *polling methods* to measure social capital:

- (a) *The direct method* (see 3.3) comes in many *variants*, which are qualitatively similar, but likely to produce different numbers. It must be supplemented with a calibration.
- (b) *Putnam's instrument* (see 3.4) is a parallel method that is qualitatively different from the direct method. It has a built in control as double entry bookkeeping and it leads to one number.

The two methods both consider the population in an *area* A with  $i = 1, \dots, N$  people. Assume that each person has a *personal social capital*:  $\omega_i$ .<sup>16)</sup> The social capital of A - that is  $\Omega_A$  - is the average of the N personal  $\omega_i$ 's in A. The ideal is that the  $\omega_i$ -distribution is normal and has a small variance.

However,  $\Omega_A$  may not be so simple - then  $\Omega_A$  becomes one of the interesting properties of the  $\omega_i$ -distribution only. Perhaps it has several peaks corresponding to something known about the population. Maybe the genders or the tribes have significantly different  $\omega_i$ 's. That is,  $A = A_1 + A_2$ , where  $A_1 \neq A_2$ , and thus  $\Omega_{A_1} \neq \Omega_{A_2}$ . The *gender or tribe-specific social capital* is thus different. This would surely be an interesting fact to know about the area. It is thus likely that a study of  $\Omega_A$  would yield (much) more interesting information than the plain average.

We can study  $\Omega_A$  by well known sampling techniques once we have a sampling question (or method) X. Using X we obtain an estimate  $F_A(X)$  of  $\Omega_A$ . There are now three problems:

- (i) The usual ones of *sample size and stratification* - these questions will not be discussed.
- (ii) The one of *calibration*. We want eventually to measure  $\Omega$  on the same scale, so that, if we say that the social capital in a village is 3.25, we know, what this *means*. The scaling of the  $F_A(X)$  reached depends upon X, so we want a conversion from  $F_A(X)$  to the  $\Omega_A$ -scale, we understand. That conversion, Z, is called a calibration of X. Our estimate of  $\Omega_A$  is hence  $Z_X(F_A(X))$ .

(ii) The *robustness* question. That is, by using different X's can we reach the same  $\Omega_A$  and hence the same  $\Omega$ ? In other words, is there a well-understood structure in the  $Z_X$ -calibration functions for a wide range of X's? We obviously want our  $\Omega_A$ 's to be robust. If the  $\Omega_A$ 's found by different - but reasonable methods - are too different, we would have to conclude, that social capital is a fragile concept.

Nothing in the argument above says that the area A cannot be the whole country. Though the larger and less homogeneous A is, the more likely it is that there are *aggregation problems*. That is, the larger A becomes, the more likely it is to contain groups with high within-group trust, and low between-group trust. That would mean two things: (1) The average would be less interesting relative to the other structural features of the distribution. (2) The average would be a poor measure of the social capital of any small area.

One particular problem could be that the trust in the government and trust among people might develop quite differently. So it may be necessary to single out the trust in the government as a particular variable. However, we normally think of trust among people as *the* social capital.

A good *national measurement* of  $\Omega$  must thus build upon stratified sampling covering all possibly different national areas and all clearly discernable groups in the country - in a large and non-homogeneous country that would require a very large sample size. However, once the national structure in is known, it will be possible to predict and interpret results from small areas in a much more meaningful way.

### 3.3 *The hard way: Measuring $\Omega$ directly using the loan question*

The most direct measure of trust seen from the point of view of a simple-minded economist would appear to be a *loan question* of the following type:

*Consider the circle of the  $m = 100$  people (outside close family) you know best. How many in this circle would you trust with a personal loan amounting to  $n = 5\%$  of your income?*

*Or: Consider the circle of the  $m = 100$  people (outside close family) you know best. How many in this circle would trust you with a personal loan amounting to  $n = 5\%$  of your income?*

How this question can be formulated to work in an actual interview will not be discussed, but it is clearly a difficult matter as it taps into a *subjective assessment* of the respondent - hence the second formulation might be the better one.<sup>17)</sup> Each choice of (n, m) gives a variant of the method, and produces a different answer. Let us imagine a choice is made. The polling is done, and we have obtained a distribution  $F_A(n,m)$  for the area A, and then a proper calibration,  $Z_{n,m}$ , gives us our estimate of  $\Omega_A$  and  $\Omega$  as discussed.

