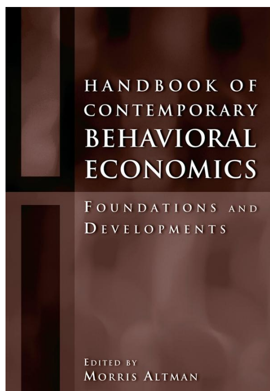
This article was downloaded by: *10.2.97.136*
On: 28 Mar 2023
Access details: *subscription number*
Publisher: *Routledge*
Informa Ltd Registered in England and Wales Registered Number: 1072954 Registered office: 5 Howick Place, London SW1P 1WG, UK



Handbook of Contemporary Behavioral Economics Foundations and Developments

Morris Altman

Insufficient Social Capital and Economic Underdevelopment

Publication details
https://test.routledgehandbooks.com/doi/10.4324/9781315703879.ch33
Hamid Hosseini
Published online on: 15 Jul 2006

How to cite :- Hamid Hosseini. 15 Jul 2006, *Insufficient Social Capital and Economic Underdevelopment from:* Handbook of Contemporary Behavioral Economics, Foundations and Developments Routledge
Accessed on: 28 Mar 2023
https://test.routledgehandbooks.com/doi/10.4324/9781315703879.ch33

PLEASE SCROLL DOWN FOR DOCUMENT

Full terms and conditions of use: https://test.routledgehandbooks.com/legal-notices/terms

This Document PDF may be used for research, teaching and private study purposes. Any substantial or systematic reproductions, re-distribution, re-selling, loan or sub-licensing, systematic supply or distribution in any form to anyone is expressly forbidden.

The publisher does not give any warranty express or implied or make any representation that the contents will be complete or accurate or up to date. The publisher shall not be liable for an loss, actions, claims, proceedings, demand or costs or damages whatsoever or howsoever caused arising directly or indirectly in connection with or arising out of the use of this material.

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

CHAPTER 33

INSUFFICIENT SOCIAL CAPITAL AND ECONOMIC UNDERDEVELOPMENT

HAMID HOSSEINI

Behavioral economists have leveled numerous objections to the narrow focus of neoclassical economics. Among these objections are (1) that conventional economic theory is not always consistent with the accumulated body of knowledge in disciplines such as psychology, sociology, anthropology, and organization theory, (2) that its assumptions are simplistic and unrealistic, in that it deduces its principles from features of human nature assumed to be constant and valid regardless of differences in time and space, rather than explaining economic phenomena on the basis of actual observed behavior, and (3) that it accepts the simplistic economic model of rational agents exhibiting optimizing behavior rather than more realistic behaviors such as the ones assumed by Simon's bounded rationality model (Hosseini 2003, 394).

In recent decades, behavioral economists have tried to make economics consistent with psychology. The granting of the Nobel Prize in economics to Herbert Simon in 1978 and to other behavioral economists more recently is an indication of their success in this effort. Behavioral economics (and thus economics as a whole) can benefit from the concept of social capital often used by sociologists and political scientists. In fact, various economists have already utilized social capital in their economic analysis during the last decade or so. Jeffrey Dayton-Johnson's 2003 paper in the *Journal of Socio-Economics* can even be regarded as an attempt to incorporate the concept of social capital into a behavioral economics model.

Defined by Robert Putnam as "features of social organization, such as trust, norms, and networks, that can improve the efficiency of society by facilitating coordinated action" (1993, 302), social capital has in fact a great deal of relevance to behavioral economics. With indirect roots in the works of Adam Smith and the institutionalists, social capital is a paradigm that is capable of bridging various social sciences. However, the utilization of social capital in economics, predictably, has been resisted by various economists, including Nobel laureates Kenneth Arrow and Robert Solow. While some economists have objected to it for the use of the capital metaphor, others have opposed it because of the difficulty of its measurement, and still others (i.e., neoclassical economists) have opposed its utilization altogether (finding it irrelevant to economics discourse).

In spite of these criticisms of social capital, and regardless of what we name it, I believe this concept can be useful in explaining economic behavior in both developed and less developed economies. I believe it is particularly useful and relevant in discussing the problem of underdevelopment, for development and its absence are closely linked to the behavior of individuals and the institutions human beings create. While both developed and less developed economies may lack an optimal amount of social capital, its deficiency is particularly pronounced in less advanced economics. Drastic changes in the less developed countries (LDCs) in the last century—

