*Iberoamericana. Nordic Journal of Latin American and Caribbean Studies*
Vol. XXVIII: 1-2 1998, pp. 209-221

# SOCIAL CAPITAL AND ECONOMIC POLICY

*Karl Theodore*

## I. INTRODUCTION

There is no question that social capital has emerged as one of the key concepts in discussions of social and economic development today. On the one hand, it is seen as an important ingredient in bringing about the required amount of physical investment, appropriate technology and human capital to boost the process of economic development. On the other hand, it is being seen as one of the vital instruments of rehabilitation and reconstruction in dealing with the social problems of both urban and rural communities. Given the renewed interest in the concept, it is important for economists to be able to make the link between this concept and the key economic variables which are in fact the subject of the major part of policy making in the modern world. We must have a clear sense of the mechanisms through which social capital affects production on the one hand, and welfare on the other. It will also be useful to know how social capital figures in the familiar trade-off between efficiency and equity. In this context it is appropriate to begin with a discussion of the usage of the term 'social capital'.

## II. MEANING OF SOCIAL CAPITAL

In a recent paper on the subject, Robert D. Putnam (1993) began with the following quotation from one of the essays of the British philosopher, David Hume:

> Your corn is ripe today; mine will be so tomorrow. 'Tis profitable for us both, that I should labour with you today, and that you should aid me tomorrow. I have no kindness for you, and know that you have as little for me. I will not, therefore, take any pains upon your account; and should I labour with you upon my own account, in expectation of a return, I know I should be disappointed, and I should in vain depend upon your gratitude. Here then I leave you to labour alone; you treat me in the same manner. The seasons change; and both of us lose our harvests for want of mutual confidence and security (Putnam, 1993).

doi:https://doi.org/10.16993/ibero.272

As Putnam went on to say, there is really nothing new in the predicament of the farmers in Hume's little story. Moreover, it is not that people who behave in this manner are irrational, or evil, or plain stupid. What we see here is a similar situation to that of the prisoner's dilemma: for want of cooperation and lack of trust both parties lose. This is the context in which the social sciences have reinvented the concept of 'social capital'. To quote Putnam once more;

> By analogy with notions of physical and human capital – tools and training that enhance individual productivity – "social capital" refers to features of social organization, such as networks, norms, and trust, that facilitate coordination and cooperation for mutual benefit. Social capital enhances the benefits of investment in physical and human capital (Ibid.).

In similar vein, Eva Cox in discussing her suggestions for raising social capital in Australia defined it as;

> the store of trust, goodwill and cooperation between people in the workplace, voluntary organizations, the neighbourhood, and all levels of government (Cox, 1995).

In her view the amount of social capital accumulated is itself an indicator of the health of communities and of nations:

> Social capital is as vital as language for human society. It enables us to build a strong active civil society, it makes democracy work, and it leads to better economic outcomes.[1]

For us in the Caribbean the tendency has been to define social capital by reference to its loss to us in several areas of social life. For example, it has become common place to point to the changes in the structure of our family system – in particular the continuing disappearance of the extended family – as being a major loss in social capital (Caribbean Group for Cooperation in Economic Development, 1996). We also point to reduced status of key people like teachers and midwives within their respective communities as a definite loss in social capital (PAHO, 1997). Finally, of course, we point to the waning of informal financial mechanisms like '*sou-sou*' or 'lend-hand' as one of the reasons why small business people are finding it so hard to cope.

The purpose of this paper is to explore ways whereby public policy – in particular, economic policy – could foster the building up or the restoration of social capital and to indicate how social capital considerations should impinge on the many social sector reforms now taking place. In the face of sluggish economic growth, deepening poverty, a stubborn unemployment situation, a rising incidence of crime, and the sense of powerlessness that threatens most societies today, there is no question that the stage is set for a major new approach to the social and economic problems at hand. The issue is that while in a general sense most people will agree on diagnoses which amount to a loss of social capital, there is certainly less agreement on how this loss might be addressed by policy makers. As Wehlage puts it;

> Social capital adheres in the set of relationships among people and those relationships are productive to the extent that they are based on a common set of expectations, a set of shared values, and a sense of trust among people (Interview with Wehlage, 1996).

