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YALE UNIVERSITY
P.O. Box 208629
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Trust: A Concept Too Many

Timothy W. Guinnane
Yale University

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Trust: A Concept Too Many

Timothy W. Guinnane

Abstract

Research on "trust" now forms a prominent part of the research agenda in history and the social sciences. Although this research has generated useful insights, the idea of trust has been used so widely and loosely that it risks creating more confusion than clarity. This essay argues that to the extent that scholars have a clear idea of what trust actually means, the concept is, at least for economic questions, superfluous: the useful parts of the idea of trust are implicit in older notions of information and the ability to impose sanctions. I trust you in a transaction because of what I know about you, and because of what I can have done to you should you cheat me. This observation does not obviate what many scholars intend, which is to embed economic action within a framework that recognizes informal institutions and social ties. I illustrate the argument using three examples drawn from an area where trust has been seen as critical: credit for poor people.

Keywords: Trust, Social Capital, Credit Cooperatives, Uniform Laws

JEL Codes: G2, N2

> … I maintain that trust is irrelevant to commercial exchange and that reference to trust in this connection promotes confusion.
>
> -- Oliver Williamson[1]

"Trust" now forms a central part of the research program in many social science, history, and related disciplines. Foundations have programs on trust, scholars meet for conferences on trust, and efforts to build trust now feature as part of policy proposals in rich and poor countries alike. Analytically, trust is closely related to the concept of social capital, and the two ideas play similar political roles. In some policy circles trust is viewed as a sort of magic bullet: governments can allegedly ameliorate social problems with little or no money if they can foster the development of trust.

Some scholars have cast a more critical eye on this enterprise. Sheilagh Ogilvie (2004a) argues that early-modern guilds used social capital to enhance the well-being of their members at the expense of a vulnerable group of outsiders: women. Ogilvie (2004b) argues that the trust embodied in guilds impeded the development of institutions that might have benefited all. Others have pursued a line of critique that doubts the efficacy of concepts such as trust and social capital. In this essay I argue Williamson's point: whatever its usefulness in other contexts, "trust" adds nothing to the analysis of commercial or more broadly economic problems. At best, talking about trust requires the introduction of new and redundant terminology; at worst it impedes understanding by replacing a clearly worked-out body of theory with something else. Orthodox economics, according to Williamson, already contains the notions implied by trust. This is not to say

[1] Williamson (1993, p.469). For the title of my own paper I apologize to D.C. Coleman (1983).

those notions are perfect or adequate, it is just to claim that the use of the term trust in commercial contexts is a best unnecessary re-labeling and at worst the willful introduction of confusion.

Many approving discussions of trust use empirical materials, but thus far most doubting discussions focus on conceptual issues, relying on empirical examples mostly to illustrate a point. Here I use a concrete set of empirical situations to argue my point that trust adds nothing that is both useful and new. I use the example of credit for poor people in the 19th and early 20th centuries in three circumstances: Germany, Ireland, and the United States. Credit institutions and credit problems have figured heavily in many discussions of social capital and trust. This is only natural. Most clear-headed discussions of trust stress that the concept only makes sense when one party risks something (eg, Gambetta pp.218-219). I lend you money today, and I hope that you will repay in the future. The very words used to describe lending imply trust. The Latin root of "credit," *credere*, means, among other things, to trust, while the German *Gläubiger* is literally one who trusts. Many transactions take place as X for Y, almost simultaneously. The seller receives payment in one hand while giving over the goods with the other. Credit, by its nature, cannot take place this way. The creditor gives over funds today, and in so doing places himself at risk that the funds will not come back.

The first section below briefly reviews some conceptions of trust. This discussion cannot exhaust the voluminous literature. The aim is to focus the discussion and provide some frames of reference for comparing "trust" as it is used in the (primarily sociology) literature. We then turn to a discussion of credit for poor people in general, why it has been viewed as an important social problem, and why this type of credit is more

problematic than credit for, say, publicly-traded firms. I then consider three examples of institutional approaches to the problem. One of them is Germany's very successful credit cooperatives, first formed in the mid 19th century. The second is the unsuccessful attempt to transplant those credit cooperatives to Ireland at the end of the 19th century. The third example is the United States in the same period, where similar institutions were weak, and leading reform organizations promoted an entirely different approach to the problem.

Credit for poor people forms an especially useful example because of the tie to modern micro-lending institutions, enterprises that use novel approaches to lend to poor people in developing countries (and less often, in wealthy countries). Scholars disagree over the extent to which these institutions work, and if so, why. The connections to the German credit cooperatives are indirect but clear, and the role of trust and social capital in small-scale credit permeates the scholarly literature.[2]

1. Conceptions of trust

Our aim here is to focus the notion of trust enough to show that it is, for our purposes, fully achieved with ideas already current in economics and other social-science disciplines.[3] We can usefully lean on Hardin's very clear discussions. Hardin notes that "encapsulated interest" accounts of trust, which include Williamson's, are fundamentally different from discussions of trust in two other situations. First, trust is not an interesting concept in situations where the person I trust views my welfare as important to her own. (that is, where my utility is a highly-weighted argument in her utility function). In such

[2] For surveys on micro-lending, see Ghatak and Guinnane (1999) and Morduch (1999).
[3] Although I do not follow him fully, I am much indebted to Hardin (2001, 2002) for my thinking on this issue. I am also very sympathetic to Coleman (1990)'s effort to construct a rational-choice interpretation of "trust."

situations treating her well cannot be distinguished from treating myself well. Second, some individuals always do the right thing because in their mind not doing so risks the wrath of God. Again, if this is the case then the individual behaves honorably simply out of fear for his own future, be that earthly or in the afterlife.

