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ENTREPRENEURIAL REPUTATION
AND SOCIAL CAPITAL

Stephen Batstone

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The Director, CSME
Warwick Business School
University of Warwick
Coventry CV4 7AL
Tel [01203] 523741/523692
Fax [01203] 523747
ENTREPRENEURIAL REPUTATION AND SOCIAL CAPITAL

By

Stephen Batstone, University of Warwick, UK

Introduction

A new sports shop has recently opened just down the road. It is only small, but it may do well: it is owned by a local sportsman of some repute. If it succeeds, no doubt this will be, at least in part, due to the local fame of the owner. Obviously the reputation of the owner will be a contributary factor in any success, but this will not in itself be enough. Financial support and organisational ability are also likely to be required. Nevertheless it is the role of reputation in entrepreneurial success upon which I wish to concentrate.

After briefly reviewing some traditional economic arguments concerning the likelihood of entrepreneurial success by new and small ventures, this paper argues first, that in certain market environments social capital (Coleman, 1990), may be of paramount importance in the formation and development of a business. Second, it is argued that market reputations built up by an entrepreneur are liable to be underpinned by the existence of social capital, whilst what might be termed corporate reputations are more likely to be engendered by advertising, warranties and the like. Finally, following this point, it will be argued that the possession of social capital by an entrepreneur can be the basis of a tangible market advantage over corporate rivals.

The Importance of Social Networks

The role of the social network in the establishment and growth of a business is now beginning to be widely appreciated (see for example Birley, 1985; and Szarka, 1990). The skill with which an entrepreneur\(^2\) can successfully utilise a network of personal contacts and tap into networks of institutionally provided
resources is a resource which should not be underestimated. Nevertheless, it is probably fair to say that although interest in the role and function of social networks in business success is increasing, it has not yet been fully assimilated into the received wisdom over the determinants of success amongst new and small firms.

The standard economic view of business efficiency addresses the manner in which the firm turns productive inputs into useful outputs. The net result of the activities of firms is seen in terms of goods and services being produced which are of greater worth than the sum of their parts. In this view, the main types of resources which are usually considered are, at their simplest, land, labour and capital. Whilst property resources are undoubtedly a very important feature of business success, they are incidental to the main theme pursued here. For that reason, problems to do with property and land will be largely set aside.

Capital is often described by economists, in its basic form as a man made aid to further production. The idea is remarkably simple. Desirable opportunities perceived by an individual to be presently available in the economy are foregone in the hope of future gain. In a nutshell, capital is nothing more than abstention. Non-economists are apt to perceive that what is meant by the term capital should be gauged in terms of the financial resources required to pursue a business venture. In practical terms there is no real problem with this, so long as it is recognised that this only partly captures the essence of capital investments.

The financial capital required for short term stocks and equipment as well as longer term financing requirements has long been perceived as a problem area for smaller firms and new start-ups. Smaller businesses are put at a cost disadvantage compared with larger firms in virtue of the fact that "compared to large firms, small firms are usually required to pay a higher rate of
interest and offer a higher level of security" (Hall, 1989 p.55).

In the UK and elsewhere successive governments have recognised the problems of financing new and small firms and have proposed various policy solutions (See Macmillan, 1931; Radcliffe, 1959; Bolton, 1971; and Wilson 1979). However, in the opinion of Woodcock (1986) the attempts to close what is generally termed the small firms' finance gap has led to the "bewildement factor" in which "small-firm managers wonder where to start in sorting out what is being thrust at them" (p.52). Thus the problem of financial capital is intimately related to the problem of management skills.

In the picture of production as being an assemblage of land, labour and capital, management skills will come under the more general auspices of the labour factor input. Conventional wisdom on the determinants of business success might well stress the need for training and education, in order to augment the management skills of the initiators of new ventures as well as the technical, or craft, skills of staff employed. Indeed, Storey (1990) states that "it remains almost a truism to say that the quality of management is central to the performance of a fast growing small firm". This view sees the possession of skill as a form of capital which can be used to increase the efficiency of the production process. Typical examples of this view are to be found in the influential UK Bolton Report (1971), in which it is stated:

"all firms at one time or another can benefit from management training. Because of the influence of managers on the conduct, attitudes and efficiency of small firms their training is particularly important and training boards will want to pay special attention to it. Management training in the small firm will often be concerned primarily with updating the knowledge of the existing chief executive." (p.242)
There are three main ways in which the key founders or owners of new or small firms can increase the management expertise available. First, through training and development the original founder/owner can become more managerially competent; second, the firm can hire employees with specialist knowledge and skills; and third, existing employees' skills can be extended and developed and in-house promotions can be conferred. In general a variety of different skills will be required in running a venture. As a business grows it becomes less and less likely that these can all reside in a single individual, thus management teams evolve.