As interested as we may be in the value of the concept of social capital, it is admittedly an elusive concept, and certainly more elusive than our concepts of physical or human capital. Social capital does not come into being from the amount of knowledge or the amount of money that any individual possesses. It is essentially a product of relationships. In a sense, since it certainly reflects our expectations it is what makes our utility functions what they are. Since the concept of social capital usually includes a notion of 'reciprocity', it is probably more correct to speak in terms of 'expected utility functions'.

Moreover, since the notion of trust suggests that the individual producer may be able to get more output from the use of the same inputs, the parameters that surround production take a different set of values in the presence of more rather than less social capital. The first consideration is therefore how to portray the social capital modifications in our utility and our production functions.

Before moving to this stage it may be useful to consider why the link between economic policy and the social capital concept may not be readily made. There are at least three reasons:

- The first concerns the 'measurability' of social capital. Is it appropriate to use outcomes as an index of greater or lesser social capital?
- The second is the ambiguity in the presumed 'relationship between social capital and other forms of capital'. Is it more one of complementarity or one of substitutability?
- The third reason concerns 'the potential of social capital to have unwanted influence on welfare and production'. Are there social costs attached to the expansion of social capital?

The paper will now briefly seek to address each of these concerns.

## III. MEASURABILITY OF SOCIAL CAPITAL

The main point that needs to be made is that the possible difficulties in measuring social capital do not by themselves reduce the value of the concept to economic planning and policy. In economics, we are familiar with the use of unobservable quantities at the initial stages of analysis mainly for purposes of understanding basic relationships. Once the fundamentals are clear we normally resort to the use of proxy variables to carry out our empirical analyses. Moreover, even when we begin with entities that are measurable in principle, we usually need to make use of a number of conventional arrangements in order to arrive at final results. In this connection, our measures of capital itself, or of inflation, or even of growth are all the subject of conventions.

In the case of social capital the first requirement is to determine just where in our economic modeling the concept is likely to arise. It would seem that there are two options.

One interesting way of looking at social capital is through the eyes of the individual participant in the labor market. Here, the utility function retains its traditional form but the constraint function will now include a social capital element. We therefore assume that the individual is maximizing utility, which depends on consumption, C, and leisure $L_e$, subject to an income constraint containing wage income, wL, and social income, rS. Here, r is the rate of return on social capital, S. Although the S itself is not immediately measurable we note at once the potential of social capital to relieve pressure on the labor market. The indirect utility function will take the form:

$$V = V(w, r;y) \tag{1}$$

Here y is the sum of wage and social income.

One advantage of this specification is that it provides us with a means of determining the demand for social capital, once we agree on an appropriate proxy variable for measuring the returns to social capital. Using Roy's identity will give us an expression of the form

$$Q_{SK} = - \partial V/\partial r/\partial V/\partial y \tag{1a}$$

Where $Q_{SK}$ is the demand for social capital. From a policy point of view this will indicate the volume of the investment needed to foster the generation of social capital.

It is obvious that with any lowering of labor market income, the same utility level can be maintained if the individual can rely more on his or her social capital. In this sense, the greater the potential to draw on social capital the less the incentive to seek labor market income. This is by no means a matter of work shirking since it may simply mean that it is now easier for the individual to earn income in other ways – probably through informal activity.

A second option for incorporating social capital into our economic analysis would be through the production function. In recognition of the familiar comment that social capital makes for greater productivity on the part of the individual or the enterprise we can begin with an aggregate production function having three capital variables – one for physical capital, K, one for human capital, H, and a third for social capital, S. The production function therefore takes the general form

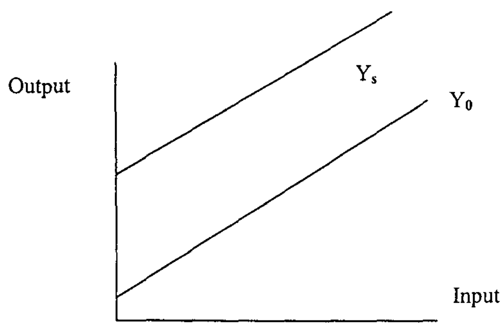
$$Y = Y(L, K, H, S) \qquad (2)$$

Moreover, since it is the productivity impact of social capital that most interests us we can treat its incorporation into the production function along the same lines as technology. In other words, the variable S, reflecting social capital can be interpreted as an argument that determines the size of the shift factor in the production function. We can therefore rewrite the expression in (2) as;

$$Y = A(t,S)F(L, K, H) \qquad (3)$$

Diagrammatically we can therefore portray the impact of social capital on output by way of a shift in the production. See Figure 1 below.