A key question is whether the structure in the answers is robust - in the sense defined above - to variation in the two parameters n and m. If that is the case, the method provides a good measure of  $\Omega$ . However, if the method has no robustness to the (n, m)-choice, the very concept of social capital is fragile. A thorough study of  $\Omega$  using the direct method is thus a large undertaking. When it is done a number of times, it will become easier, but it will take considerable effort to turn this into a quick and easy method.

Finally, our discussion of loans raises a tantalizing possibility for finding an easy proxy for social capital. One may get a handle on  $\Omega$  by asking banks about their lending policies, notably their loans to households. Perhaps the fraction of such loans given without collateral could provide a good macro-proxy for social capital.

### 3.4 *The quick and easy way: reading Putnam's Instrument*

Putnam's  $\Pi$  is the density of voluntary organizations. It might be polled exactly as the loan question to obtain a  $\Omega_A$ -distribution. However, the question is much easier to pose, and a check is built in, so one needs a smaller sample, and, finally, it tries to catch *one number* that has an *objective existence*.

Let us once again consider area A with  $i = 1, \dots, N$  people, where person i is a member of  $n_i \geq 0$

organizations. We want to know the density of voluntary organizations of any type.<sup>18)</sup> Imagine there are  $j = 1, \dots, M$  such organizations, each having  $m_j$  members. The sum of organizations of which each person is a member summed over all persons, must be the same as the number of members each organization has, summed over all organizations. The density is thus defined in two ways as:

$$\Pi = \frac{\sum_N n_j}{N} = \frac{\sum_M m_j}{N} \quad (5)$$

The measure  $\Pi$  can therefore be estimated in the same two ways - so that we have the double entry bookkeeping quality of a built-in check:

*The N-count:* asking a representative sample of people which organizations they belong to.

*The M-count:* identifying the organizations and asking each how many members it has.

If the two estimates give the same result, we know that we have counted correctly. If they are different, they also provide information pertaining to type of errors made.

In both estimates there are likely to be problems catching everything. Some organizations have vague criteria for membership, while others keep membership a secret. Masonic lodges take secrecy as an integral part of the mystique, while, for example, gay and lesbian societies may want to protect their members. Still others may be illegal. However, even if a few informal or secret organizations escape the net, it should - in a limited location - be reasonably easy to apply both methods and find a number that makes sense.

It has often been mentioned that the different types of organizations should be weighted differently. Maybe they should be weighted by the intensity of their activity. Maybe some organizations (as criminal or tribe-chauvinist ones) should be given a negative weight. However they are typically among the secret organizations that will not be caught by such sampling methods as we discuss.

In order to know the reliability of Putnam's instrument, one would have to make a dozen large detailed studies directed to measure  $\Omega$  directly, so that we can know how closely related the two measures are. If they are closely related, one can go ahead using Putnam's cheap and easy Instrument.

Finally a word of caution: Putnam's empirical claim is that  $\Pi$  is a variable that changes (very) slowly and predicts, (much) later, changes in political and economic variables. This claim has been disputed, and the evidence is not as clear as one might like.<sup>19)</sup>

### 3.5 *A note on the first attempts of measurement*

A number of questionnaires have been constructed in connection with the large scale attempts to measure social capital by the World Bank (see IBRD, 1999a & b). Krishna & Schrader (1999) have even compiled a set of "master questionnaires" of about 40 pages containing all social capital questions that have been found to work in one connection or another. They add up to a frightening number of questions, and the master questionnaires are still growing.

The proper way to develop the best set of social capital questions is surely by a two-step procedure: First, spread out a wide net of questions. Second, tighten the net, by cutting away the least relevant or overlapping questions, until the "optimal questionnaire" is reached. At this time, the net is still spreading.

The promising findings are: (i) Several questionnaires have produced social capital measures, which are as effective as standard human capital measures in explaining household income differences. (ii) Till now

the most successful questions are of Putnam's type, but the questions about numbers of organizations should be supplemented with questions about the intensity of contacts with the organization. The most discouraging findings are that it appears (iii) that different questions work better under different circumstances.

There is, however, still a great deal of disagreement about the questions, so perhaps general results can still be reached. If a small, reasonably general questionnaire with a dozen questions can be developed, social capital would become a simple easy instrument to use. Also, it will be quite cheap to measure at least on a local basis.<sup>20)</sup>

#### **4. Changing social capital: The dilemma of third-party enforcement**

Above we have argued that the process of institution building is related to that of social capital building. Here outside support and third party enforcement often enter, though not necessarily constructively. Trust enters into the building of all institutions (and businesses). Cooperative movements operate on (almost) pure trust. They hence form a particularly good study case - especially as they have a mixed record. We also look at social capital and normal business and at social capital and institution building.