Amongst the most entrepreneurial of all business ventures must surely be fast growth small firms, in virtue of the constantly changing and frequently hostile environment in which they operate. Good examples of fast growth small firms can be found on the UK's junior stock market, the Unlisted Securities Market. Using a matched cases methodology which compares firms listed on the USM compared with similar unlisted firms, Storey (op cit) finds that, in order to grow, firms have to supplement the original, often functionally limited, managerial skills of the original key founder/owners by assembling teams of specialist managers. Financial specialists are frequently bought in some time after start-up, presumably to circumvent the "bewilderment factor". Storey also notes that managers in growing small firms perceive their role as essentially one of leadership and communication. Surprisingly little emphasis is placed on originality or entrepreneurial initiative.

Investment in the skills of employers and employees is generally known as human capital investment (Becker, 1964), reflecting the cost in terms of time and resources spent on acquiring new skills or updating existing ones. Partly as a result of the opportunity cost associated with investment in human capital and partly as a result of a lack of internal economies of scale in many new and smaller ventures, the acquisition of some management skills is often seen as lying outside of the reasonable ambit of the firm.
In recognition of this in the UK and many other economies, successive governments have sought to provide managerial assistance and expertise to small firms (see Bolton op cit; Department of Employment, 1991).

In terms of investment in the human capital of the workforce, it is often noted (SBA, 1988) that employees in smaller firms have lower levels of educational attainment and training compared with larger firm counterparts. Again this reflects the cost of resources. In the UK it was suggested that "because the management lacks time and expertise to set up and run its own training schemes and because the facilities needed are often beyond the means of a single small firm the idea of pooling resources becomes very attractive" (Bolton ibid. p.242)

Evidently there are problems facing new and small firms in terms of both their capital and labour inputs into production. What is noticeable is that capital cannot simply be described in terms of finance. Finance is a means towards acquiring physical capital such as plant and machinery and for investing in property, but it is not the actual capital. As stressed previously, capital is an investment: it comes from abstention. In this way we also see that the labour resources used in new and small ventures typically need augmenting. This is also an investment which is costly in terms of the present resources available to a firm. Both physical and human capital appear to be crucial success factors in the formation and development of a business.

If the only significant resources available to a new or small business were those of land, labour and capital then it would be difficult to see how such businesses could be described as forming anything more than a periphery sector of the economy. Small firms, for instance could only be expected to fill in the gaps where economies of scale facing larger businesses were insufficient to warrant production in some small niche. The
traditional view of the firm as a composite tripartite production function imparts a very narrow vision of the relative strengths of small business. The diversity and endurance of the small firm sector suggests that it is something more than satellite production for larger concerns which could choose to swallow up the activity if demand were to increase sufficiently. By considering the role of social networks it becomes possible to see more clearly where the comparative advantages to smaller ventures lie.

Trust and Social Capital

Sometimes, a fourth factor is added to the list of factors which make up the traditional tripartite production function. This fourth factor is managerial ability. This is considered in terms of an entrepreneurial function of coordinating and managing economic activity (Lucas, 1978; Oi, 1983). By considering the role of human capital, however, it is easy to see that management ability might reasonably be seen as an amalgam of a labour input augmented by an investment in training. That is unless, perhaps, there is something more to management ability. Perhaps there is some natural kind, persons set aside from the rest of society: are there really individuals with an entrepreneurial personality?

Many commentators, particularly those who perceive the main role of the entrepreneur as one of arbitrage, argue that the entrepreneur does not need to be the owner of any of the resources used in the production process (see for example Kirzner, 1973). This case of entrepreneurship as a process of arbitrage serves to highlight many interesting points and is worth pausing over.³

In standard production theory workers receive a wage as payment for the labour input which they own privately and which is hired to the firm. Similarly, capital receives a payment in terms of the rate of interest paid to the owner or lender of the capital
resources, as measured by the rate of interest. Both of these factor payments come about because both labour and capital are "loaned" by their owners to the firm.

In contrast the entrepreneur need invest neither physical nor human capital and as arbitrager will not receive a wage for a simple labour input. The basic question which needs answering is why, if the entrepreneur invests no resources of his own, will there be a payment for entrepreneurship?

Kirzner's arbitrage theory (1973, 1979) suggests that the entrepreneur spots gaps in the market and exploits them. These need not simply be the small scale market niches which the "typical" small firm is meant to enter, but may include new ways of organising existing resources. The entrepreneur is alert to possibility for which, if successful, payment will be in terms of profit. The entrepreneur is an intermediary between the owners of an economy's resources who serves to make possible hitherto unrealised gains from trade. As such the entrepreneur can be seen as coming between buyers and sellers, just as the barrow boy takes from the wholesalers to the market; or more sophisticatedly between buyers of a firm's produce and the land, labour and capital needed to initiate the production. The key founder of a business venture may indeed own resources. He may also be the business owner, but that is incidental. Ownership of resources may just serve to make the entrepreneurial task that bit easier; to make success that much more likely.