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

such as the breakdown of traditional social structures, the rise of excessive bureaucracy, and the emergence of unpopular and unaccountable governments—diminished traditional elements of social capital, and the replacement elements needed for modernization and economic development were not fully developed. The absence of needed elements of social capital in these countries helped to perpetuate poverty and underdevelopment. Assuming the relative deficiencies of markets and the government in achieving development in recent decades, I will argue that social capital can play two important roles in the process of development. On one hand, social capital can be explained as a complement of physical and human capital in the process of economic development. In this function, social capital, I will argue, can serve as a social glue complementing other forms of capital in the process of development. "The latest equipment and most innovative ideas in the hands or mind of the brightest, fittest person, however, will amount to little unless that person also has access to others to inform, correct, assist with, and disseminate work. Life at home, in the boardroom, or on the shop floor is both more rewarding and productive when suppliers, colleagues, and clients alike are able to combine their particular skills and resources in a spirit of trust, cooperation, and commitment to common objectives" (Woolcock 1998, 154). On the other hand, social capital can play a second role in the process of development: it can overcome the failures of markets and the government in the process of development, since the simultaneous failures of those institutions are, to a large extent, attributable to insufficient levels of social capital. A healthy dose of social capital can provide this missing link.

Before discussing these dual functions of social capital in the process of development, I will describe, as a critique of recent theory and practice of economic development, the evolution of the roles of physical and human capital in development economics. This critique requires a discussion of the shortcomings of the Harrod-Domar model (and similar models) of development that utilized human capital. While both physical and human capital are necessary, my contention is that policies based on these models alone are not sufficient to produce sustainable development. This section will be followed by a discussion of the use of social capital in economics, and the criticism leveled against it. Finally, after discussing the failures of both markets and governments in the process of development, I will discuss the use of social capital in overcoming the shortcomings of markets and governments. I will demonstrate that the absence or deficiency of the elements of social capital (such as trust among individuals and between individuals and agencies) is a major cause of economic backwardness in the less advanced countries. Assuming that the inadequacy of social capital in less developed economies is rooted in the undesirable policies of unaccountable (and often foreign-imposed) governments and the breakdown of traditional social structures and their replacement by weak and unstable social institutions and civil society, I believe social capital can be enhanced. The essay will end with a presentation of the ways social capital can be enhanced.

EXAGGERATING THE ROLE OF PHYSICAL CAPITAL IN EARLY DEVELOPMENT LITERATURE

Before World War II, the economics profession had ignored the less advanced economies, that is, the poor underdeveloped economies outside Europe and North America. Paul Rosenstein-Rodan's 1943 *Economic Journal* article, "Problems of Industrialization in Eastern and South-Eastern Europe," is said to be the first work dealing with underdevelopment but, as its title suggests, did not deal with poor non-Western societies. The extent of this neglect becomes obvious if one reads the 1938 League of Nations World Economic Survey. This report, prepared by the future Nobel Prize winner James Meade, had only one paragraph about Latin America and nothing whatsoever about

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

Asia and Africa (Arndt 1987, 33). Development economics is essentially a post–World War II phenomenon.

Influenced by Stalin's industrialization policy, the solutions provided for the Great Depression, and the Marshall Plan, early development economics essentially emphasized physical capital as the factor of production causing economic development. In doing so, these writers ignored the behavior of individuals and institutions in the less advanced countries. Early development economists had observed that the Marshall Plan, which financed the reconstruction of infrastructure and physical capital in Western Europe that had been destroyed by the Second World War, led to a quick recovery of Western European economies. "By analogy, it was assumed optimistically that, with decolonization, a similar injection of finance into developing countries would lead to their rapid economic development" (Adelman 1999, 3). In fact, the World Bank, the International Monetary Fund (IMF), and bilateral foreign assistance programs had all followed the proposition that, in these countries, physical capital was the only thing missing (ibid., 4), not realizing that physical capital needs to be complemented by both human and social forms of capital. This physical-capital-centered view was the basis of Rodan's big-push argument, and explains why Arthur Lewis wrote: "The central fact of economic development is rapid capital accumulation" (1954, 139). It is no wonder that many development approaches were predicated on the (investment-based) Harrod-Domar model, that Rostow's stage of takeoff (i.e., the stage requiring the most amount of physical capital/investment) received the most attention, that in the Sawan-Solow model growth reflects the use of physical capital and technology, and that human capital did not even play a role in these models. Interestingly enough, this one-dimensional notion of development continued for a long time. Development economists did not realize that a great gulf (that far exceeds the endowment of or access to physical capital, and which includes social capital) separated countries such as Germany and the poor LDCs.

The popularity of the Harrod-Domar model in the early years had to do with its simplicity, that is, the exaggerated role of physical capital (i.e., investment) in the process of development. In spite of its lack of success, that popularity did not end for many years. As William Easterly writes, "The Harrod-Domar growth model still lives in many international organizations. Over 90 percent of country desk economists at the World Bank use some version of this model in their projections" (1997, 12).