Finally, we turn to the broader question of the nature of enforcement. Here it is important to distinguish between two levels: an *active* and a *passive* level. Passive enforcement consists in building the legal and institutional framework allowing people to enjoy "law and order". This is surely a precondition for having social capital. In the interest of brevity we shall not discuss the relation between passive enforcement and social capital. We concentrate on active enforcement, where third parties come in and "induce" - or even "force" - people to trust each other and work together.

##### *4.1 Cooperative movements: some cases*

If social capital matters and concerns trust and cooperation between people, it should be particularly relevant for cooperatives. This is certainly alleged by Putnam (1993, ch 6) and is the basis for several of the new World Bank studies. There is a large body of knowledge on cooperatives. We have found no good surveys of the evidence, and the literature has not used the concept of social capital. Our approach is to consider a couple of cases.

A large growth wave occurred in Danish agriculture in the last 25 years of the 19<sup>th</sup> Century - about half a century after a big wave of land reforms that had created a new class of family farmers. A key factor in the expansion was the cooperative movement.<sup>21)</sup> Between 1850 and 1900 a rather powerful cooperative movement arose in the agricultural sector in Denmark. The beginning was the creation of savings banks<sup>22)</sup> - at the onset, they were like most of the mini-credit schemes started in the LDCs in the later parts of the 20<sup>th</sup> century. Later followed dairies, slaughterhouses, shops, etc. The cooperative movement was *fully voluntary*, as it began while the government was in the hands of the last of the old landowners who were engaged in a fierce constitutional fight with the farmers.<sup>23)</sup> One may even see the building of the cooperative movement as a defense of the farmers against their enemy - the State.

A similar story can be told about the cooperative movement in Tanzania during colonial days.<sup>24)</sup> There were almost 2000 voluntary cooperatives, owning trucks, chicken houses, grain and fertilizer storage and marketing, etc, at the time of independence in 1960. The movement was, however, modest in size and concentrated in the most wealthy part of the country, and did not spread very fast.

The cooperative movement was much in accord with the socialist ideology of the new regime of

independent Tanzania. And, in the late 1960s the government launched a large cooperation movement (the Ujamaa-movement). It was a collectivization drive almost along classical soviet lines.<sup>25)</sup> The new cooperative villages were to be the vanguard of socialism under the leadership of the party. By 1973 the movement was in deep trouble, but nevertheless the government outlawed the cooperatives of old voluntary movement. In the second half of the 1970s almost all Ujamaa villages were abandoned.

In the mid 1980s the Tanzanian government tried once more to organize the farmers in a large-scale cooperative movement under the stewardship of the Party. The cooperation should cover all services only, that is, provision of all outside farm inputs and handling and sale of all outputs. Instead of the Soviet-sounding rhetoric, a Northwest-European sounding rhetoric was used. This had a handsome pay off, in the form of development aid in the order of at least \$150 million (in 1999-\$) during the second half of the 1980s. However, once burned, the farmers distrusted the idea of imposition of cooperatives from above, and the movement rapidly used the aid and collapsed. The old voluntary cooperatives reappeared, but in the summer of 1996 there were fewer cooperatives in Tanzania than in 1960.

It is not only in Tanzania that large amounts of external support were squandered on cooperative projects. But sometimes third party interference has helped: the Grameen Bank (in Bangladesh) started as a bottom-up institution, but, when it later received aid, it continued to grow.<sup>26)</sup> A 100% “hands off” approach is therefore not necessarily the best one. Fortunately, the distance between giving gentle support to local initiative, already well under way, and a heavy-handed external take-over, is a large one.

Table 4. A summary of lessons obtained from the study of cooperative movements

C1	<b>Bottom-up \ trust building:</b> cooperatives formed voluntarily based on risk sharing tend to grow slowly, but to have a long life
C2	<b>Top-down \ third party enforcement:</b> Cooperatives created from above can be build quickly, but tend to have a short life
C3	<b>External support:</b> External support to top-down cooperatives is often a waste of money
C4	<b>Social capital suggestion:</b> It differs from location to location how easily cooperatives bloom. The difference might be due to initial differences in social capital

It seems that the experience points to the generalizations of Table 4. C4 is a suggestion only, but if social capital is a significant factor of production, it must surely be important. With large social capital “available” in the society, trust and cooperation easily emerge among members of cooperatives as well.

