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978-0-521-88649-9 - The Political Economy of Trust: Institutions, Interests, and Inter-Firm Cooperation in Italy and Germany

Henry Farrell

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[More information](#)

## I

# Introduction

### I.1 A POLITICAL ECONOMY OF TRUST

What are the sources of trust and cooperation in political and economic life? This question lies at the heart of key debates within political science. However, it remains unresolved, in large part because of serious weaknesses in our understanding of the relationship between social structure, trust, and cooperation.

These weaknesses are not the result of neglect by political scientists. The two dominant approaches to the explanation of comparative politics, political culture and rational choice, both place trust and cooperation at the core of their research agenda.<sup>1</sup> Yet there is something unsatisfying about the arguments that they offer. Scholars of political culture have almost uniformly concerned themselves with macrolevel arguments based on aggregate survey data. Their arguments have scanty microfoundations, a rather serious problem if one wishes to explain how individuals may come to trust each other and thus cooperate. Rational choice scholars have constructed models with clearly specified microfoundations, but they have had great difficulty to date

<sup>1</sup> I do not include historical institutionalism as a separate account of political behavior, as different variants borrow their microfoundations from both rational choice and culturalist accounts of politics. See Hall and Taylor 1996. More recent varieties of historical institutionalism build upon results from path dependence theory (Pierson 2000; 2004), but they do not have unique microfoundations. However, see Chapter 2 for a more detailed discussion of historical institutionalist claims.

Cambridge University Press

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Henry Farrell

Excerpt

[More information](#)

in building mid-level theories that can capture the consequences of institutions and other such broader phenomena for trust. All too often, rational choice scholars implicitly or explicitly equate trust with simple institution-induced expectations,<sup>2</sup> a move which nonrational choice scholars (correctly) view as reductionist.

In this book, I try to set out the beginnings of an alternative approach to the understanding of the “political economy” of trust; that is, of the relationship between institutions, trust, and cooperation in economic interactions. My account builds upon the basic foundations of rational choice theory. The above-stated caveats aside, I argue that rational choice provides excellent building blocks for a coherent and persuasive theory of what motivates actors to trust each other in economic situations, and thus to cooperate. On the one hand, scholars such as Douglass North (1990) and Jack Knight (1992) provide us with the means to analyze institutions as sets of rules that can shape individual behavior. On the other hand, recent work by Russell Hardin (2002) and others, most particularly Margaret Levi (1998) and Cook, Hardin, and Levi (2005), on the “encapsulated interest” account of trust and related ideas, allows us to see how individuals may draw inferences about the trustworthiness of others from the interests that those others have in behaving trustworthily. In other words, rational choice has the two basic components for the kind of theory that I seek to construct: it provides arguments about (1) the origins and nature of institutions and (2) the bases of trust and social cooperation.

Even so, it is difficult to draw these two literatures within rational choice together into a coherent whole without falling into the trap of reductionism. How may institutions affect the possibility for relations based on trust without, at the same time, entirely determining them? If everything is explained by institutional incentives, then it is difficult to talk about trust in any meaningful way. We have a powerful (and, I believe, valid) intuition that trust encompasses something rather richer than the mechanical sets of incentives and relationships that formal models depict. In two important contributions, David Kreps (1990a) and Gary Miller (1992) provide the beginnings of a more fruitful line of inquiry, which builds on game theory to understand trust in a less mechanistic fashion. In this book, I seek to build on

<sup>2</sup> For an especially trenchant statement of this claim, see Jackman and Miller 2004.

Cambridge University Press

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Henry Farrell

Excerpt

[More information](#)*Introduction*

3

their insights, to integrate them with recent advances in institutional theory, and then to apply them to the comparative political economy of inter-firm relations.

The relationship between institutions, trust, and cooperation is an important one for many avenues of inquiry in the social sciences. I argue that it has a particular relevance for comparative political economy. A recent landmark essay by Peter Hall and David Soskice (2001) endeavours to set out the beginnings of a general comparative approach to political economy, building on both historic institutionalism and rational choice theory. I hope to contribute to the “varieties of capitalism” literature that Hall and Soskice wish to systematize, albeit with a different understanding of the forces that guide institutional change and the likely consequences of institutions for individual behavior.