With the utilization of this model, many incorrect projections were made about the prospects of development in the LDCs. It is no wonder that Kamarck's 1967 book about African economic development, *The Economics of African Development,* was very optimistic about the prospects of economic development in sub-Sahara Africa. To him, the abundance of mineral resources in these countries provided them with the opportunity for high savings, investment, and development. Development economists such as Kamarck, while ignoring the roles of human and social capital, should at least have realized that there are serious absorptive capacity constraints to high investment in poor countries, and the injection of extra capital in those countries is subject to sharply diminishing returns.

HUMAN CAPITAL AND DEVELOPMENT ECONOMICS

The theory of human capital was developed by two Nobel laureates, Theodor Schultz and Gary Becker, in the 1960s and used by later development economists. However, it is interesting that the importance of what we now call human capital to economic development had been acknowledged previously by Simon Kuznets (another Nobel laureate in economics), who suggested that a nation's degree of growth (development?) requires not only physical capital but also "the body of knowl-

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

edge amassed from tested findings and discoveries of empirical science, and the capacity and training of its population to use this knowledge effectively" (1955, 39).

According to Schultz, a society's endowment of educated, trained, and healthy workers determines and enhances the productivity of physical capital. This suggests that society should invest in its citizens through expenditures on education, training, and research. "Capital goods are always treated as produced means of production. But in general the concept of capital is restricted to material factors, thus excluding the skills and other capabilities of man that are augmented by investment in human capital. The acquired abilities of a people that are useful in their economic endeavor are obviously produced means of production and in this respect forms of capital, the supply of which can be augmented" (Schultz 1964). That is to say that education helps individuals fulfill and apply their abilities and talents. Education and training increase productivity. In fact, as argued by George Psacharopoulos and Maureen Woodhall, the average return on education and human capital is higher than that of physical capital in the LDCs (particularly for primary education) (1985, 21–22).

On the basis of the above, one can argue that low endowments of human capital would constitute a primary obstacle to economic development. In other words, human capital can help to realize the economies of scale inherent in the process of development/industrialization.

While Schultz and Becker developed the concept of human capital in economics, Chicago economist and Nobel laureate Robert Lucas applied it to growth and development. Lucas (1988) tried to argue that while physical capital by itself is subject to constant returns, it would be subject to increasing returns when it is combined with human capital. As Lucas (1988) and Romer (1994) have demonstrated, the productivities of both physical and (raw) labor would be magnified by a factor that reflects the level of human capital. They have demonstrated that when human capital and knowledge are low, economic growth too would be characterized by low degrees of economies of scale. To them, low human capital and knowledge are conductive to low productivity and growth rate (and a stationary state that leads to low per capita income levels). In contrast, however, if human capital and knowledge are high, economic growth would be subject to increasing returns to scale, which corresponds to high factor productivity and a high growth rate (and a stationary state that leads to high levels of per capita income). According to this line of thinking, investment in human capital and knowledge are therefore all that governments must do to propel developing countries from a low-growth trajectory to a high-growth one (Adelman 1999, 4).

Of course, human capital and knowledge, although necessary for productivity and growth, may require more to be effective in bringing about economies of scale than what is implied. For example, nonprice barriers (and an insufficient degree of social capital) might prevent the smooth transfer of resources necessary to take advantage of potential economies of scale, even if human capital is not in short supply. Insufficient social capital may also lead to missing markets, in particular for capital, preventing investment activities needed for the realization of potential scale economies.

SOCIAL CAPITAL AS CAPITAL

Social capital has been defined in different ways. As a result of this diversity of definitions, Joseph Stiglitz argues, it is "a concept with a short and already confused history" (2000, 59). A good definition is provided by Richard Rose: "social capital is defined as the stock of formal or informal social networks that individuals use to produce goods and services. In common with other definitions, this emphasizes that social capital is about recurring relationships about individuals" (2000, 149). Without using the term, Douglas North discusses the importance of social capital in

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

economic history and economic development: "In the modern Western world, we think of life and the economy as being ordered by formal laws and property rights. Yet formal rules in even the most developed country make up a small (although very important) part of the sum of constraints that shape choices. In our daily interactions with others, whether within the family, in eternal social relations or in business activities, the governing structure is overwhelmingly defined by codes of conduct, norms of behavior, and conventions" (quoted in Rose 2000, 150).