**Figure 1** - IMPACT OF SOCIAL CAPITAL ON PRODUCTION




In the diagram $Y_O$ represents the input-output relationship without the possible impact of social capital and $Y_S$ the same relationship under the influence of social capital. For simplicity, the input relationship is portrayed as being linear. Of course, the same differences can be portrayed using non-linear production relationships. In any case, it can be assumed that the diagram above speaks to a portion of a non-linear function which is approximated by the lines $Y_O$ and $Y_S$. What the above portrayal demonstrates is the possibility of measuring social capital as a component of the shift factors in the production function. In a context where we can assume that technological change is a predominant influence the measurement of social capital becomes simpler.

In order to portray the productivity effects of social capital, we can assume that the production function takes a form such that the stock of social capital available is positively related to productivity indicators, but through different mechanisms. The labor productivity, $\rho_L$ for example, could take the form:

$$\rho_L = \lambda_0 e^{\lambda(S)} \qquad \text{.......... ..........................................} \quad (4)$$

where the relationship between social capital, S, and labor productivity, $\lambda$, is assumed to be positive. That is $\lambda$ (S) > 0. On the other hand, the relationship between the productivity of capital, $\rho_K$ ,and the stock of social capital is mediated through the behavior of the depreciation rate, $\delta$. Here, we postulate that the relationship between the social capital and the depreciation rate is a negative one. This we portray by the capital productivity expression:

$$\rho_K = \delta_0.{*}e^{\delta(S)} \qquad \text{.......................................................} (5)$$

Here we have $\delta$ (S) < 0.

Taken together, what these assumptions jointly tell us that, if social capital forces are at work then the rate of depreciation and the productivity of labor should be inversely related. This is an empirical hypothesis which can be tested.

One interesting implication of this result is that moving to better and better technology is not the only way of improving the productivity of labor. In fact it can be argued that where social capital abounds the impact of obsolescence is postponed. If the same productivity result can be had from higher degrees of cooperation and trust there is no pressure to opt for the latest technology. Moreover, since much of what the latest technology does is to make certain forms of labor less necessary. The postponement of adoption eases the pressure on the labor market in a context where unemployment is already a matter of concern. The problem is how to deal with issues of trust and cooperation in an empirical manner.

By its very nature, there may never be a straightforward method of measuring the value of belonging to a certain family, or coming from a certain village, or attending a certain school, or being known as a reliable person. In a study of social capital in rural Tanzania, Narayan and Pritchett (1997) made use of a household survey to measure "trust and the extent and characteristics of associational activity". It was found that higher village social capital was associated with higher levels of individuals' incomes, even after taking into account education and physical assets. The evidence seemed to clearly show that social capital affects incomes through mechanisms like better publicly provided services, greater use of modern agricultural inputs, more community activity on roads, and greater use of credit in agriculture.

What follows from this type of study is that even when we cannot put a cardinal measure on social capital it is possible to unambiguously distinguish situations of higher levels of social capital from ones of lower levels. Of course, as Portes and Landolt (1996) have argued, there is always the risk of circular reasoning that comes from blurring the distinction between social capital itself and the benefits or advantages of social capital. However, so long as we remain aware that social capital is but one of the factors influencing welfare or production the chance of circular reasoning poses less of a problem.

Reference is sometimes made to the link between the stock of social capital and the generation of human capital on the one hand, and between the stock of social capital and the accumulation of physical capital, on the other. These two sets of links take us to the second main consideration of the paper: the nature of the relationship between social capital and other forms of capital.