The entrepreneur in this view is not so much an organiser as a re-organiser. It is the changing redefinition of economic activity which characterises the entrepreneurial act. In this way it is distinguishable from common work-a-day routine in management practice. If business were unchanging there would be no room for profits, only factor payments. It is the unrelenting uncertainty of the economy which suggests a potential role for entrepreneurship. Entrepreneurship is seen as speculative. It is
nothing more than "the necessity of guessing the course of the relevant condition and their possible change during the forthcoming action" (Rothbard, 1971).

There seems to be a significant difference, though, between hired labour and capital inputs and the entrepreneurial input. Routine management may be seen as a factor of production, simply because the end, or goal of the manager's activity is already predetermined. In contrast, since the entrepreneur does not do anything he cannot be hired with a task in mind and hence can receive no wage. In this way the entrepreneur might be taken as a presupposition of production rather than a factor input of production (Smith, 1986).

Theory which stresses an intermediary role for entrepreneurship, in which the entrepreneur receives no factor payment and exploits opportunity in a relentless pursuit for profit, is all very well, but it still does not tell us anything about who becomes an entrepreneur, over and above the subjective point that it is the most perceptive members of society. If the entrepreneur is penniless, or at least can be, how can he expect to secure the cooperation of the owners of factors of production? If someone came up to you offering a business proposition into which he was not prepared to invest any funds, but into which you were expected to sink your hard earned savings, wouldn't you be just a little bit suspicious?

The problem the potential entrepreneur faces is one of trust. Trust is fundamental in society. It is all pervasive (Henslin, 1981). In economic life "trust is important and businessmen rely on it much more extensively than is commonly realized" (Williamson, 1975 p.108). The reason for trust's primacy in economic affairs lies in the relationship with exchange. Quite simply, exchange cannot occur without elements of trust. In all exchange situations there are likely to be non-contractual as well as contractual elements (see Macauley, 1963). As Hodgson (1988)
notes:

"Exchange itself always contains elements of a gift and relies to some significant extent on trust. Exchange is always in part a leap into the unknown...The argument here is not simply to recognize the world of uncertainty in which such a leap exists. For such a dangerous act to become commonplace it must be enforced to a large degree by routine and guided by a good measure of trust" (p.166-7)

The consequences of the need for trust are far reaching. One particularly relevant upshot of explicitly considering relationships of trust may be that it provides us with a clearer understanding of the arbitrage role of the entrepreneur. Whilst the entrepreneur may wear many hats a role for the entrepreneur as arbitrageur seems a natural corollary of the etymology of the term entrepreneur. This entrepreneurial function is particularly apposite in the description of entrepreneurial reputation to be presented here.

The American sociologist James Coleman (1988,1990) has recently been arguing that trust can most readily be engendered when there is what he terms a closed social structure. The "closure" of a social structure leads to the emergence of norms which regulate behaviour, since it permits the effective sanctioning of an untrustworthy agent. The implications of this for entrepreneurship are quite interesting. Remember, as it has been defined, the term entrepreneur carries no burden of ownership. The entrepreneur might be considered as an agent who acts as a trustee for the investments of the owners of factor inputs, who must place trust in this entrepreneur. Coleman states that "it is in the trustor's interest to create social structures in which it is to the potential trustee's interest to be trustworthy rather than untrustworthy" typically, this might occur in a "close community" (1990, p.111).
What is interesting about this view is that it redefines a role for the social network. Without the social network, the entrepreneur is unlikely to be able to function effectively even if he has the perception required to spot profitable market opportunities. The entrepreneur cannot exist alone, apart from society, but is dependent upon the way in which society defines norms and sanctions which enable the entrepreneur to perform his role. The entrepreneurial function is more than mere arbitrage, it "is one in which the intermediary induces the trust of several trustors and combines these resources, ordinarily placing them in the hands of one or more actors who are expected to realize gains for the original investor" (Coleman, 1990 p.181). In this way the entrepreneurial function can only exist if a social structure exists in which the placement of trust is required, and moreover, the structure of the social networks which exist define the bounds for the opportunities facing the potential entrepreneur. Crucially, it is the case that to perform the entrepreneurial function successfully, the potential entrepreneur must be situated within one or more social networks.

This turns the wisdom on entrepreneurship on its head. Entrepreneurship is not a gift given like Manna from heaven to those with the requisite psychological traits. Instead, it is grounded in the very fabric of our society. It flows from the position which the individual is able to define for himself within society.