#### 4.2 *Business and social capital: entrepreneurial skills vs social capital explanations*

One of the explanations often given in development theory for the slow development of certain regions is the *lack of entrepreneurial skills*. This is frequently used as an explanation for the slow development of (sub-Saharan) Africa. However, anybody who has lived and traveled in Africa cannot have failed to have encountered the typical African market teeming with entrepreneurial activity - in fact, there seems to be plenty of entrepreneurial skills and activity all over Africa.<sup>27)</sup>

The problem is rather that the African firm fails to grow past the (modest) *threshold*, where the owner gives an employee responsibility for decisions that cannot be simultaneously monitored.<sup>28)</sup> We are probably dealing with a question of trust and hence a social capital question. To run a large business, one

has to trust employees with managerial positions in semi-independent parts of the company. This argument takes us back to the monitoring cost discussion of section 2.3. With little social capital, monitoring costs are forbiddingly high.

We also note that many of the most successful larger firms in Africa are run by ethnic minorities, who reserve managerial positions involving trust for group-members. In social capital terms they have more (group-specific) social capital than the rest of the population, as discussed in 3.2 and 5. Together these arguments suggest that Africa may be a continent with low social capital. This may be the explanation for the lack of economic growth, in spite of abundant entrepreneurial spirit.

The literature about management and the development of trust in organizations can (no doubt) be developed to take existing background levels of social capital into consideration. The main point is here that everything enhancing cooperation and trust in a firm also adds to social capital in the region where the firm is located. Social capital here once again appears as a social *externality*, as discussed by Collier (1998).

#### 4.3 *Observing development projects - social capital as a device for controlling costs*<sup>29)</sup>

Many studies of the success-rate of development projects show large *unexplained regional differences* (see the annual evaluation reports from OED-IBRD or Paldam, 1997a, ch IV.1).

That is, regional differences still come out highly significant, even if all (other) measurable differences in background variables are controlled for. The total differences might be as large as 40% - if the success-rate is 70% in the best region, it might be only 30% in the worst region. We may explain half of the gap of the 40 percentage points by differences in educational level, GDP per capita, growth rate, industrial structure, etc, but that still leaves half the gap - that is 20% - unexplained.

Most observers would probably agree that a good deal of the explanation “missing” is that it is (much) more difficult to build the institutions necessary for obtaining project sustainability in some regions than in others. Development projects routinely include *institution-building costs* in the order of 10%. These costs pay for the training period when expensive expatriate staff runs the project, and for local people to be sent abroad for advanced training. Also, courses might have to be run in the surrounding villages, etc.

Often it is arbitrary whether institution building costs are set at 7%, 10% or 12% of project cost. That is, in a \$ 25 million project, these costs may differ by half a million dollars for no good reason. If two teams plan the same project independently, these costs are likely to differ by such a sum. However, it is often a crucial post, as anybody observing development projects will have noticed. Experienced project-planners develop intuition about the size of institution-building costs based on similar projects in similar locations. Such intuition is hard to document, and experiences might be with projects in areas that “look” similar, but are really quite different in the relevant field. So if a good method could be developed allowing a sound estimate of the “ease of institution-building” in a location, it would save a good deal of money.

Social capital is defined almost as the *ease of institution-building*. That is, a low  $\Omega$  in the project location means that it is difficult and expensive to build the trust and cooperation necessary to make the project sustainable. With plenty of social capital available, it is even possible that the example from the project will spread once it is demonstrated how something might be done.

With enough data we can calculate cost functions, for the institution-building-costs,  $C_i$ , as a function of other project costs,  $C_o$ , project type,  $\theta$ , and social capital,  $\Omega$ , available at the project location:

$$C_i = C_i(C_o, \theta, \Omega), \text{ where } \partial C_i / \partial \Omega < 0 \quad (7)$$

If a simple measure can be developed (as discussed in 3.5), all that is needed for a sound estimate of the institution building costs is a reading costing \$ 2.000. This is surely a small sum when we are speaking of costs that (i) easily differ by half a million dollars by a slight of hand, and (ii) which might be crucial for success and failure. Social capital may therefore turn out to be an eminently practical matter.