Nobel laureate economist Robert Solow finds it misleading to use the term *capital* to refer to what is usually called *social capital,* because capital is typically identified with tangible, durable, and alienable objects, such as buildings and machines, whose accumulation can be estimated and whose worth can be assessed (Solow 1995, 2000). However, social capital more closely resembles knowledge and skills. So if, as the case of human capital suggests, economists have not "shied away from regarding knowledge and skills as forms of capital, we should not shy from its use in the case of social capital either" (Dasgupta 2003, 4). Kenneth Arrow (2000) urges the abandonment of the capital metaphor and thus the term *social capital,* emphasizing that the term *capital* implies a deliberate sacrifice in the present for future benefits that he claims is inappropriate to describe elements of social capital. I agree with Robison, Schmid, and Siles that "social capital may indeed involve a saving and investment today to obtain future benefits and Arrow's objection seems misplaced" (2002, 7). Baron and Hannon (1994) criticize the social capital metaphor, arguing that to qualify as capital an entity must possess an opportunity cost, something that social capital lacks. However, Robison, Schmid, and Siles argue that people can also make deliberate, hence costly, efforts to increase their social capital (2002, 8, referring to Woolcock 1998, 46). Even institutional economists find social capital problematic. "Institutional economists have long argued that social relationships involved in habit, custom, norms and law make a difference in the realization of the potential in physical goods and human skills. But a new name extending the capital metaphor is not needed to describe the institutions of collective action" (Schmid 2002, 747). Notwithstanding the merits of these arguments against the use of capital metaphor, it is perhaps too late to change it: "Arrow's recommendation that the term social capital be abandoned comes too late. The calves are out of the barn and into green pastures and not likely to return soon. The term social capital is now firmly entrenched in the language of social scientists" (Robison, Schmid, and Siles 2000, 7).

Many writers argue that several essential properties of physical capital also exist in social capital: transformation capacity, durability, flexibility, substitutability, decay, reliability, opportunities for investment, and alienability. According to Robison, Schmid, and Siles, "social capital," as they define it, "shares all of these essential capital-like properties" (2000, 9).

INSUFFICIENT SOCIAL CAPITAL: AN OBSTACLE TO DEVELOPMENT

Let us begin by providing a few concrete examples demonstrating that, as a result of the differences in the endowment of social capital, countries, regions, or cities that are similar in their endowments of physical and human capital can achieve very different levels of economic growth and development. In other words, social capital is an essential complement of the other two types of capital.

For example, on the basis of various papers published by the World Bank (Dasgupta and Serageldin 2000), and a 1996 paper by Joseph Stiglitz, we can attribute the economic success of East Asian countries partly to the abundance of social capital in those countries. As another example, after the 1991 fall of Somalia's government, civil disorder prevailed and income declined throughout the country, but the port city of Boosaaso was an exception—because of the efforts of community leaders and clan elders to bring about order, trade in the city flourished and income

improved (Grootaert 1998, 1). Putnam (1993) demonstrates that the differences in the levels of development in northern Italy and southern Italy are due to differences in the endowments of social capital in those two regions. Putnam also discusses the case of Gujarat India, where community mobilization and joint efforts ended violent confrontations over the way forests (a source of export income) were managed, leading to the growth of income and the end of economic crisis for the residents of Gujarat.

Among the less advanced nations seeking development and industrialization, there are those that do not suffer from the absence or inadequacy of physical as well as human capital. However, in these countries the presence of even the abundance of these two forms of capital have not necessarily implied or led to development and industrialization. It is possible to argue that the presence or even abundance of physical and human capital will not necessarily amount to development if there is an insufficient degree of social capital. For example, economic development will not occur if there is no rule of law, or if trust among individuals, between individuals and organizations, and between the people and government does not exist. This suggests that elements of social capital behave as a complement to physical and human capital. A few decades ago, Kenneth Arrow and Gerald Debreu (1954) provided the proof of Adam Smith's conjecture two centuries earlier on the efficiency of invisible-hand allocations. But insufficient amounts of social capital imply failure of markets. As Bowles and Gintis argue, "The axioms required by the Fundamental Theorem of Welfare Economics were so stringent that Arrow stressed the importance of what would now be called social capital in coping with its failure" (2002, 423). What Bowles and Gintis had in mind was the following statement by Kenneth Arrow: "In the absence of trust . . . opportunities for mutually beneficial cooperation would have to be forgone . . . norms of social behavior [may be] . . . reactions of society to compensate for market failure" (Arrow 1971, 22). And Arrow relates economic backwardness to market failures caused by the absence of social capital: "Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence" (1972: 357).

Markets will not give rise to the production and exchange of commodities unless individuals are connected through "social networks and the norms of reciprocity and trustworthiness that arise from them" (Putnam 2000, 19). In other words, if countries are to produce needed commodities and provide them through markets for exchange in an efficient manner (i.e., a way that can lead to development), we need to have a sufficient quantity of social capital—features of social organization such as trust and the norms of behavior and networks needed for the efficient production and exchange of these commodities.