In order to develop this contribution properly, I make use of two rich bodies of empirical evidence. First, I turn to two case studies of trust and cooperation within the political economy: the packaging machinery industry in Emilia-Romagna in Italy, and the machine-tool industry in Baden-Württemberg in Germany. These cases are important examples of “industrial districts,” areas of small firm concentration, which, according to the existing scholarly literature, are characterized by extraordinarily high levels of cooperation among firms. In the classic industrial districts, intensive inter-firm cooperation appears to serve as a substitute for hierarchical production within the firm, a pattern of production that is both extraordinarily rare in advanced industrial economies (Miller 1992) and difficult to explain using standard approaches to the relationship between hierarchy and market (Williamson 1975; 1985). Furthermore, some scholars have claimed that this cooperation involves a kind of trust that cannot be explained using rational choice theory (Brusco 1990; Sabel 1993). In short, industrial districts present important puzzles for both political science and rational choice theory. Emilia-Romagna and Baden-Württemberg are among the “classic cases” of the industrial district phenomenon (Brusco 1982; 1990; Burroni and Trigilia 2001), and thus provide especially important test cases, while also providing a high degree of variation on institutions. Thus, they allow one to study the effects of institutions on trust and cooperation among actors with a reasonable degree of clarity and precision.

Cambridge University Press

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Henry Farrell

Excerpt

[More information](#)

Second, I examine an empirical context characterized by widespread distrust and opportunism – relations within the Sicilian Mafia. For obvious reasons, this case is not directly comparable to mechanical engineering – the problems of trust are rather starker for a mafioso seeking to determine whether his apparent friend wishes to lure him to a secluded spot so as to strangle him, than for a producer of packaging machines trying to determine which subcontractor is trustworthy. Even so, it provides a parallel demonstration of how the mechanisms of expectation formation and information transmission that serve to underpin trust in one set of circumstances can help lead to pervasive distrust in another.

I use empirical evidence drawn from these cases to assay my broader theoretical claims. These case studies, even if they exemplify quite important phenomena, provide only an imperfect means of testing generalizable arguments. Yet there are some very real intellectual advantages to proceeding in this fashion. Robert Bates, Avner Greif, Margaret Levi, Jean-Laurent Rosenthal, and Barry Weingast (1998a) recommend the use of “analytic narratives,” a combination of abstract theoretical argument, and detailed exegesis of empirical facts, to disentangle the causal relationships in complex strategic situations. Analytic narratives, as described by these scholars, are problem driven rather than theory driven; they seek to account for particular outcomes rather than to establish general causal relationships. Yet, as Peter Hall (2003) notes, studies of this sort may also serve wider theoretical goals beyond the specific explication of the particular cases under examination.

Indeed, such studies may be quite essential to the mapping of certain kinds of causal relationships. Hall suggests that the methodologies used by comparative social scientists have increasingly fallen out of step with the underlying ontologies that they assume. Cross-national multiple  $n$  multivariate analysis rests on assumptions about the underlying data such as the independence and noncollinearity of relevant variables. However, these assumptions do not sit well with the accounts of politics that have increasingly come to the fore in comparative analysis, which stress path dependence (Pierson 2000), or, as in this case, strategic interdependence among actors. Hall suggests that “process tracing” – the careful examination of paths of causation

Cambridge University Press

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Henry Farrell

Excerpt

[More information](#)*Introduction*

5

to see if outcomes are congruent with those predicted by theory – is a more appropriate way to test the validity of complex causal models.

I seek to build on insights from both the analytic narratives approach of Bates and his co-authors, and the historical institutionalist approach to process tracing advocated by Hall. On the one hand, I draw inspiration from the kinds of formal models emphasized in the analytic narratives approach.<sup>3</sup> On the other, I seek to use theory and evidence not only to provide an account of the relationships in a specific setting but also to draw conclusions that may potentially have wider applicability.<sup>4</sup>

Before so doing, however, it is appropriate to situate this book more precisely within existing debates in the field. In the remainder of this introductory chapter, I will set out in turn the main benefits and shortcomings of the political culture approach and current rational choice approaches to trust and cooperation. I will then go on to examine issues of trust and cooperation in the field of comparative political economy, with particular reference to the literature on industrial districts and other regionally based forms of economic cooperation. I then conclude by stating more precisely how this book contributes both to broader arguments about trust and cooperation and more specific debates about how these concepts explain outcomes in the political economy.