#### 4.4 *Carrots, sticks and social capital*

Our discussion above suggests that external support easily becomes too much, and can become counterproductive, actually destroying social capital.<sup>30)</sup> This brings us back to the point made in the introduction and in 2.3: Social capital is a measure of the capacity for self enforcement - or voluntary group enforcement - as contrasting to third party enforcement.

Up to a point, it is surely cheaper if people monitor themselves and control each other. Some activities are, however, difficult to monitor. Without trust, such activities can hardly be undertaken at all, and they may be important for development. However, discussions to make everybody agree also cost money, and worker operated firms are not normally efficient. We are dealing with complex takeoffs.

Adequate social capital may allow better solutions even in strict hierarchies. One of the most efficient of such organizations was the Prussian-German army in its heyday (1860-1916), as directed by its famous General Staff. It is interesting that its main organizer and thinker General Moltke (the elder) placed great emphasis on the creation of trust among the top officers. Orders were orders up to a point. Then everybody had to take their own decisions imbued by joint schooling and much esprit de corps (see Goerlitz, 1953, notably Chapter IV.II).<sup>31)</sup>

It is thus an important insight that social capital can be destroyed by too much enforcement. It is worth considering an extreme case.

## 5. **Social capital as a hypothesis explaining the slow transition from socialism**

According to official ideology, the main aim of the 70 years of the Soviet system was to create *a new man* who was more social than capitalist man. The idea was that the new man would work better together with the members of his team than the individualistic capitalist man. Once the new man emerged, third-party enforcement would be unnecessary, and state power would vanish. In the meantime, developments went the other way: Large efforts were made to thoroughly organize and control the society - under the historically and scientifically right leadership - and to root out the old civic society.<sup>32)</sup>

### 5.1 *A switch of terminology from ideology to social capital*

In our terminology, the main idea was to build social capital on a large scale from the top down. In order to create the right kind of social capital, all *voluntary* organizations were brought under the centralized leadership and, in fact, control of the one and only party. The old social capital - defined as in Table 1 - was thus destroyed. For this and other purposes, an extensive and very frightening control-system was created.<sup>33)</sup>

Imperial Russia (before World War I) was neither as totalitarian nor as ruthless as the Soviet Union, but the Russia of the Czars was an oppressive and centralized system<sup>34)</sup> - in several ways not unlike the Kingdom of Naples before the Italian unification. Thus, communist societies had weak civic traditions before the rule of Communism.

Many studies of the 70 years of the Soviet Union give an impression of a system that went unusually far in *destroying* social capital, as all nonparty social structures and private - independent - initiatives were ruthlessly eliminated. In fact, few activities were more dangerous in the Soviet Union than to organize anything on a voluntary basis - outside the party. Secret voluntary organizations such as masonic lodges or ethnic organizations were forbidden and severely punished. During the purges people thoroughly learned to *trust nobody*, and to restrict all activities to the (relatively) safe one of obeying orders.

On the other hand, great efforts were made to organize everybody from the center. Even the boy scouts were replaced by party scouts (pioneers). All sports clubs etc were brought into the system. The state made almost all decisions and coerced people to do certain things. So by the time the system collapsed - 1988-92 - there was no social capital, with one exception:

Plans were cumbersome and slow to change, and there was pressure on top management to meet objectives, even with a little wheeling and dealing. Middlemen and fixers (known as “*tolkach*”), were therefore tolerated, even if they lived a precarious existence. However, as managers were high party officials, there was some protection for these small pieces of *grey networks*, as long as they remained small, informal and did not become involved in any kind of politics.

After the Second World War the Soviet system was enforced in the Red Army to a number of neighboring countries.<sup>35)</sup> There were small differences which involved the tolerance of private business and the church organizations (notably in Poland). The result was, however, also corrupt societies. The destruction of *civic society* was, however, not as complete as in the Soviet Union.

## 5.2 *Collapse and the slow upturn*

From the 1960s partial reforms were attempted to improve the soviet system, but most of the reforms were half-heartedly carried out and absorbed by the system. However, as time passed, the reform efforts became more vigorous, and in the late 1980s they took a dramatic momentum of their own, resulting in a monumental collapse of the *political and economic system*. Hence the old social capital was much reduced - by the deliberate destruction - and the centrally created “social capital” crumbled.

When a country has to be rebuilt, social capital is crucial. In Germany, after the defeat and large scale destruction of physical and human capital in 1945, the pre-Nazi political parties and organization came nonetheless back at a remarkable speed. The Nazi regime lasted a dozen years only, and even when it did much to destroy moral and social values, the process was of short duration. Also, there was much to destroy. After a decade (West) Germany was already well on its way to recuperation.