Trust implies a three-part relationship involving at least two actors and one act: I trust specific individuals or specific institutions to do specific things. I might trust my friend with $100 but not $1000; there are other people I would trust with more, and some I would not trust with anything. A claim that I would trust any individual with everything borders on absurd, as does the claim that I would trust everyone with any one thing. An assumption to this effect underlies much of the empirical work done in this area, however, and renders meaningless some of the claims about patterns of trust today. Mackey (2001), for example, makes much of the responses to the following Eurobarometer question: "I would like to ask you a question about how much trust you have in people from various countries. Please tell me whether you have a lot of trust, some trust, not very much trust, or no trust at all." No statistical analysis of this question can produce a useful result. Are the French being asked whether they trust the Germans not to invade, or to be polite on the Autobahn? Which German are the French being asked to trust – Joschka Fischer, or some composite football lout?[4] Much of the literature on trust that talks about declining trust in institutions misses this simple point. Consider the idea of trust in government. I trust my government with my tax money but not my son's life, both because I care less about my money than about my son, and because the institutions that prevent government corruption appear to function better than those that

[4] Mackie's Table 8 also 1 relies on the illegitimate assignment of cardinal values to a question that does not have a natural metric. Fukuyama (1995) illustrates a different problem common in much of this literature: "trust" in his view is inferred in any situation he finds admirable.

prevent my government from starting wars. Asking someone whether she "trusts the government" can only elicit a meaningless answer.

Many discussions of trust confuse or conflate *trust* with *trustworthiness*. There is an important analytic difference. In our context what we really want to know is not whether the lender is a trusting person, but whether the borrower can be counted upon to repay. Most of what observers call problems of trust are actually problems in the trustworthiness of specific actors. Not trusting someone who is untrustworthy is not pathological, it is simply rational. Hardin gives the illuminating example of the medical professional. Many discussions presume that declining trust in doctors reflects some general and pernicious process in the society at large. Perhaps this is so. But perhaps doctors have simply become less trustworthy, or, more likely, they were never so trustworthy but now we know more about them.

Trust as a moral or psychological problem

Most of the accounts of trust to which I object share the feature of treating trust as a moral or psychological issue, and the lack of trust as a moral or psychological failing.[5] This essay should not be read to deny any moral or psychological component to the issue, or to issues closely-related to the commercial sense of "trust." But we must avoid erring on the side of locating what is essentially an institutional failure within the heads of actors whose own views may well be irrelevant. Muldrew (1988)'s discussion of commercial transactions in early-modern England makes a powerful argument that the framing notions of commercial trust grew out of a more strictly moral vocabulary. His closely-reasoned and deeply-research work has few counterparts, unfortunately. Most

[5] Ogilvie (2004b) calls this definition "trust as sentiment," which might be a better term.

empirical studies fail to distinguish between the lack of trust as a problem of what goes on inside people's heads and a problem concerned with the institutional context within which one acts. Modern credit institutions lend millions of dollars to entities whose moral qualities are to them opaque; the lenders count on an institutional structure of information-gathering and legal enforcement to make even "immoral" borrowers repay.

A simple example illustrates how empty the "trust as sentiment" approach can be. Consider a large financial institution in the United States that can lend domestically or to firms in several different countries. We might observe that it simultaneously lends in situations where one might think trust was very high (eg, Germany) and very low (eg, Russia). Presumably the Russian loans have higher interest rates and might be structured differently. But the key issue is that the bank does not care about Russian personalities or whether Russia is a "high-trust" society. The bank cares only that the loans can be structured and secured in such a fashion that it is likely to get its money back. The bank, that is, cares only about the specifics of institutions related to commercial loans. The sort of question Mackie (1991) analyzes might show that American banks are simultaneously lending in countries Americans find trustworthy and in countries whose people Americans trust very little.

Trust as information and sanctions

Suppose you and I have entered into a joint venture. We each made non-reversible investments in the project, and before it can pay off, we each have to make more investments. Along the way each of us has chances to act opportunistically ("fink") with respect to our venture. Opportunistic behavior here means that we take some action that

is in our private interest but harms the eventual value of the venture. If one or both of us takes too many opportunistic actions, the venture will fail, and be worth nothing. As I have described it, trust is clearly central to the success of this venture.

