INNOVATIONS AND INFORMAL INSTITUTIONS: AN INSTITUTIONALIST APPROACH TO THE ROLE OF SOCIAL CAPITAL FOR INNOVATION

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Abstract

This article seeks to add to the debate on the role of informal institutions on innovations within firms. It argues that social capital arising from informal institutions can either help innovation or inhibit it within small enterprises. The paper attempts to provide a conceptual framework of how social capital fosters innovation within small firms. Like physical and human capital, social capital is also considered an explanatory factor in theories of innovation. Social networks become an essential element in the economic activity of the small businesses as they are more likely to rely on them to obtain information and learn about new techniques of productions due to their smaller resource base.

Keywords: *Social capital, innovation, informal institutions, Pakistan*

1. INTRODUCTION

In most developing countries where the formal institutional architecture is either absent or in poor state, the informal institutions gain prominence for playing a more active role in economic activity. By taking an institutionalist approach, this paper seeks to add to the existing literature on the potential of the informal institutions for economic gains. Institutional economics gives us an opportunity to analyze economic behaviour in more meaningful ways and beyond the assumptions of complete rationality and perfect information. What makes this approach so realistic is the acceptance that economic behaviour is shaped by institutional arrangements of the society and all institutions whether social, political or legal influence each other and influence economic choices. Institutions might mean different things to different people and the academic literature is also not very clear on its definition (Acemoglu & Johnson, 2004). Institutions are usually defined as a 'broad cluster of arrangements that affect economic outcomes'. Institutions can be formal and as well as informal. Formal institutions can be laws, contracts, political systems, organizations, markets, etc. whereas informal institutions are norms, traditions, customs, value systems, religions, social trends etc. In North's (1990) works, we find equal importance given to the informal institutions along with the formal ones. He predicts that informal social institutions have a crucial impact on economic well being as all other rules of the game.

The next section will explain the various theoretical views on the role of informal institutions on economic performance. Then it will be argued that informal institutions like trust, reciprocity and goodwill tend to promote innovation within firms as they provide a conducive environment to the innovative agents to come together and assume risks. The last section discusses three case studies to explemify the role of informal institutions in economic outcomes. The conclusion will revisit the main thesis and discuss its implications for policy making.

2. THE ECONOMIC ROLE OF INFORMAL INSTITUTIONS

The integration of institutions in the economic theory is used as an explanation of cross country differences of economic performance (Acemoglu & Johnson, 2004, Classens & Leaven, 2003, Knack et al, 1995). Institutions are rules, regulations, laws and policies that affect economic incentives and thus the incentives to invest in technology, physical capital and human capital. The basic argument for the role of institutions in economic activity is that it reduces transaction costs. If the rules and regulations are clear and transparent and market mechanisms are working efficiently, business works smoothly and it gives further incentive for future investments.

The presence of transparent rules, regulations, laws and polices ensures that gains form economic activities would be equitably distributed.. Moreover, the influence of the informal institutions manifests in honesty, reciprocity and good will in the society at large which is an incentive to invest in economic activity.

In many ways, informal institutions of norms, customs, and traditions impact economic outcomes. Informal institutions are responsible for generating social capital, which has been considered as an additional factor of production in recent literature (Clercq & Dakhli, 2004). Social and cultural norms impact the utilization of resources in many ways. People who share a common background, language, culture, and customs can mobilize their resources effectively towards creating positive synergies. Social capital captures the impact of informal institutions and provides an opportunity to operationalize the value generating aspect of social ties and to incorporate the strength and influence of such relations in our economic lives and policy development. However, it must not be understood by this that we use this term to 'capitalize' on the social relations and try to gain some economic benefit through every acquaintance or relationship. We use this concept to give value to our social side of life and to sensitize our minds to the immense strength of such ties, which remains largely unaddressed in policy frameworks but remain very close to the hearts of individuals and affects their emotional and economic well being. The use of this concept is spread across many academic fields and its definition differs according to its contribution. Some of the useful definitions for the present discussion include Narayan (1999) who describes it as, "glue that holds groups and societies together –bonds of shared values, norms and institutions."

In the words of Pierre Bourdiu (1985) "the aggregate of the actual or potential resources which are linked to possession of a durable network of more or less institutionalized relationships of mutual acquaintance or recognition".

Social associations have a direct bearing on the contacts that help in accessing resources and helping the economic processes. An example of such associations is the Grameen micro –credit program in Bangladesh. Village women benefit from their affiliation with a particular group by obtaining loans without collateral (Woolcock & Narayan, 2000).

3. SOCIAL CAPITAL AND INNOVATION

The work of Putnam on Italian regional governance can be considered the pioneering work on social capital and provides a great insight about its benefits for the society. The way he looks at it, confirms the role social capital can have on innovations. His thoughts on the regional differences in governance and economic success in two different regions in Italy provide a great insight how he has linked successful social relationships to these variables. The organization of the society is critical to effective governance and civic management. Participation in social networks- as an indicator of social capital for him- ensures that people trust each other and share values. 'Social networks allow trust to become transitive and spread: I trust you, because I trust her and she assures me that she trusts you' (Putnam, 1993). He concludes that such relationships encourage networks of civic engagement in society. Solid networks of social exchange result in generalized reciprocity norms. In a society with high levels of trust, there is cooperation and feelings of reciprocity among its members which makes the environment more efficient than a distrustful society (Putnam, 1993). It implies that transaction costs would be lower and contracts would be more likely to be honored. This helps to understand that in such a society which has efficient governance mechanisms, high sense of civic responsibility and trust will lead to an environment where innovative agents can come together and assume risks.