## IV. Social Capital and Other Forms of Capital

We have already suggested that social capital cooperates with two other forms of capital, physical and human capital – in generating the output of the community and that of the nation. From a policy perspective, in a context where resources are scarce, it would be important to know whether social capital should be seen as complementary to or substitutable for physical and human capital. It was argued earlier that social capital can be taken to be substitutable for labor "in the latter's capacity to be a source of income". However, if social capital is substitutable for other forms of capital then what will be required is some knowledge of the efficiency relationship which holds between the different pairs of "capitals".

It can be taken as given that when an individual or society is facing severe constraints in respect of physical endowments, there is a tendency to rely more heavily on its non-physical assets – its brainpower and its social relationships, in particular. Translated into the terms of our present analysis, this means that the harder it becomes for a society to acquire physical capital the more it will seek to produce its output using its social capital. What this suggests is that the relationship between physical capital and social capital is really one of substitutability. In a period of structural adjustment, therefore, even as the society seeks to rebuild or to build up its stock of physical capital role of public policy is to foster networking among individuals and agencies, thereby developing and strengthening its social capital.

A similar argument can be made in respect of human capital. It seems safe to assume that regardless of his or her connections, if an individual possesses demonstrably superior human capital endowments, he or she will not really need a significant amount of social capital to make progress in life. On the other hand, for the individual with an average endowment of human capital the chances for economic and social advancement will greatly depend on the amount of social capital available to him or her. It would seem, therefore, that for a given level of accomplishment the levels of human and social capital required are inversely related. In other words, these two forms of capital are essentially 'substitutable'.

What this suggest is that the need for information clearing houses, the need for sharing of existing facilities across sectors, the need for reliability of social institutions must all become important criteria of government action. It can therefore be said that, the familiar call for governments to become more efficient in what they do and more conscious of the impact of their actions on other social agents is really a call for expanding the stock of social capital.

Coleman (1988:595-5120) has identified three crucial elements of the social capital generation system:

- trustworthiness of social relationships;
- information channels; and
- prevailing norms and the effectiveness of sanctions.

When families make the sacrifice to get their children to school or when taxpayers find that they must make contact with the health system, they expect that the services delivered will be of a certain quality. It is well known that one of the important influences on non-compliance is the quality of the service provided. If the government cannot be expected to keep its word, it will be difficult to make any long-term business projections.

The tremendous emphasis on information today has given new meaning to the Latin saying – *scientia potentia est* –knowledge is power. The role of public policy is therefore not merely to make relevant information widely available but to work on those factors that restrict the flow of information. In an age when small- and medium-size businesses have no choice but to look to export markets for their survival and growth, special emphasis must be placed on ensuring that these businesses have up-to-date information about potential markets and about the potential competition. Since acquiring the financial capital needed to provide this information for themselves may change the profitability status of their endeavors, there is a clear need to provide at least the Internet access that these businesses must have. The pool of information that thus becomes available will contribute to expanded outputs even in microenterprises with a modicum of physical capital.

Turning to norms and sanctions, the point needs to be made that the value of social capital will evaporate if public policy tolerates deviant behavior for narrow political interest. What this means is that transparency and fairness must characterize public policy. Government departments simply cannot condone the non-payment of taxes, for example. Government departments simply cannot share privileged information in a way to give special individuals or groups unfair advantage. It is widely acknowledged that deviance in informal financial arrangements imposes negative externalities on others and threatens the viability of emerging networks. It is more true that government-tolerated deviance will destroy the potential for social capital to make effective substitutions for human and physical capital. The fact that such deviance may itself be a product of networking raises the question of possible negative effects of social capital generation.

## V. Negative Potential of Social Capital

Portes and Landolt (1996) have pointed to three possible downsides to social capital expansion:

- the possibility of "unfair" exclusion from economic opportunities;
- the possible stifling of individual initiatives; and
- the possible gravitational pull of the community.