In underdeveloped economies, insufficient amounts of social capital have implied the weakening of interpersonal networks, and thus an absence of trust among individuals and between individuals, organizations, and government agencies. In these countries, insufficient amounts of social capital cause numerous negative consequences (including the free rider problem). For example, absence of trust would prevent entrepreneurs from joining with other entrepreneurs in partnerships to organize new productive enterprises, banks from providing loans to those entrepreneurs, and individual companies and banks from accepting personal (or even small-company) checks unless endorsed by more credible/trustable individuals. Absence of trust in these societies leads to high transaction costs and to incomplete and even missing markets.

Trust is an important ingredient of social capital in the LDCs. It is related to the expectations individuals form about the actions of others that have a bearing on their choice of action when that action must be chosen before they can observe the actions of others (Dasgupta 2003, 8). Economically speaking, trust is important because its presence or absence can have a bearing on

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

what we (as entrepreneurs, workers, consumers, etc.) choose to do, and in many cases what we can do. Thus, its absence can imply investments not made, needed goods and services not produced, workers not hired, or transactions not made.

Insufficient social capital also relates to government failures in the process of development. This is because sustainable economic development at least requires the rule of law; this is needed to protect property rights and to ensure the proper enforcement of agreements and contracts. Absence of social capital also leads to the absence of a sense of responsibility on the part of civil servants and members of the judiciary and law enforcement, which in turn would lead to corruption and red tape. Thus, in the LDCs, the prevalence of corruption and the absence of the sense of responsibility among these groups are not conducive to the upholding of the rule of law and thus to the fulfillment of the terms of contracts and economically related agreements. Corruption and the absence of responsible feeling imply unsuitable punishment for breaking (economic) agreements and contracts, for such behaviors would lead to people not acquiring the appropriate incentive to fulfill them. As a result, mutually beneficial economic agreements and contracts (starting companies, making new investments, or engaging in transactions) would not be initiated.

Trust, confidence, and other relevant aspects of social capital are interconnected. For example, if individuals lose trust or confidence in the legal system, they would not trust others to fulfill the terms of an agreement, and thus they may choose not to enter into agreements and contracts. The interconnectedness suggests that social capital (such as trust) "is riddled with beneficial externalities" (Dasgupta 2003). In fact, from a macroeconomic perspective, it is a public good that is necessary in the productive process.

MARKET VERSUS GOVERNMENT FAILURES IN DEVELOPMENT ECONOMICS LITERATURE

Conventional economics assumes the efficiency of the market mechanism in its ability to allocate goods, services, and factors of production. In a perfectly competitive economy, it is assumed that market forces ensure an optimal allocation of commodities and resources, both statically and dynamically. Even if the extra obstacles to the smooth functioning of the market mechanism in the LDCs are ignored, there are still limits to this presumed efficiency. In other words, there are cases where markets fail in achieving efficiency, even in the most advanced of nations. Obviously, the pressure of monopoly power, external economies, public goods, imperfect information, and asymmetry of information would prevent markets from working efficiently; neither would the market mechanism work efficiently if we are dealing with the cases of merit and orphan goods, or capital market myopia. For markets to bring about efficiency, prices must provide correct signals. However, prices may not provide right signals due to the distortions caused by any of the above distorting forces. Distortions in the market may cause labor or other factors of production to respond to price signals inadequately or even perversely. And, although ready to respond appropriately to correct price signals, factors of production may be immobile, unable to move quickly (as in the case of labor) or at all (in the case of land).

Going back to the early years of development economics during the 1940s and 1950s, most of its pioneers assumed market failures to be even more pervasive in the less developed countries. This point was in fact mentioned in Paul Rosenstein-Rodan's 1943 article, and it was elaborated by Tibor Scitovsky in his 1954 paper "Two Concepts of External Economies." Many development economists have emphasized that markets work even less well in the LDCs. Some development economists have gone as far as suggesting that a greater degree of market failure is the distinguishing characteristic of underdevelopment. An example is Hla Myint (1985), who argued

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

that the nonexistence or segmentation of particular markets, caused by high transaction costs, forms a characteristic feature of underdevelopment. From this perspective, such economies fail since they are incapable of creating certain markets. Early development economists, because of their emphasis on the need for physical capital, emphasized the types of market failure that would prevent investment activity in productive enterprises and those in much-needed infrastructure. However, more recently, development economists have also discussed other types of market failure, in particular those that arise from the various facets of the learning process.

Because of the pervasiveness of market failures in the LDCs, many development economists of the early years found a strong government direction and participation as a necessary ingredient of economic development. It was as a result of the presumption of such failures of the market that early development economists proposed policy prescriptions such as the big push. Because of those market failures, as Rosenstein-Rodan argued, government has a great responsibility to make things ready for the takeoff: "there is a minimum level of resources that must be devoted to a development program if it is to have any chance of success. Launching a country into self-sustaining growth is a little like getting an airplane off the ground. There is a critical ground speed which must be passed before the craft can be airborne" (quoted in Hosseini 1999, 125).