The crucial resource which the entrepreneur possesses and which he does invest, is what is called "social capital" (Coleman, 1988; 1990). Without social capital, the entrepreneur cannot hope to succeed. Social capital, like human capital, is intangible, but more importantly, what distinguishes social capital from other forms of capital investment is its public good properties. Social capital arises out of the relationships which exist between members of a society. It can have no meaning outside of a given social context. In this way it seems to be a very different
beast from physical and human capital.

As a form of capital, the concept of social capital must be related first and foremost to abstinence. In the case of social capital potentially profitable trading opportunities are set aside in the hope of even more profitable opportunities in the future. So far this sounds no different to any other type of capital, but the difference lies essentially in the payback. In the case of both physical and human capital, privately owned resources are invested in the hope of gain which will accrue to the investor (at least primarily). The investment is realised as a private good. In the case of social capital, however, it is a public good which is being created. The concept of social capital recognises that investments can also be made in social structures.

The formation of social capital arises from reciprocal obligations built up by agents over time\(^6\). These obligations give value to various aspects of social structure since they provide a resource which agents can use to realise their interests. The obligations can be thought of as credit slips to be traded in when necessary. Like vouchers from petrol stations many will never be redeemed. For the most part this is of no consequence, however, since most social capital is a by-product. It is created or is destroyed in the course of other activities not designed to bring it about.

The entrepreneur cannot exist without social organisation. The entrepreneur needs to acquire the trust of buyers or sellers of resources. Without this trust there is no market for his services. The entrepreneur needs to take advantage of the social capital which society creates. "Social organization constitutes social capital, facilitating the achievement of goals that could not be achieved in its absence or could be achieved only at a higher cost" (Coleman, 1990 p.304). Social capital comes about "when the relations among persons change in ways that facilitate
action". It is "embodied in the relations among persons" (Ibid.)

With this investment in a public good, any entrepreneur's contribution to the investment is just as likely to lead to reward to another entrepreneur as to the original investor. Moreover, the creation of this public good, social capital, means that any number of entrepreneurs may simultaneously benefit from the generous gift of abstinence on the part of others. Since many of the benefits of social capital accrue to others, it is often not in any individual's private interest to invest in the social fabric. This clearly relates to the question of entrepreneurship.

It has already been argued that the penniless entrepreneur needs society to function. As Kirzner notes, the "costs of securing recognition of one's competence and trustworthiness are truly social costs. They would exist under any system of economic organisation" (1979 p.101). It is only the entrepreneur who also owns resources who achieves a measure of independence from the ravages of society's influence. But even here, the problem of trust reasserts itself in terms of selling the product: whilst owning resources means that you only have yourself to convince about the appropriate use for such resources, once you have committed them you still need to convince others that it is in their interest to partake of what you create. The consequence of this is that it is not the success of entrepreneurs which generates the successful society, but rather, the relationship is symbiotic. Successful social organisation makes successful entrepreneurship possible.

In this view entrepreneurship is no longer a presupposition of production, but instead the entrepreneur takes up his position alongside the other factors of production once more. The entrepreneur is no more a presupposition of production than society itself, or indeed any other resources used in production, each of which must be assumed to have a price. The potential entrepreneur has at his disposal a resource which must be traded
in accomplishing the entrepreneurial act.

The entrepreneur must invest the credit slips of obligation which he has accumulated, or let obligations on his part to others build up, which might be redeemed at any date. Interestingly, the profit, which the entrepreneur privately appropriates, belongs properly to society as a whole since it represents a return on the whole of society's investment in social capital.

The reason why it may be appropriate for the entrepreneur to slap in a claim on profit, is because the entrepreneur may play a pivotal role in the establishment and maintenance of social structure. The payment for entrepreneurial services represents a payment by society for a scarce resource. Trust within society has tangible economic benefits, but engendering trust is a problem which all social organisation faces. What is required is the establishment of effective norms which, as noted previously, arise in closed social structures with dense mutual dependencies. Entrepreneurship may constitute an effective substitute for social closure. In this way entrepreneurs may be able to successfully broaden the realm of social organisation.

The formation of a business can be taken as a classic example of entrepreneurship. Much business entry is by smaller ventures, often with limited resources for whom the preceding discussion is of some import. Johansson (1988) has argued forcefully, in a similar vein to the line of thought being pursued here, that the social network is the prime resource available to potential entrepreneurs. He suggests that personal attributes of the entrepreneur "merge in a networking competency" (p.83). The entrepreneur must be able to handle both dependence and independence, since the entrepreneur can be seen as both an autonomous actor and one who is externally controlled. A number of arguments supporting his thesis are presented. The first of these argues that to succeed new and small businesses must specialize, primarily because of the disadvantages of scale and
newness in terms of labour, capital and property resources, as considered earlier. However, to effectively manage in a complex environment demands a variety of resources. Only a personal network can reconcile these apparently conflicting forces.