The danger of exclusion is one that will remain a serious one in plural societies. We tend to laud the way in which certain ethnic groups "support their own" and condemn the way in which other groups provide no such cover for their individual members. At the same time, however, we are very much aware that the tight control exercised by certain groups over access to financial or technical support for business purposes is also used to effectively exclude others. What is more, the exclusion is almost never done explicitly on the basis of ethnic difference. There is always a convenient rule or criterion which is employed for the purpose. In Portes and Landolt, examples abound. The dominance of certain ethnic groups in the construction industry is well known and in a sense tolerated by the authorities. The entry requirements are usually placed at levels known to be out of the range of some groups. What is more, even when members of the dominant group do not meet the requirements their connections with "inside" members is usually enough.

In some parts of the Caribbean, the claim has been made that certain elements of the financial sector have systematically applied different access rules to different sections of the population. True or not, this charge is not facilitated by the numerical dominance of certain groups in the financial sector of some countries.

The economic implications of this use of social capital can be very serious. Not only could it have a permanently negative impact on the distribution of income and wealth, but it could also restrict growth below its full potential. It is, therefore, important that relevant public agencies keep a watchful eye on this possible development. If social equity remains an important criterion of public policy this negative consequence of social capital generation will need to be kept in check.

A second possible unwanted consequence of social capital is the suppression it may impose on individuals. It is well known that one of the main advantages of small communities is that everyone knows everyone else. This works well when individuals need access to credit or some similar support. However, the same cohesion that provides this support is sometimes brought to bear on anyone who dares to be independent minded. The rise of family clans in some cities in the US has been attributed to this feature of social capital. In the Caribbean there are numerous reported instances of individuals being disinherited for marrying the "wrong" race of for giving up the family's traditional religion. Defying the group can have significant and painful economic consequences.

While it is difficult for public policy to intervene in these arenas it will certainly be useful if leaders at different levels refrain from the kind of public statements which give validity to these negative manifestations of social capital.

We now turn to the last of the three downsides of social capital – the possibility for groups to keep individuals from progressing. The example of street gangs and cults readily comes to mind. In a sense, the gang or cult is a manifestation of the type of bonding and social support that individuals actually need if they are to get ahead. Yet, when the gang or cult becomes the only means by which a young man or young woman experiences a sense of sharing or even self-respect, this is a clear case of social capital gone bad. What is more, any attempt to break away and try for self-improvement may meet with opposition and even violence. The pressure to stay with the group, the pressure to remain at a low level of life is very strong. In the words of Portes and Landolt;

> "The product of a long history of discrimination, these pressures ironically

> perpetuate the very conditions that the groups decry. In these instances, social capital does not increase human capital but prevents acquiring it" (Portes and Landolt, 1996:21).

## VI. Conclusion and Recommendations

From a public policy point of view, what is important is to know what are the instruments by which social capital can be expanded and what are the appropriate targets to which the social capital should be channeled. In this regard the suggestion in Gary Green (1996:4-5) - that 'entrepreneurship' be taken as the focus of the social capital interest of the government – is one that we too can seriously consider.

In a study which concentrated on the importance of social capital on entrepreneurship and small business development, the Green study highlighted the role of family businesses in the development of communities. In a sense, the relationship is a symbiotic one. The interdependence between the businesses and the communities, which house them, is a normal feature of socioeconomic life. In the case of family businesses, these are clearly not "purely individualistic-rational actors". In fact, they are "embedded in a web of social ties and relationships". While there may be an overall tendency towards inter-temporal profit-maximizing behavior, it is probably more realistic in the short-run to portray these businesses as maximizing a utility function where profits are being traded off against the generation of goodwill which posterity will inherit. Green put it as follows:

> Social relations are important in generating trust and discouraging malfeasance in economic transactions. The need to embed transactions in social ties explains why many businesses continue their transactions with others that they know even when they could cut their costs elsewhere (Green, 1996:4-5).

The point is further made that this link between social capital and entrepreneurship will become increasingly important as the process of globalization continues. With the devil-take-the-hindmost characteristic of the market ethic which drives the trend to globalization, the risk of being marginalized is multiplied if individuals and businesses operate without the benefit of the kind of network support which defines social capital generation. Taken to the national level, what this suggests is that cost minimization cannot be the single-minded purpose of public policy. While businesses must strive to surpass certain thresholds of efficiency, the need to encourage certain kinds of inter-business relations must also be taken into account. In economies already suffering from the lack of domestic inter-sectoral links, the role of communities in building up secure lines of production cannot be ignored. Moreover, the value of focussing the policy of generating social capital on family businesses is enhanced by the natural tendency of such businesses to take an intergenerational perspective on all decision-making.