## 1.2 APPROACHES TO TRUST – POLITICAL CULTURE

Trust has been a central concept in comparative politics at least since the first wave of the behavioral revolution. This may in large part be traced back to the research agenda set out in Gabriel Almond and Sidney Verba's *The Civic Culture* (1963). Almond and Verba sought to

<sup>3</sup> As Bates et al. (1998a) note, the analytic narratives approach can be used together with non-rational-choice approaches; however, to date it has usually been identified with the rational choice paradigm.

<sup>4</sup> As Bates et al. (1998a) suggest, there are serious theoretical problems involved in reaching generalizations on the basis of game theoretic models that have been constructed to capture the specificities of a particular case. However, although the approach in this book borrows heavily from results in the game theoretic literature, its main argument is driven by mechanisms of equilibrium selection that are external to game theory, and that are thus less vulnerable to the problems that Bates et al. identify.

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Henry Farrell

Excerpt

[More information](#)

locate the sources of political success in the political culture of a country: those beliefs, norms, and values held by the country's citizens. Specifically, they argued that countries with "parochial" cultures, in which individuals failed to identify properly with their fellow citizens, instead relying on local or familial ties (Banfield 1958), were likely to do less well than countries with "subject" cultures, or (the ideal) "participatory" cultures. In Almond and Verba's (1963, 284) view, this could in large part be traced back to social values stressing cooperation: "The degree to which cooperative interpersonal behavior is valued is directly related to the propensity to create political structures."

Trust rapidly became a key explanatory variable, if not *the* key variable for scholars of political culture. They argued that it explained the relative levels of development of different countries. Countries with a high level of diffuse interpersonal trust were likely to be politically and economically successful; those that did not were likely to do poorly. As described by Lucian Pye (1965, 22), "political cultures are built either upon the fundamental faith that it is possible to trust and work with fellowmen or upon the expectation that most people are to be distrusted and that strangers in particular are likely to be dangerous." This emphasis on trust as "one of the most basic ... attitudes" supporting mass democracy persists in contemporary work on political culture (Inglehart 1988, 1204). Ronald Inglehart, in a series of articles and monographs (1988; 1990; 1997; 1999), has sought to show that diffuse interpersonal trust remains a key explanatory variable for political science, and Robert Putnam's work, which is deeply influenced by the political culture tradition, also stresses trust as a vital explanatory factor.

Even if scholars of political culture see trust as a core concept, their account of its origins and effects has problematic microfoundations. Three problems stand out. First, the political culture account of diffuse interpersonal trust (and other cultural factors) rests on an insufficiently specified causal model. This has been a criticism of political culture accounts since Almond and Verba's original research. The concept of political culture had its beginnings in Parsonian sociology (Almond 1956), which notoriously employed a conceptually muddy and functionalist approach to the explanation of social institutions and practices.<sup>5</sup>

<sup>5</sup> For an intellectual genealogy that situates political culture firmly in the Parsonian tradition, while arguing that Almond and Verba got their concept of culture "exactly right," see Eckstein 1996.