A second argument stresses the need for recognition by a new venture, not just by the market, but from other third party institutions as well. Such recognition is provided via the network, since "a network of trust relationships is strong enough to transcend institutional boundaries" (op cit p.97). Thirdly, the social network can be viewed as the means to promote entrepreneurial action. Finally, and perhaps most importantly, networks are seen to create new ventures. Unique networking competencies possessed as a resource by individual entrepreneurs place them in an enviable intermediary position. Johannison gives as an example, new firms which have formed when an employee with competencies considered unique to both customers and employer alike leaves the company to set up on his own account. Whilst such an example seems to underplay the importance of arbitrage in entrepreneurship, it is nevertheless quite consistent with the much broader trust thesis presented here.

The main problem with Johannison's approach is the rather lax use of "competency" as a catch-all term to cover the benefits of combining various aspects of the network. Not enough attention is paid to the way in which this competency must be externally perceived, and that this relies to a large measure on trust and reputation. "Social capital" has the great advantage over "competency" in that it provides a rational explanation of how the entrepreneur is linked with his environment, together with a clearer understanding of the benefits which accrue both to society and to the individual entrepreneur of his actions.

**Entrepreneurial Reputation**

Having outlined what is meant by social capital, and the
consequences of its creation and use, it now needs to be explained exactly why social capital is of such particular significance in the entrepreneurial process. Crucially, it needs to be explained how social capital is related to the market phenomenon of reputation, since "it has long been recognized that a firm which has a good reputation owns a valuable asset" (Shapiro, 1983 p.659)

It has been asserted that entrepreneurship can help to "close" social structures, thus engendering the appropriate incubator environment for the establishment and maintenance of norms. So far no attempt has been made to explain how this might happen. In essence the idea is simple. Entrepreneurship can be seen to provide a social linkage or network between agents in the economy where none existed before. This provides economic benefit to society because it gives force to reciprocal obligations through the possibility of sanctioning opportunistic behaviour. To understand this more fully the common economic scenario of two person exchange needs examining, since this provides us with a fully closed social system in which, since there are only two agents to consider in the economy, all agents are linked socially to one another.

Assume that a trade is being contemplated between the only two agents in a hypothetical economy, which is potentially mutually profitable if the right deal is struck. In considering a traditional simple dyadic exchange situation, in which exchange is considered as a one-off game and there is the possibility of malfeasance, Leibenstein (1987) has shown that in the absence of some moral code exchange is unlikely to occur. This is so even if both agents in the exchange relationship have full information about the possible outcomes. It might be thought that the dual interests of the agents would promote trustworthy behaviour. Typically this will involve the possibility of sanctioning opportunistic behaviour. In a one-off game, however, it is not easy to see how this might occur.
Again, consider a two person exchange relationship, but this time a number of transactions or "plays" may occur. What will induce one agent to trust another? Dasgupta (1988) argues that trust is based on reputation and that a reputation arises through observation of behaviour through time in circumstances that are well understood. Such regularity of behaviour as gives rise to reputations only makes sense in a dynamic setting. As such, if Dasgupta is correct in asserting the dependence of trust upon reputation, then the phenomenon of trust itself can only be understood dynamically. Distrust can be expected in all situations where opportunism is feasible such as where repeat transactions do not occur. It is thus seen that distrust and trust are different constructs arising out of different types of circumstance" (Zucker, 1986)

In a dynamic setting with two persons contemplating exchange, one of whom must elicit the trust of another, two possible scenarios may be distinguished. First, a situation in which the number of transactions is finite and second, where there are an infinite number of possible transactions. It can be shown (Dasgupta, op cit) that in the former case if we know the seller's history then should he have been untrustworthy in the past, nothing will induce the buyer to purchase. In the latter case, on the other hand, there may be a possible cooperative solution. Whilst the customer knows the seller to be dishonest at heart, he also knows that a credible threat of a withdrawal of the buyer may induce out-of-character honest behaviour.

Now if we allow these agents to invest in the acquisition of a reputation the situation may change somewhat. In general we might imagine that in the beginning there was distrust, but that with an increasing number of transactions a degree of trust builds up to replace the air of distrust: in short, the seller is acquiring a reputation. If at any time he reneges, then his reputation will plummet. As Zucker (ibid p.62) puts it "reputation is a symbolic
representation of past exchange history".

How can agents invest in their reputation? There are essentially two routes: the social capital route and the financial outlay route. The first of these sees reputation arising out of the investments in the stock of social capital in society. Obligations and expectations are built up against individuals who will be expected to be true to their word. Goodwill is built up between parties to a trade. But this goodwill comes not only from the history of their contractual linkages but from social ties also. If they act dishonestly in any sphere then their reputation becomes a poor one and contractual trade as well as social linkages will be withdrawn. Fulfilling obligations creates goodwill and promotes a good reputation.