One implication of this suggestion is that while there is undoubted merit in seeking to encourage "the widest possible participation" in business enterprises, this should not be done at the expense of the support that should be given to family businesses. Such businesses should be probably be given preferential tax treatment for the early period of their existence. In small countries like ours in the Caribbean, the family business is likely to be the most secure foundation of community development. The spillover effects on health and education, in particular, can be very significant. The incentive to keep the labor force in the best of health will not depend simply on the impersonal drive for increased productivity, but also on the familial ties which will permeate the communities. Similarly, the incentive to provide the best education and training for the young ones will be bolstered by the vision of the children and grandchildren carrying on in the profitable family tradition. In other words, 'the strengthening of family businesses is one way of ensuring a sufficient supply of human capital' - the software for the development process.

The hardware for development – the physical capital stock is also enhanced by fostering family businesses within a community development setting. In an interesting study of the savings process in developing countries, Angus Deaton (1989), made the bold claim that in the poorer countries of the world, where rural communities abound the motive for saving is not the accumulation of capital. By the very condition of the existence of these communities – and in particular, the uncertainty that surrounds their income flows - the primary motive for saving is for consumption smoothing. For our purposes, one important implication of this is that these communities will tend to find themselves in a vicious cycle of poverty since not enough saving will go towards physical capital accumulation. What this means, however, is that so long as the income uncertainty does not lead to simultaneous income reductions for all families in the community, the opportunity for one family to share in another family's harvest means that with the risk of starvation lowered more of the current surplus of the average family can be set aside for capital accumulation. In other words, here again cooperation works to the eventual advantage of the individual units participating. The degree of trust that is necessary here is no doubt a very high one. What is clearly implied however, is that 'the greater the degree of trust the greater will be the accumulation of physical capital'.

By a judicious use of the education system and other communication means, the public sector will therefore need to do all that is necessary to foster the building up of trust. Until the degree of trust begins to feed on itself, communities will need to be give appropriate incentives to pool and to share among themselves.

## References


Caribbean Group for Cooperation in Economic Development (1996), *Caribbean Regional Health Study.* Washington, D.C.: IDB and PAHO/ WHO .

Coleman, James S. (1988), 'Social Capital in the Creation of Human Capital'. *American Journal of Sociology*, Vol.94, Supplement, pp. 595-5120.

Cox, Eva (1995), 'A Truly Civil Society: Raising Social Capital': The 1995 Boyer Lectures. Radio broadcast. Australia: Radio National.

Deaton, Angus (1989), 'Saving in Developing Countries: Theory and Review'. *Proceedings of the World Bank Annual Conference on Development Economics*. Washington, D.C.: The World Bank

Green, Gary P. (1996), 'Social Capital and Entrepreneurship: Bridging the Family and Community'. Paper presented at the conference on the Entrepreneurial family – Building Bridges. Ithica, N.Y.: Cornell University.

Narayan, Deepu, and Pritchett, Lant (1997), *Cents and Sociability: Household Income and Social Capital in rural Tanzania*. Policy Research Working Paper no. 1790. Social Development and Development Research Group, Poverty and Human Resources. Washington, D.C.: World Bank.

Pan American Health Organization (1997), *Health Conditions in the Caribbean.* Scientific Publication No. 561. Washington, D.C.: PAHO.

Portes, Alejandro, and Landolt, Patricia (1996), 'The Downside of Social Capital'. *The American Prospect* No, 26 (May-June):18-21, 94. The Electronic Policy Network: [On-line]. Available: http://epn.org/prospect/26/26-cnt2.html.

Putnam, Robert D. (1993),'The Prosperous Community: Social Capital and Public Life'. *The American Prospect*, No. 13 (Spring).

Wehlage, Gary, G (1996), 'Community Collaboration and Social Capital: An Interview with Gary G. Wehlage'. Interview by Anne Turnbaugh Lockwood, University of Wisconsin, Madison (January).