Cambridge University Press

978-0-521-88649-9 - The Political Economy of Trust: Institutions, Interests, and Inter-Firm Cooperation in Italy and Germany

Henry Farrell

Excerpt

[More information](#)*Introduction*

7

Almond and Verba were robustly criticized for assuming that culture caused structure, rather than vice versa (Pateman 1980; see also Barry 1978). More recent versions of political culture theory have argued that the causal arrows run both ways, so that culture may affect structure/and or politics, and vice versa (Inglehart 1990). In broad terms, this claim is inarguable, but without more specific – and testable – arguments as to how each relates to each, it is also rather unhelpful (Johnson 2003). Further, generalistic arguments of this sort may in practice shade into functionalist accounts of the origins of trust, as in Robert Putnam’s *Making Democracy Work* (1993). For Putnam, civic values, networks, and norms (informal institutions) go together to make up social capital. He states that the norms of diffuse reciprocity that underpin cooperation and trust in society evolve “because they lower transaction costs and facilitate cooperation.”<sup>6</sup> Arguments that seek to explain a social practice in terms of its broad social benefits, without providing clear causal mechanisms connecting the two, have little intellectual merit (Farrell and Knight 2003). In short, even while scholars of political culture have provided intriguing – and important – empirical evidence on topics such as the relationship between certain sets of values and material well-being in a society (Inglehart 1990), they have failed to provide a satisfactory account of where culture comes from and how it is related to other important factors, which in turn leads to implausibilities in their account of trust.

Second, the notion that trust is an “attitude” (Inglehart 1988), or that certain cultures have “dominant values [that] stress cooperative behavior” (Almond and Verba 1963, 284) rests on a deterministic, and conceptually flawed, account of what attitudes and values are (Johnson 2003). It is important to note that there are controversies among scholars of political culture about how best to conceptualize cultural variables. Scholars such as the late Harry Eckstein follow Parsons in suggesting that culture largely consists of learned patterns of orientation (Eckstein 1996; 1997). Under this account, culture is the product of socialization, and it plays a strong role in determining individuals’ behavior. The general problems with accounts of this sort are well known (Granovetter 1985; Johnson 2003). However, they also have specific consequences for the understanding of trust.

<sup>6</sup> Putnam 1993, 172, emphasis added.

Cambridge University Press

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Henry Farrell

Excerpt

[More information](#)

They suggest that diffuse interpersonal trust is something that is learned rather than considered, so that there is limited (if any) scope for individual agency or decision making in explaining it.

But there are scholars who view political culture as playing a less overwhelmingly determinative role. Both Elkins and Simeon (1979) and Barnes (1988) argue that culture does not define the individual so much as it provides her with an understanding of the assumptions that are shared in her society; she need not agree with a belief or orientation in order to recognize it as an important facet of her culture.<sup>7</sup> This second account of culture provides much greater scope for human agency and is at least partly compatible with a broadly rational choice perspective on cultural factors.<sup>8</sup> Unfortunately, however, it is Eckstein's rather less supple account of political culture that has predominated in empirical work. Ronald Inglehart, for example, applies Eckstein's concepts in his cross-national work on culture (Inglehart 1990), with direct consequences for his understanding of interpersonal trust, which he sees as resulting from very broad social forces (such as national history) rather than from the interplay between individual actors.

Finally, most work in the political culture tradition applies a particular set of tools to the understanding of culture: the statistical analysis of survey data. Even if one is not so profound a skeptic of the ability of survey methods to uncover cultural patterns as James Johnson (2003), one may still note that broadly framed questions, such as those in the World Values Survey, provide a doubtful proxy for how trust and cooperation actually work in a society (Hardin 2002). Surveys typically ask respondents whether or not they believe that others in their society can or cannot be trusted as a general rule. When patterns of trust or distrust involve specific individuals and specific matters (as they usually do), questions that seek to ascertain levels of generalized, impersonal trust are unlikely to provide helpful insights into actual motivations or behavior. Thus, it is at best unclear whether the survey data used to study trust is a good proxy for how individuals trust (or do not trust) each other.

<sup>7</sup> Johnson (2003), argues that this analytic "distance" between culture and individual personality traits is necessary if culture is properly to be understood.

<sup>9</sup> See Johnson 2002; for an empirical application, see Farrell 2003.



Cambridge University Press

978-0-521-88649-9 - The Political Economy of Trust: Institutions, Interests, and Inter-Firm Cooperation in Italy and Germany

Henry Farrell

Excerpt

[More information](#)*Introduction*

9

All of these problems suggest that political culture approaches to trust, at least as they are commonly construed, have problematic microfoundations. They rest on imprecise or functionalist causal models, apply a Parsonian theory of culture that provides little scope for individual agency, and use survey data that provides a poor proxy for actual trust and cooperation. A more successful account of trust and cooperation should rest on secure microfoundations, such as those provided by rational choice theory.<sup>9</sup> However, as discussed in the following section, rational choice theory faces its own theoretical problems in describing trust.