In the East-Block countries no physical and human capital was destroyed in 1990. But the new market economies are nevertheless doing quite poorly. The drop in real GDP was about 40% at its peak - in the mid 1990s, and today only Poland, the Czech Republic and Hungary are well under way.<sup>36)</sup> Most projections suggest that it will take at least another decade for Russia to reach the pre-1990 income level, and in the meantime Russia has moved toward the position as one of the world’s most corrupt societies (see Levin & Satarov, 1999). Mafias are powerful as in the South of Italy, and politics take strange forms. The absence of trust and the rapid growth of the grey/black sector of corruption and crime worsened transition and created a truly Hobbesian anarchy.

If social capital is the glue holding together society in the absence of third party enforcement, a country without social capital will collapse dramatically if the enforcement system weakens. Social capital



theory therefore provides a powerful explanation of the size and the speed of the collapse that occurred in Russia around 1990. To find data allowing a test of the explanation is obviously a difficult job.

### *t.3 The deep gloom of Putnam's perspective*

The use of markets and free-trade rather than centrally-planned economy leaves room for beneficial voluntary organizations and entrepreneurship. This move also makes it harder for harmful rent-seeking interest groups to redistribute to themselves, because definition and enforcement of property rights will be simple and clear-cut.<sup>37)</sup> So, the new market-institutions will probably build social capital in the economies under transition from socialism.

However, in his study Putnam repeatedly stresses the long time horizons necessary to build civic society - the Soviet experience seems to confirm this impression. Putnam's proposal is that it takes a couple of centuries to build social capital - when starting from a low level. Applying this perspective to the new Russia gives predictions that are bleak indeed. Our analysis is bleak also, in suggesting that social capital building is a social process where the government needs a light touch.<sup>38)</sup>

Perhaps we can see that Putnam's long time horizons are supported also when it comes to the eradication of social capital. One can point out that short campaigns as the Cultural Revolution in China did not accomplish very much. The eradication has been most successful in Russia, where social capital was probably never large and the totalitarian regime was strongest and lasted longest - it came to exceed the lifetime of all but few of the population.

## **6. Concluding remarks - the dilemma of social capital**

We started our essay by pointing out that there is a lot of smoke smelling like social capital. The discussion showed that there might be some fire behind the smoke. The newest empirical research (IBRD, 1999a & b) is promising in this report.

Social capital can matter for production in three ways: (i) As a factor of production parallelize physical capital and human capital, and as a determinant of (ii) transaction costs or (iii) monitoring costs. We have also discussed the possibility that social capital is formed by processes with discrete equilibria, with nice quasi-static properties as development models. That is, there may be low and high growth equilibria as in the North and South of Italy.

Three types of measurement have been discussed: (i) Experimental economics might measure social capital as the frequency with which people cooperate in prisoners' dilemma games. (ii) A direct measure uses a *loan question* of the type: How many of the people, you know best, would you lend to or could you borrow from? Finally, we turned to (iii) Putnam's Instrument: the density of voluntary organizations. If social capital is as important as suggested, experiments with measurement techniques are crucial.

Our main aim was to discuss how policies can change social capital. This discussion was based on casual empirical evidence (in the absence of measurement). One example looked at cooperative movements. Another example dealt with the concept of "missing entrepreneurial skills" which in many cases could be confused with "low social capital". The second formulation has rather different policy implications. Also, the concept of "institution building" in connection with development projects was discussed.

Our main example dealt with the former communist society. We presented a story of a large-scale

deliberate extermination of the “old” social capital during the soviet period. When the central enforcement apparatus crumbled in the late 1980s, new market economies appeared without the crucial component of social capital. This story is potentially powerful in explaining the size and the speed of the collapse and the slow recuperation of the new economic systems.

A key theme in the essay has been the voluntary nature of social capital versus third party enforcement. Social capital is enforced by people themselves. This brought us to the question of policy. If social capital is as important as some of our arguments suggest, there is substantial benefit from a policy increasing it. That is, if the government can do something helpful. Here there is a dilemma:

*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.*

We have noted several examples where this has clearly been the case, but we have also seen examples where government interference has helped - or at least not been harmful - social capital. Future research may reveal the optimal mix between self and third party enforcement.