Of course, to various conventional economists, market failures were not sufficient to warrant government intervention, in particular to the extent suggested by Rosenstein-Rodan's big-push policy. An early example was B.T. Bauer, who proposed a severely limited role for the government in LDCs, almost exclusively relying on markets including on world capital markets rather than foreign aid for external capital needs. Of course, not every conventional economist was as extreme as Bauer. Some conventional economists, while accepting the possibility of market failures in the LDCs, did not think that governments would necessarily be more successful. One such economist was the late Harry Johnson, who said, "The possibility of market failure is not sufficient to prove the certainty of government success" (quoted in Arndt 1985, 157). Arndt, paraphrasing Campos, explains this line of thinking as follows: "The price system with all its acknowledged defects, may yet, on balance, be the lesser evil, compared with the operation in practice of bureaucratic planning and control" (ibid.). More recently, Krueger has emphasized the case of government failure in the process of economic development: "Whether market failures had been present or not, most knowledgeable observers concluded that there had been colossal government failures. In many countries, there could be little question but that government failure significantly outweighed market failure" (1990, 9–10).

According to Krueger, there existed many government failures, involving both commission and omission. To her, government failures of commission included "exceptionally high-cost public enterprises, engaged in a variety of manufacturing and other economic activities not traditionally associated with the public sector." For failures of omission, Krueger mentions deterioration of transport and communication facilities (which raises costs for both public and private sector activities) and maintenance of fixed nominal exchange rates in the face of domestic inflation, among others. As a result of these government failures, large-scale and visible corruption emerges, and many programs whose objectives were to help the poor would end up benefiting the more affluent members of society (Krueger 1990, 10).

SOCIAL CAPITAL: A COMPLEMENT OF MARKETS AND GOVERNMENTS

As economists, we know that markets are important institutions. "Markets are attractive because of their ability to make use of private information. So where comprehensive contracts may be

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

written and enforced at low costs, markets are often superior to other governance structures. Moreover, where residual claimancy and control rights can be closely aligned, market competition provides a decentralized and difficult to corrupt disciplining mechanism that punishes the inept and rewards high performances" (Bowles and Gintis 2002, 423).

The institution of the government too has its advantages; it is well suited for handling particular classes of problems. For example, it alone has the power and ability to provide and enforce the rules of the game that govern the interaction of private agents. Therefore, in cases "where an economic process will be effective only if participating is mandatory (e.g., participating in social insurance program, or paying for national defense) governments have an advantage" (Bowles and Gintis 2002, 424).

As stated in the previous section, there are also situations where both markets and governments fail, though these are not always acknowledged directly. For example, traditional supporters of laissez-faire and markets, by emphasizing "a thousand points of light" (President George H.W. Bush), "it takes a village" (Senator Hillary Rodham Clinton), and "faith-based initiatives" (President George W. Bush), have come to admit the failure of the market in providing certain public goods (and thus the need for social capital). Traditional and strong advocates of the role of the government, by admitting the shortcomings of five-year plans and the limits of government capacity and accountability, have come to the realization that social capital can help to overcome the failures of the government (ibid., 420). As suggested in the previous section, markets and governments have in particular failed in the less advanced countries. In these countries, because of high transaction costs, uncertainty, or insufficient information (not to mention the insufficiency of both physical and human capital), much-needed markets often did not come into existence. Even when they did, they were not strong enough to bring about development and industrialization. And governments, because of the insufficiency of information, lack of accountability, and the prevalence of corruption, were unable to correct the failures of the market in helping to bring about development and industrialization.

Obviously, to achieve industrialization and sustainable development, the less developed economies need both physical and human capital. Development and industrialization require infrastructure; they also need investments in various sectors of the economy, in particular in the manufacturing sector. As history has demonstrated, sustainable development also requires human capital (education, skills, knowledge), which requires investment in various levels of educational institutions. These various types of investments require the participation of markets (i.e., the private sector) and the government (the public sector). As argued before, in the process of development/industrialization, there are situations where both markets and governments fail and social capital is required as a remedy. It can be argued that even in the situations in which markets and governments can play their proper historical roles (including more advanced economies), social capital is still required. Endowment of trust, a sense of civic and social responsibility, and other elements of social capital not only complement the existence of physical and social capital but provide what markets and governments fail to provide. Trust and sense of civic and social responsibility and belonging in society set in motion various forces in society that allow the otherwise missing markets to appear, loans to be made, and investments to be undertaken; it can also remedy the failures of markets and governments. A society endowed with an adequate quantity of social capital can find it easier and cheaper to acquire certain types of needed information, types that might be expensive and hard to gather by firms, banks, and governments. Such a society gives rise to more cooperation and interaction among its members. This will lower the cost of acquiring knowledge about the behavior of other members and would increase the benefits of doing so. Such a society will minimize the free rider problem that is problematic in poor nations, impairing the sense of community and trust in these countries. A

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

society endowed with social capital is motivated to punish free riders, which in essence implies the provision of a public good. By combining self-interest and non-self-interest, such a society can enhance the sense of cooperation and trust and reduce the type of corruption that leads to a reduction of service and productivity.