In general society is made up of more than two agents! Thus it is likely that persons with whom anyone might wish to trade are not linked to them via any obligations or expectations. For simplicity imagine the economy is now made up of three people. John and Anna each have commodities they wish to trade, but because no goodwill exists between them in virtue of no history of trading, they are unsure about whether trade is appropriate and a potentially profitable opportunity is about to go begging. The third person, Sarah has had dealings with both John and Anna in the past and has built up a network of expectations and obligations with each of them separately. By Sarah acting as an intermediary - she provides a sort of certification - John and Anna can be fairly sure about the outcome of the trade, since neither will wish to dissipate the links they already have. Sarah acts as the entrepreneur, filling a gap in the market and providing the substitute for social closure which might have sufficed to enable trade.

It should be noted that if the entrepreneur possesses no other resources than the social capital which is common to all then even if the transaction is perceived to be a one-off, it is still
in the entrepreneur's interests to participate since their are no
gains to be had in damaging his reputation. In this way the
entrepreneur overcomes many problems non-entrepreneurial agents
must address. If the entrepreneur is also an owner of resources
which are being used, then the situation is slightly more
problematic since, if the number of transactions is expected to
be finite, it may be in the interests of the entrepreneur to
trade in the loss of goodwill against the gains which cheating
may bring, such as, for instance, insisting on a high price for
shoddy merchandise.

All of this begs the question, of course, of how the entrepreneur
actually acquired a reputation and built up reciprocal links,
possibly in the absence of any ownership of resources. The simple
truth is that it is impossible except where resources have been
committed somewhere down the line, not necessarily in an
entrepreneurial act, or where common membership of a social
group defines bounds within which kinship can successfully
function. In general there are three ways in which the sense of
expectations and obligations which may lead to trust can arise.
Zucker (op cit) describes these as process based trust;
characteristic based trust and institutional trust.

Process based trust is most closely allied to the discussion so
far. That is because it is explicitly tied to exchange. Process
based trust captures Dasgupta's conjecture that trust is based on
reputation. Characteristic based trust is tied to socio-economic
features of individuals such as family background, ethnicity and
sex. These factors may form a bond between members of a society
with similar characteristics and enable obligations and
expectations to be more readily discharged. The third type of
trust producing mechanism is institutional. It can be specific to
a firm or individual, such as membership of a professional body
or association, or it may be a specific intermediary mechanism
such as money (see Alchian, 1977) or specialist intermediaries
such as banks.
The common feature of both process and characteristic based trust is that no private market is required. Trust comes about because of social capital. Furthermore, as was noted earlier, because social capital commonly comes about as a by-product, it is often essentially costless to acquire. In contrast, institutional trust requires that expenditure be incurred in building up goodwill. In many societies in which characteristic based trust is prevalent, the stable structure of such characteristics will leave little room for entrepreneurship, except as a means of arbitrage with other tightly bound societies. Indeed, it might be argued that social stability is inimical to entrepreneurship. As such, characteristic based trust is only relevant to entrepreneurship in that it provides the resource of social capital to the entrepreneur in a costless manner, without the need for an apprenticeship to earn goodwill within the group. This provides a resource which can then be combined with goodwill which must be built up by building up expectations and obligations with another group. Once the potential entrepreneur has goodwill with two or more groups in society he is in a position to exploit entrepreneurial possibilities.

The potential entrepreneur may be able to draw on resources of kinship within a group to be able to create obligations on the part of another group. For instance, it may be relatively cheap to subsidise the potential entrepreneur doing a favour for someone in another group. By investing in social capital when it is relatively costless to him and the society of which he forms a part the entrepreneur can create obligations which can be traded in at a premium.

A good example of this type of behaviour is to be found in the expanding literature on ethnic entrepreneurship. It is often noted that there is a sense of "closeness" in business relations amongst ethnic entrepreneurs which is not shared in other sections of the business community. This could be explained in
terms of social capital. Werbner (1984) describes how social ties help to generate give and take behaviour which succeeds in generating trust. The cultural ties binding workers together in the rag trade (see Ward, Randall and Krcmar, 1986; Sakar, 1989) may efficiently overcome the problems of organising production and finding reliable subcontractors.

A similar type of scenario, not built on ethnic ties, but on geographical proximity is to be found in the now extensive debate on the Italian "industrial district". The industrial district is widely perceived as a role model for small firm activities. It has provided a successful route to integrating the economic activity of a region whilst maintaining a degree of independence from corporate concerns through extensive small firm subcontracting. Small firms trade within the district on the basis of give and take, with large elements of trust required. Trade with other districts is conducted by merchants with social and business links which span communities (see Lorenzoni and Ornati, 1988 for a discussion of this phenomenon).