**1.3 TRUST AND RATIONAL CHOICE THEORY**

Rational choice approaches to politics, like political culture, take the problem of cooperation as a central concern. Noncooperative game theory, despite its name, provides a powerful set of tools for understanding the circumstances under which individuals will or will not cooperate with each other. What is less clear, though, is how well rational choice approaches can explain trust, which typically involves complex and personal relationships that are difficult to model using a game-tree or similar methodology.

Three approaches to the understanding of cooperation predominate in rational choice theory. First, scholars such as Oliver Williamson treat the decision of whether to cooperate or not with others as being for the most part an exercise in parametric decision making (Williamson 1975; 1985). Williamson suggests that the decision of a firm to produce internally or to outsource (cooperate with another firm) in a given instance, depends on the cost of the transaction at hand, which in large part is a function of the potential for opportunism. The risks of opportunism, however, primarily adhere to the type of transaction,

<sup>9</sup> I note that rational choice is not the only theory with strong microfoundations. There is an increasingly important literature in actor-centered sociology, not all of which, by any means, adopts a rational choice perspective. See, for example, Fligstein 1996. While some of this literature is less sensitive to considerations of power and interest than the perspective set out in this book, it in turn may capture aspects of cooperation that are difficult to encompass in a broad rational choice framework.

Cambridge University Press

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Henry Farrell

Excerpt

[More information](#)

rather than the type of partner.<sup>10</sup> Unsurprisingly, Williamson has little patience for theories of trust, arguing that they have little purchase in the realm of economic decision making, where interests are unambiguous (Williamson 1993). Thus, Williamson argues that trust is unnecessary to the explanation of economic cooperation; instead, cooperation flows more or less directly from the interests of economic actors.<sup>11</sup>

Second, there is a burgeoning literature that treats trust and cooperation as features of games. Work in this vein ranges from relatively simple treatments such as Partha Dasgupta's "Dishonest Salesman" game (1988) to the sophisticated use of game theory to model bilateral cooperation within a large group of agents.<sup>12</sup> In the latter body of work, infinitely repeated games are used to model institutions that "promote the trust necessary for efficient exchange" (Milgrom, North, and Weingast 1990, 1). Institutions are usually represented as subgame perfect equilibria, in which no actor has an incentive to deviate from her strategy.<sup>13</sup> Given appropriate parameter conditions, and the existence of a specific institution, actors will have no incentive to behave in an untrustworthy fashion, so that trust and cooperation can be maintained among quite large groups of actors. Institutions, under this approach, may involve quite complex sets of social relationships and information exchange, in which, for example, one actor may serve as a central clearinghouse for information.

<sup>10</sup> This is perhaps one of the reasons for the conceptual ambiguities in Williamson's efforts to update his original model (1975), which treated only of markets and hierarchy, to include networks as a third form of governance (1985). In including networks, Williamson attempts to incorporate long-term relationships between firms, without fully examining the implications of strategic action for these relationships, thus creating a set of arguments which, while powerfully suggestive, have important lacunae.

<sup>11</sup> Williamson (1993) acknowledges a role for "institutional trust," but his remarks on what this might involve are not entirely transparent.

<sup>12</sup> See, especially, Milgrom, North, and Weingast 1990, Greif 1994, and Greif, Milgrom, and Weingast 1995. For a theoretical *summa* of this approach, see Calvert 1995b.

<sup>13</sup> There is some disagreement among scholars as to the precise definition of an institution. Douglass North (1990) and Jack Knight (1992), both define institutions as sets of rules and distinguish them from organizations, which are collectivities of actors. Calvert (1995b) starts from game theory and sees both institutions and organizations as equilibria, albeit differing in their levels of complexity. I follow North and Knight's definition, which I suggest provides more specificity and thus greater purchase on the root causes of cooperation.