CONCLUSION

As argued before, the less advanced economies may or may not suffer from a shortage of physical and human forms of capital. However, these countries seem to be short in at least some aspects and elements of social capital. The insufficiency of social capital in these countries often results in a type of image among individual economic agents that can be characterized as zero-sum. Lack of trust among individuals and between individuals and agencies/firms leads to a lack of civic and social responsibility that will result in missing markets, inefficient and inadequate transactions, corruption, a substantial amount of free riding, and other problems. Such behaviors on the part of individuals, markets, firms, and governments constitute substantial obstacles to sustainable economic development and industrialization. These societies, I believe, need to make changes that would transform these zero-sum images to positive-sum perceptions. Obviously, this is a big task, requiring changes in various institutions as well as relations. These societies must create norms of individual behavior that advocate coordinated efforts. They must convince economic agents that by changing their less-than-cooperative or uncoordinated behavior, they will improve their benefits. Without such incentives, economic agents will not find changes in their behaviors advantageous.

Concerned policy makers in the LDCs, where elements of social capital are scarce, must encourage a climate of cooperation and trustworthiness, and promote norms of behavior that emphasize civic responsibility; these will enhance the endowment of social capital in their countries. In doing so, they must keep in mind the following. First, individuals and economic agents must become convinced that they alone will own the fruits of their efforts. They must have the confidence that they are the beneficiaries of their change of behavior—that is, the beneficiaries of more efficient productive enterprises, banks, and market exchange; better distribution of public goods; reduction of corruption, free riding, and red tape—and that the achievement of economic development will benefit all. Second, rule of law must be respected by individuals, organizations, civil servants, and those in the judiciary and law enforcement. This must be emphasized by policy makers and civic leaders alike. In a society in which the rule of law is emphasized, the efficiency of markets, firms, organizations, and government agencies will be enhanced, and the free rider problem, corruption, and harmful rent-seeking activity will be minimized. All of these factors are preconditions of development. Third, policy makers and civic and governmental leaders must emphasize equal treatment and nondiscrimination in government agencies, in firms, in the marketplace, and in all other organizations. This will build trust in various levels of society and bring greater economic efficiency. Fourth, free riding must end at the workplace, in particular in government agencies, where work effort is not always maximized. This, in addition to improving efficiency of various economic and governmental organizations, will enhance trust in government agencies (again, all prerequisites of economic development). Finally, government, civic, and economic leaders must build into the structure of social and economic relations opportunities for mutual monitoring, and punishment for noncooperative, corrupt, and free-riding behaviors. If all individuals have the sense of responsibility to monitor these unproductive behaviors, trust and efficiency would be perpetuated. Achieving these goals might not be easy (although education, political accountability, and a strong civil society would help in this effort), but these steps must be taken if the LDCs are to join the ranks of economically developed and industrialized countries.

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

REFERENCES

Adelman, Irma. 1999. "Fallacies in Development Theory and Their Implications for Policy." Paper presented at the 1999 conference of the Society for the Advancement of Behavioral Economics, June 13–14, San Diego.

Arndt, H.W. 1985. "The Origins of Structuralism." *World Development* 13, 2.

———. 1987. *Economic Development: The History of an Idea.* Chicago: University of Chicago Press.

———. 1988. "Market Failures and Development." *World Development* 16, 2: 219–29.

Arrow, K. 1971. "Political and Economic Evaluation of Social Effects and Externalities." In M.D. Intriligator, ed., *Frontiers of Quantitative Economics*, 3–23. Amsterdam: North Holland.

———. 1972. "Gifts and Exchanges." *Philosophy and Public Affairs* 1: 343–62.

———. 2000. "Observations on Social Capital." In Partha Dasgupta and Ismail Serageldin, eds., *Social Capital: A Multifaceted Perspective*, 3–5. Washington, DC: World Bank.

Arrow, K., and G. Debreu. 1954. "Existence of Equilibrium for a Competitive Economy." *Econometrica* 22: 265–90.