Contrast this with what might be termed corporate reputation. The corporation, as an institution, if it is to build a reputation must gain trust through market processes. For instance, members of the firm may join professional associations and the firm may belong to the chamber of commerce, etc. These are costly in themselves, but the greatest cost is likely to be in gaining access to a market.

Most of the economic literature which addresses the way in which firms acquire reputations focus upon mechanisms which are costly to the firm. (see for example, Schmalensee, 1978; von Weiszacker, 1980; Klein and Leffler, 1981; Shapiro, 1983; and Holmstrom, 1985). Typically this cost is seen to function as a signal of goodwill.

In comparing a new entrant with a well established firm von
Weiszacker (1980) notes that "a new supplier first has to establish a quality reputation. If he offers good quality from the beginning his products will first have to be sold at a discount compared with products of equal quality of long established suppliers. Goodwill is a valuable asset precisely because it takes time to acquire it". Digressing slightly, as we shall see shortly two features of this are what may give the entrepreneur an advantage. First, the time taken to acquire the reputation or goodwill, and second the costly price cutting that must be engaged in.

Klein and Leffler (1981) also consider the predicament of a firm wishing to enter an established market. They argue that investments in brand names or advertising signal to potential customers a long term faith in the product, since such expenditures are effectively sunk costs. Shapiro (1983) argues that features of markets designed to act as proxies for reputation such as warranties and advertising do so only imperfectly. He echoes von Weiszacker in arguing that in order to establish a reputation for good quality a seller must initially price at less than cost, as an investment in long term reputation. He states that "there necessarily are costs to building up a reputation" (p.661)⁹.

**Entrepreneurial and corporate reputation**

The basic difference between entrepreneurial reputation as we have defined it and corporate reputation is one of ownership. Entrepreneurial reputation arises out of the commonly owned public good, social capital, whereas corporate reputation requires expensive private investments. Because social capital is basically costless, there is prima facie evidence of a cost advantage for new entrepreneurial firms drawing on social capital compared with the corporation. Furthermore, corporate reputation is likely to take time to acquire after entry has occurred, whilst the resource of social capital and the benefits of a
social network as a means of generating custom are available from before the time when the venture starts up. There are nevertheless some severe qualifications to this conclusion which need to be made.

First, it is quite possible that the gains due to social capital in terms of building a reputation which is in place prior to any actual market entry may be outweighed by other factors in which the corporation may have a comparative advantage. Foremost amongst these will be the possibility of achieving economies of scale. This suggests that the advantages of social capital will be greatest in market niches where no substantial economies of scale can be reached. This seems to bring us back to a vision of small firms forming the periphery. This may be the wrong conclusion to draw, however, since theories stressing satellite status for the small firms sector tend to predict long term decline as the economy increases in size. In contrast, as increasingly flexible technologies come to be used in the economy, the benefits of scale are likely to diminish in many activities. This may well mean that over time the benefits of the social network become more pronounced compared with more traditional economies of scale.

The second reservation concerns the uniqueness of the entrepreneur in being able to draw on social capital. Why can a corporation not also draw upon social capital? The answer is that it probably can, but to a far more limited extent. This is because the corporation is a legal institution rather than the individual who is the entrepreneur. Thus any obligations towards the corporation created are to the institution rather than to an individual. This matters because the dissolution of an institution is much easier than the dissolution of an individual.

A firm with outstanding obligations can often simply close down and restart in a new guise, if it has resources to invest. The simple juristic difference between the way sole proprietorships
and joint stock companies are treated bears testimony to this. Whilst if an individual sole proprietorship is made bankrupt, it is almost impossible to start afresh, it is almost part of folklore that some directors of insolvent companies, particularly fraudulent ones, just walk away from their obligations. Limited liability is significant in this respect in that it reduces the strength of obligation. The obligations outstanding against an individual entrepreneur cannot be readily cancelled in the manner of a corporation. Because of this the ties between individuals can be considered to be stronger than those involving corporations. This means that trust and reputation may be more readily accomplished.

Since entrepreneurship is often strongly associated with innovation, the question of whether reputations can be maintained in more turbulent, innovative business environments is worth briefly addressing. It would seem that since the way in which an individual acquires social capital and reputation is based on his personal characteristics and known obligations, this may well be more effective in attracting confident backers and trust than a corporation which must rely on a reputation gained within a very specific market context which may bear little relation to the proposed innovation. The difference arises again because individual potential entrepreneurs have reputation at their disposal from the outset, whereas the corporation needs to work at acquiring one. Of course many corporations do have reputations which are readily transferable, and ultimately it is an empirical matter whether individuals or corporations have more readily transferable reputations. Furthermore, the benefits of retained earnings as a source of funding to a corporation engaging in innovation should not be overlooked, since these overcome the problems of finding confident backers.