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## Netsource

IBRD Social Capital homepage: <<http://www.worldbank.org/poverty/scapital/index.htm>>. Most IBRD papers referred to are available from this homepage.

## Notes:

1. Section III on measurement (A1) is placed after Section II on theory (A2). Normally theory and measurement develop in a simultaneous way. However, it is easier to give a systematic exposition starting with theory.
2. Also, in the same vein: In discussions of economic development it is often said that "what really matters is culture". Some look wise and profound when they say so, while others lift their hands in despair. Those who have tried to formalize "culture" into one (or a few) operational concepts have (till now) been rather unsuccessful.
3. Two large social capital projects at the World Bank (IBRD, 1999a & b) are both in their final stages. They provide a large amount of micro data. See also Woolcock (1998) and Grootaert (1996).
4. However, Bourdieu & Passeron (1970) used a concept of *cultural capital* in a related sense, when analyzing the process of learning, and later *social capital* (see Loury, 1977, and Bourdieu, 1984, 1986) as a generalized concept of the goodwill/credibility of the individual.
5. The confusion is thus double: related, though different, concepts have the same name, and also different names. The confusion exists even within the same field, but when social scientists from different tribes communicate on the matter, it is hard to prevent some double Dutch from cluttering the discussion.
6. The other social sciences used to claim only the land beyond the pale of rationality, but the imperialistic adventure

of economics has moved the pale so far into sociology and politology that these tribes are now quickly embracing rationality, as their own long lost brother now happily rediscovered. The concept of social capital is partly another attempt to extend rationality. However, sometimes religious and moral movements do manage to change values in society in ways that are both important for social capital and difficult to deal with within economics.

7. Similar ideas are found already in Aristotle, observing the Greek polis, founded this way of viewing man's behavior as social and pursuing common interest in the 4th century B.C. Another well-known example is that of Karl Marx' class theory in which all individuals, due to class, voluntarily organize to act in their common interests. Rousseau-like ideas are also found in the *Arusha Declaration* of 1967, defining the ideology of the ruling party of Tanzania - parts of the story told in IV.1 can be seen as an attempt to return to the original state.
8. Note that trust is a *public* good, unlike human and physical capital which are (often) private goods. Traditional Eskimo society had little in the form of social superstructure, so no third party existed to enforce anything; but the society needed a lot of social capital to function. However, social ostracism was a mortal threat, and it also happened that people, who broke the implicit or explicit rules of the society, did not return from a hunt.
9. One may also add *natural capital* for the stock of natural resources. It depreciates by use and might be destroyed. It is not a produced capital, but it increased by new discoveries and technical progress.
10. One part of human capital is produced as learning by doing. It is a fairly close parallel to social capital in the sense of being a byproduct accumulated by activities serving another purpose. Note, however, that the learning-by-doing component of human capital tends to be disregarded in empirical studies.
11. Note that it is easier to make a system a savings banks in a society where a network of, eg, football clubs already exists, and where, consequently, some people are known as trustworthy.
12. Formulation (3) might include the role of  $\Omega$  as a factor determining both transaction and monitoring costs. However, while it is natural to imagine that transaction costs are proportional to the number of transactions, it is not obvious that monitoring costs are.
13. This is probably too optimistic:  $(Q)$  is likely to have a curvature, so that linear approximation only works within a narrow range for the variables.
14. In experiments where standard (Hobbesian) theory predicts a certain amount of free riding the empirics consistently show that the amount is less. See the broad survey of the results of experimental economics by Schram (1998) or the study of social capital related experiments by Winden, Dijk & Sonnemans (1999).
15. We have been told that such experiments are actually well under way.
16. The reader may here recall the reference to Bourdieu (1984), operating also with personal social capitals.
17. This is surely a type of question where it is difficult to obtain true answers. The reader may also consider the wallet test - how many lost wallets are given back to the owner? This fraction is known to differ from almost 1 in Singapore to almost zero in many other places.
18. The voluntary organizations referred to by Putnam (1993) are: neighbourhood associations, choral societies, cooperatives, sports clubs, mass-based parties, tower societies, mutual aid societies, literary societies, guilds, unions.
19. Putnam's original evidence has been further explored in Helliwell & Putnam (1993), and by the 6 authors contributing to the special issue of the *American Journal of Political Science* 40 (3): 607-716. See also the negative outcome of the tests by Knack & Keefer (1997).
20. With such a questionnaire and all manuals written a locally experienced team of 5-10 interviewers could probably measure the social capital in a local area in less than a week at a cost of \$ 2 - 3.000.
21. It is interesting to contemplate that Denmark was one of the most feudal societies in Europe in the 18<sup>th</sup> Century, with an income distribution that was probably much skewer than anything known in the world today. Danish economic history is written up mostly in Danish, but a survey in English is found in Paldam (1991).
22. The first cooperative saving schemes were started already in the 1820s by idealistic big landowners of Holsten origin, who had read (in their native language) about such "banks", which had been started in SW Germany. Basically these banks were circles of the most reliable people in the village. They met and received savings, which were at first