The society's willingness to assume risks and face uncertainty is greatly associated with innovative behaviour and these characteristics depend on the presence of trust, norms of appropriate behaviour and reciprocity. Trust, whether it is in people or in institutions, is associated to a great extent with the willingness to assume risks. According to Coleman (1988),

"a group within which there is extensive trustworthiness and extensive trust is able to accomplish much more than comparable group without that trustworthiness and trust".

The higher levels of honesty, ensure that contracts will be honored and thus ensure lower compliance costs as there is minimal chances of litigation. This encourages risk taking and ultimately innovations by the entrepreneurs. Therefore, presence of social capital provides a conducive environment in the society for the systems of innovation to develop and encourage innovation.

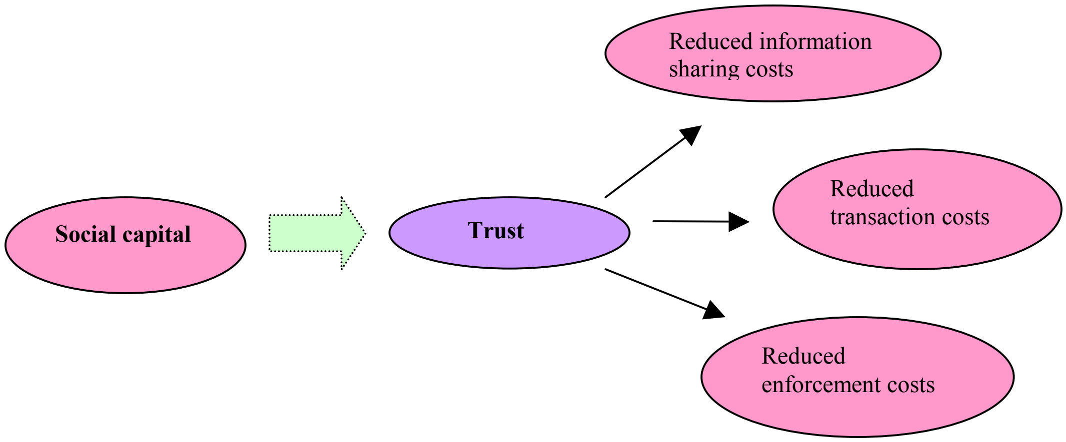

Figure 1. *Social capital, trust and innovation*

Thus, what makes social capital a vital ingredient to the innovative process is that it reduces certain costs like information sharing, transaction costs and enforcement costs and this leaves many resources available for use for innovation-related expenditure. It is a productive resource that emerges from social links and provides opportunities and benefits to the members of the group that own it (Pastor & Ausina, 2008). With an environment where there are feelings of trust for each other, contracts are more likely to be honoured which means lesser chances of litigation and flow of information would be smooth and would increase the probability of innovation. (Knack & Keefer, 1995:97). Moreover, since there are lesser costs in terms of bribes, private security etc., the resources are available to be used for innovation related activity (Figure.1)

Another way of looking at the innovation-inducing social capital could be through the concept of networking which explores the social dynamic of relationship of firms with other actors in the environment and is well captured through networking theories which have shed light on the importance of social ties for innovation for both developing and developed countries (Mytelka, 1993; Nadvi, 1999; Schmitz, 1999). Landry et al. (2001), provide a good definition of innovation to understand the social dynamic of innovation;

" *innovation results from combinations of tangible forms of capital in conjunction with intangible forms of capital characterized by disorderly and sustained interactions occurring between firms and diversified sets of actors. These interactions are holistic, influenced by history, social values, institutions, and interdependence*."

Among some advantages of networks are exchange of information, reduced costs of finding a job, exchange partners and lower transaction costs. (Tsai and Ghoshal,1998). All these benefits and smooth functioning of the networks depends on the degree of trust as it increases 'the capacity to form new associations' (Fukuyama, 1995).

The impact of social capital on innovation is that it provides access to resources for people both within their group and beyond that. It can help in accessing vital contacts and sources of information. Since, there is generalized trust among the networks, information sharing regarding job options, new sources of resources, new techniques of production, and latest news about new products etc., flow through the whole group smoothly and frictionless. Social capital possessors can gain direct access to economic resources like subsidized credit, protected markets etc, and can increase their cultural capital through contacts with experts and can affiliate with institutions that can give institutionalized support (Portes, 1998). Bridging social capital ensures access to diverse domains of knowledge and financial resources beyond ones group and a combination of all such circumstances increase the propensity to innovate (Clercq & Dakhli, 2004).