One of the major weaknesses of social capital is that it may not necessarily be a stable resource. If individuals start waiving obligations, the social fabric may start to collapse and the benefits of social capital may easily be lost. In a society in
which trust is largely absent entrepreneurship is likely to be difficult if not well nigh impossible\(^\text{10}\).

Another problem with social capital is that for many potential entrepreneurs the extent of their social capital may well be limited to local circumstance. As geographical distance increases social linkages may well weaken. This means that any benefits a new or small venture may reap from social capital are likely to be limited to the local economy. It also helps to explain why those who have been in business before may have a better chance of success than first time entrepreneurs. Previous business experience gives the opportunity to acquire a broader social network, thus increasing opportunity.

To a large extent the spatial closeness of many social bonds need not matter since local markets are where most entrepreneurs choose to trade. These may well give the entrepreneur with a local presence and reputation based on his position in the community, and gained in an essentially costless manner since birth, an advantage over a firm which is a newcomer and which must incur much expenditure to overcome distrust and suspicion in order to establish a successful business. The problem arises with expansion, since as the firm expands local market demand may well prove insufficient and moving outside of the local context means a loss of the benefits of the locally derived reputation.

**Conclusion**

Reputation is important in business to the extent that the possession of it may confer advantages over and above those traditionally presumed to arise out of efficient combination of traditional economic resources. It has been argued that two type of reputation, individual and corporate should be distinguished. Individual reputations are embedded within the social framework and arise out of basically free investments in the public good social capital. In contrast corporate reputation must be paid for
privately. For this reason the social network of the entrepreneur provides him with a valuable asset in a relatively costless manner. Seen in this light it is perhaps not surprising that recent research in entrepreneurship has started to pay increasing attention to the role and function of the social network.

In a well known article Granovetter (1985) gives four reasons why there is a widespread preference for dealing with individuals whose reputation is known. The information conveyed is cheap; one's own information is certainly trustworthy; relational contracting brings with it an economic motivation to be trustworthy; and finally continuing exchange relations become embedded in social relationships carrying expectations. For these reasons, if it were not for disruption of our economic routines entrepreneurship would be exceptional, in that the preferred trading links would usually be a matter of routine. The entrepreneurial act may have been necessary to initiate trade, but following this, non-entrepreneurial routine commonly takes over. This may not be untypical of much smaller firm behaviour. The start-up process may be seen as entrepreneurial but following this many businesses slip easily into a comfortable routine.

Granovetter's arguments are important because they suggest why small firms may persist. It may well be "because a dense network of social relations is overlaid on the business relations connecting such firms and reducing pressure for integration" (p. 507). Similarly, Dore (1983) tries to explain the predominance of small subcontractors in Japanese industry in terms of the give and take characteristic of goodwill. In fact, his article presciently anticipates Coleman's concept of social capital. Moreover, he argues that this system of relational contracting to be found in Japan may provide economic benefits to the overall economy which outweigh the economies of scale and scope which might come through integration.

Neither of these examples describes the entrepreneurial act, but
they do bring us back nicely to where we began: discussing the disadvantages of small scale. Our original focus was on a small business which had just opened and which was run by someone with a known reputation. Though it is sometimes difficult to see why a reputation on the sporting field should readily transfer to reputation in business, the success of countless celebrities in business ventures is surely testimony to the strength of social networks in entrepreneurship.

Notes:
1. I would like to acknowledge the helpful advice given by members of the Warwick University SME seminar group and the ESRC Post Keynesian Study Group in preparing this paper. Obviously no blame attaches to them and all errors remain the responsibility of the author alone.
2. Although there is a conceptual problem over the appropriate link that should be made between small business and entrepreneurship, for convenience it is taken for granted that new and small ventures are likely to be run by an entrepreneur.
3. In no way is it being claimed that this is the only entrepreneurial function which should be considered. It is just that it proves particularly suitable in analysing the role of social networks.
4. The personal pronoun "he" should not be taken to imply any exclusive masculinity in the acquisition of business reputations.
5. Hebert and Link (1989), for instance, identify twelve distinct themes characterizing entrepreneurship in the economics literature alone.
7. Similarly, continuing entrepreneurship - the growth of a business in an uncertain environment - is seen to be dependent on the external social network (Johannison, 1990).
8. The reasons given by Johannison (1988) for this are somewhat different to those which the logic of the present argument would furnish. Johannison places emphasis on "the mental and social
support needed to launch experiments and rationalize their outcomes" (p.97) as a means of staying alert to possibility. In contrast, I would argue that it is in providing an information system which unconsciously advertises profitable opportunity that the social network furnishes assistance in promoting entrepreneurial action.


10. It is interesting to conjecture if this is not largely what is happening in Eastern Europe at present.

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