Baron, J., and M. Hannon. 1994. "The Impact of Economics on Contemporary Sociology." *Journal of Economic Literature* 32, 3: 1111–46.

Bowles, S., and H. Gintis. 2002. "Social Capital and Community Governance." *Economic Journal* 112: 419–36.

Dasgupta, P. 1988. "Trust as a Commodity." In D. Gambetta, ed., *Trust: Making and Breaking Cooperative Relations.* Oxford: Blackwell.

———. 2003. "Social Capital and Economic Performance." In E. Ostrom and T.K. Ahn, eds., *Foundations of Social Capital.* Northampton, MA: Edward Elgar.

Dasgupta, Partha, and Ismail Serageldin, eds. 2000. *Social Capital: A Multifaceted Perspective*. Washington, DC: World Bank.

Dayton-Johnson, J. 2003. "Knitted Warmth: The Simple Analytics of Social Cohesion." *Journal of Socio-Economics* 32: 623–45.

Easterly, W. 1997. "The Ghost of Financing Gap: How the Harrod-Domar Growth Model Still Haunts Development Economics." Available at http://www.worldbank.org/html/dec/Publications/Workpapers/WPS1800series/wps1807/wps1807.pdf.

Grootaert, C. 1998. "Social Capital: The Missing Link?" Social Capital Initiative working paper no. 3. Washington, DC: The World Bank.

Hosseini, H. 1999. "The State and the Market, Their Functions and Failures in the History of Economic Development Thought." *Managerial Finance* 25, 3–4: 19–38.

———. 2003. "The Arrival of Behavioral Economics: From Michigan or the Carnegie School." *Journal of Socio-Economics* 32: 391–409.

Kamarck, Andrew. 1967. *The Economics of African Development.* New York: Praeger.

Krueger, A. 1990. "Government Failures in Development." *Journal of Economic Perspectives* 4, 3: 9–25.

Kuznets, S. 1955. "Toward a Theory of Economic Growth." In Robert Lekachman, ed., *National Policy for Economic Welfare at Home and Abroad.* New York: Doubleday.

Lewis, Arthur. 1954. "Economic Development with Unlimited Supplies of Labor." *Manchester School* 22: 139–91.

Lucas, R. 1988. "On the Mechanics of Development Planning." *Journal of Monetary Economics* 22: 3–42.

Myint, H. 1985. "Organizational Dualism and Economic Development." *Asian Development Review* 3, 1: 24–42.

Psacharopoulos, George, and Maureen Woodhall. 1985. *An Analysis of Investment Choice*. New York: Oxford University Press.

Putnam, R.D. 1993. *Making Democracy Work: Civic Traditions in Modern Italy.* Princeton, NJ: Princeton University Press.

———. 2000. *Bowling Alone: The Collapse and Revival of American Community.* New York: Simon and Schuster.

Robison, L., A. Schmid, and M. Siles. 2002. "Is Social Capital Really Capital?" *Review of Social Economy* 60, 1: 1–21.

Romer, Paul. 1994. "The Origins of Economic Growth." *Journal of Economic Perspectives* 8: 3–22.

Rose, R. 2000. "Getting Things Done in an Antimodern Society: Social Capital Networks in Russia." In P. Dasgupta and I. Serageldin, eds., *Social Capital: A Multifaceted Perspective.* Washington, DC: World Bank.

Downloaded By: 10.2.97.136 At: 01:24 28 Mar 2023; For: 9781315703879, chapter33, 10.4324/9781315703879.ch33

Rosenstein-Rodan, P. 1943. "Problems of Industrialization in Eastern And South-Eastern Europe." *Economic Journal* 53: 202–211.
Schmid, A. 2002. "Using Motive to Distinguish Social Capital from ITS Outputs." *Journal of Economic Issues* 37, 3: 747–67.
Schultz, T. 1964. *Transforming Traditional Agriculture.* New Haven, CT: Yale University Press.
Scitovsky, Tibur. 1954. "Two Concepts of External Economies." *Journal of Political Economy* 62: 54–67.
Solow, Robert M. 2000. "Notes on Social Capital and Economic Performance." In Partha Dasgupta and Ismail Serageldin, eds., *Social Capital: A Multifaceted Perspective,* 6–12. Washington, DC: World Bank.
Stiglitz, Joseph. 1996. "Some Lessons from the East Asian Countries." *World Bank Research Observer* 11, 2: 151–77.
———. 2000. "Formal and Informal Institutions." In P. Dasgupta and I. Serageldin, eds., *Social Capital: A Multifaceted Perspective.* Washington, DC: World Bank.
Woolcock, M. 1998. "Social Capital and Economic Development: Toward a Theoretical Synthesis and Policy Framework." *Theory and Society* 27: 151–208.