An important aspect of social capital is its potential for sharing of information. Access to information empowers and provides the basis for further action. However, accessing information is costly and requires time and attention. Social relations provide a means of accessing information and facilitate action (Coleman, 1988). Such relations prove valuable in providing information without any financial burden attached to it as information is exchanged in informal social interactions.

However, strong social capital can be seen both as a liability and as an asset. Dense networks sometimes inhibit innovative practices and new ideas (Burt, 1992). Absence of ties has been seen as a way of generating new ideas and knowledge. Weak ties sometimes play an important role in bridging the gap between informal and more formal sources of financial and technical support (Deakins et al., 2007).

Reputation for trustworthiness is an important cause for networks to develop overtime. Reliable and effective flow of information is vital for the innovative process and therefore, an environment of trust, reliability and lesser opportunistic behaviour leads to greater possibilities of innovation.

To summarize the above discussion, we can say that social capital impacts innovation within firms in two ways: directly and indirectly. The broader social capital of the society marked by feelings of trust, reciprocity and goodwill among all members of the society help innovative agents to come together and assume risks. In a way, this general environment is also indirectly related with the firm level social capital and helps to develop networks- the indirect influence of social capital in the society on innovation. Direct influence, can be seen from the networking of firms and their ability to exchange ideas, know-how and information related to markets. The next section throws some light on the various dimensions of social capital on economic life.

4. A TALE OF THREE REGIONS

Man, remains after all embedded in interpersonal networks, seeking refuge in a friend's embrace or finding solace in the company of a loved one. In the earlier sections, I have tried to explain the contributions of social institutions to the business activity especially with reference to innovation. What follows is a brief presentation of three cases[1] where we see interesting faces of social institutions in economic life.

[1] I rely extensively on the authors for the case studies and the information presented.

4.1. TRUST AND TIES- TANZANIA[2]:

A study of the urban town in Mwanza is interesting. Despite the population growth and urbanization, the city still maintains the 'small town feeling' to it. The study on various sections of the businesses operating in the town tells the story of high trust relationships built through social networks and within communities that flourishes innovation. Businesses rely heavily on the information generated in their social circles regarding reputation and trustworthiness of each other for future business relationships. Suppressive policies of the state are also coped with by sharing information and relying on social networks for gauging the severity of the issues that arise out of such policy shifts, dealing with tax audits and revenue authorities. Moreover, such high trust networks are an important platform for exchange of ideas, new product designs, tricks of the trade and know-how. Such interactions, as expected, were very beneficial to small and medium scale firms. Being 'known to many', helped such businesses to build reputation and obtain potential sources of financing and strengthening business interests.

4.2. FAMILY-RUN BUSINESSES - PAKISTAN[3]

Successful collective action as a result of social networks manifests itself in the story of the surgical goods cluster in Sialkot, Pakistan. For a cluster of family owned businesses, with little knowledge of modern day management practises, it is marvellous how these firms organized themselves and attracted government support for the collective good of all. They managed to set up a dry port to lower costs and tackled with US ban on their goods through mobilizing diplomatic and financial support during the eighties. Through trade bodies and organized groups, the cluster managed to embark upon public-private partnerships, deal with poor infrastructure, and establish foreign partnerships to train engineers and form joint ventures.

4.3. MINORITIES BUSINESS AND SOCIAL TIES- A CASE OF SCOTTISH ETHNIC MINORITIES[4]

It will not be surprising if we find that social institutions nearly replace formal institutions for minorities anywhere in the world. There is a strong reliance on social networks and families in minorities. Such relationships manifest themselves in interesting ways in the business context. A study of ethnic minority businesses in Scotland illustrates the effects and side - effects of such institutions. On one hand, the reliance on family and friends was found to be a burden in a way that it inhibits the personal growth or limits individuality in businesses. But constant interactions among the community is an effective way of

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[4] Deakins, D.et al. Ethnic Minority Businesses in Scotland and the Role of Social Capital**.** International Small Business Journal. Vl.25, Nr.3. 2007

knowledge diffusion and identifying sources of advice and resources (often professional sources), development of opportunities to diversify and enter into new businesses. The wealth of social capital in such communities works complementarily with the formal resources and is the explanatory chapter of the South Asian and the Chinese business success story in Scotland.

To sum up, in all the studies presented above there is strong evidence of the social institutions and their bearings on economic outcomes. Whether it is the role of networks, or the success of family businesses, or the close family linkages in the minority businesses, the common element is the reliance on social ties and networks in businesses. We may take the liberty to say that among the many factors that affect business decisions and outcomes, one of those are social institutions, which are influential in our personal lives as well as have the power to play the role of an additional factor of production in economic lives.

5. CONCLUSION

The choices we make in life are influenced by our values in life and are embedded in our relationship with others. This is also true for our economic lives as well. Therefore, economic outcomes are influenced by network properties such as mutuality, trust and cooperation, or their opposite. The analysis of relationships between people and its dynamics, the properties that weave them together, and the significance of institutions of cultures, kinship ties, and ethnic ties etc. are important to study for achieving better economic outcomes. Incorporating social capital in the equation will provide a better picture for policy makers to understand the losers and winners of any policy intervention at the grassroots level rather than a simple economic analysis.

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