- invested by the landowner, but later they used the money to lend to other people in the village. Many of the new Micro Credit Programs use the similar, but contemporary, Grameen Bank in Bangladesh as the model.
23. Here the point about made in III.2 about a divergence between the trust among people and peoples trust in the government becomes pertinent.
  24. Most of the documentation is found in reports from donor agencies. Paldam (1997a) gives references to published sources - and reports on a study tour covering the cooperative sector in Tanzania in the summer of 1996.
  25. The parallel is striking, though perhaps not fully deliberate. For some years there were even forced collectivization in Tanzania, but the bloodshed was much more modest than in Russia in the late twenties.
  26. There are reports, however, that the external support has been excessive and a problem. When presenting this paper, we have been informed of other cases where third part enforcement has helped developing cooperatives, but it appears that no systematic collection of the evidence exists.
  27. There is a marked difference between the widespread entrepreneurial activity in (most of) Africa and in, eg, Greenland, where the economic system is strongly detrimental to all such activity, see Paldam (1997b).
  28. Maybe the owner has a couple of brothers or sons whom he trusts, but the number of competent members of the close family determine the maximum size of the firm. Part of the problem is the simple one of honesty, another part is the complex one of delegation as analysed, eg, by Letterie & Swank (1997).
  29. This section is based on Paldam (1997a) - a study of 37 development projects in 9 countries. The projects were visited and reassessed five years after they were declared completed and formally handed over to the donor country.
  30. This is a bit like the *paradox of gifts*: Once received they ought to be as good as any other income. Rationality demands that people look ahead, not back. However, we all know that people care much more about things that have been acquired by hard work.
  31. Putnam also points to the “stiffness” of hierarchy when explaining the difference in density of voluntary organizations. The North and South of Italy started on divergent paths back in the eleventh century when the South was subjected to a hierarchical Norman kingdom, which systematically reduced the amount of trust people could have to each others and to their leaders. Ordinary people and leaders were not interacting socially and voluntary organizations were regarded with distrust, so little social capital was built. So, the South experiences the Hobbesian outcome of amoral familism, clientelism, lawlessness, ineffective government, and economic stagnation (Putnam, 1993: 180-83). The solution would then be to scale down the role of hierarchical state intervention so to avoid this “southern deadlock” and thereby leave room for voluntary organizations (see Tanzi, 1996:176).
  32. Once more, we are dealing with a large literature. A fine synopsis of the official ideological handbooks from the 1950s and early 1960s has been published in Fleisher (1965).
  33. Historians will probably discuss how many the system killed for a long time, but the range is between 10 and 30 mil, while 2-3 times as many were jailed for non-criminal reasons, see Conquest (1968) for the standard estimate.
  34. A main theme in the great Russian literature has always been the “Russian Soul”, and how much it differs from the one of the “West”. It is often alleged that the main difference is that the Russian needs and loves a “strong hand”, and can be ruled only by such a hand.
  35. The soviet take-over was mostly from regimes set up by the Nazis that had already destroyed a great deal of civic society.
  36. A complex story might also be told of the late DDR. It turned out to be much more difficult and expensive to absorb into Germany than expected. The explanation given is normally the one of the bad competitiveness generated by the 1:1 exchange rate when the East-Marks were converted to West-Marks. However, the DDR system was one of the most totalitarian in the East Block, and it came on the top of the 12 years of the Nazi Regime, so perhaps the shortage of social capital should be considered as an alternative explanation.
  37. Olson (1982) argues how harmful, rent-seeking groups accumulate over time and destroys economic growth in society - several cases studies (as Svendsen, 1998, 1999) have applied this framework.
  38. Some evidence suggests the possibility of good circles especially as regards trust in governments. That is, govern-

ments that privatize and create economic growth benefit from increased credibility, making further development and reforms easier (see Gros & Steinherr (1995) and IBRD (1996)).