Yet I entered into this arrangement, which suggests I thought you would uphold your end. Why? Because I thought you would find it better, according to your own interest, to act honorably rather than opportunistically. This is adherence to Williamson's dictum: psychological and cultural claims may not be irrelevant to commercial transactions, but rarely are they specific enough to tell us the answer to question of interest in our context. Invoking them at the outset tends to crowd out more useful lines of thought.

Two simple notions get us very far: information and sanctions. How hard is it to learn that my partner did in fact fink on me? That is, how can I be sure we experienced a bad outcome because of his conduct, and not because of the weather or some other force beyond his control?[6] Information is also related to sanctions. How can I punish you if you fink, which is to say deter you from finking in the first place? Is there a legal system capable of detecting and punishing bad conduct? Can I go to some less formal authority – perhaps a village elder, or the leader of a kin group – and threaten a larger group for the conduct of its single member? This is one way to understand Ben-Porath (1980)'s observations about the importance of family connections in commerce, even in quite developed societies. Families members have multiple channels through which to collect

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[6] As later discussion makes clear, there are two complicating issues. One is that there are general forces, such as the weather, that are beyond either partner's control. This fact does not pose a problem so long as the weather and its consequences for the venture are entirely observable. The second complication arises if the weather is not observable or if the weather's impact on the venture cannot be determined. In this latter case, one party might blame the other for problems that are really due to the weather, while a guilty party might shirk his responsibility by blaming the weather. We return to this issue below.

information about one another, and can sanction each other effectively and cheaply in ways that might not affect the business connections directly, but which would be useful nonetheless. Perhaps my business partner does not care if I think badly of him, but does care if others think badly. That is, the most useful sanction might not be something I impose directly, or cause to be imposed directly (such as a court order), but my ability to damage his ability to carry on other commercial relationships that he values.

Now take a step back. Both my partner and I know the situation in which we operate. That is, we both know the conditions under which our venture will succeed or fail, and we both know the institutional context in which we operate. We know what the court system is, whether there are non-legal forms of sanctions, the state of the information environment, etc. I know (and he knows that I know…) what I can do if he finks. The fact that we have entered into such an agreement shows that we both think it will work. This understanding might just reflect the general environment. But it might reflect specific features that we have written into our agreement to make finking unattractive. If I find the potential punishments insufficient to deter my partner's bad conduct, for example, I might demand in advance, as a condition of setting up the deal, additional guarantees. That is, I might ask him, as a condition of our venture, to increase the penalties he has to pay to me if he finks. I might not really want the penalties. I just want him to have the right incentives to act honorably. I might ask him, for example, to post a cash bond that he forfeits in case of bad behavior. This has the effect of raising the cost of bad behavior.

Note that this analytical approach can also account for the role of reputation. Suppose I ask my partner to pledge a bond of $100,000 when the most he can gain from

finking on me is $25,000. He has little reason to fink; forfeiting the bond costs him more than he can gain, in my example. Now forget the bond, but assume we live in a situation where I can easily communicate his dishonesty to many or all potential future business partners, and where he cannot do business without a partner. If he finks on me then he loses his reputation for correct conduct and cannot work in this line of business again. Forfeiting his reputation is like forfeiting the bond.

This approach does not rule out all bad behavior, but does limit finking to two very clear situations. One is where the institution itself is insufficient, most likely because of new circumstances that make the old arrangements powerless to deter finking. This situation is implicit in many accounts where a traditional institution breaks down in the face of social changes that promote mobility or a more anonymous form of society. Another circumstance is simple bad luck. Suppose my partner has posted a $5000 bond, and can only gain $1000 through dishonest conduct. If he finks then I know it was beyond his control – given the parameters, it would never be in his interest to fink if he could avoid it. One uncomfortable implication of many game-theoretical models is that the principal must punish the agent for not performing correctly, *even though the principal knows the agent only fails when failure is beyond the agent's control.*[7] If the principal refrains from such punishment, then all other agents may stop performing. Note the implication of this for the "trust" analysis. If some of the economic world is beyond the control of any actor, then we may observe "punishments" even when the institutions

[7] This is a clear implication of my paper with Miller (Guinnane and Miller 1996), which is actually contract theory rather than game theory. In that model, the only circumstance in which a tenant would not pay his rent is where he has had bad luck and cannot pay. The landlord knows this is the only circumstance – that is, the landlord knows that all non-payment reflects bad luck rather than shirking – but the landlord still has to eject non-paying tenants to keep the incentives right. Put differently, in these models sometimes the principal has to punish people he knows are innocent to, as Voltaire said of Viscount Torrington's hanging, "encourage the others."

deter bad conduct as much as they can. We should not equate the finding that there are some examples of finking with the claim that the institutions fail to generate honest conduct.

Now consider these issues in the context of a credit transaction. Suppose Smith lends Jones $100 for a year at 5 percent interest. Smith risks the opportunity cost of his money. The question is not whether Smith trusts all potential borrowers or would trust Jones with his children, his house, or his life. Smith just needs to think that Jones will come up with $105 in a year. Thus the interesting questions here are mostly about Jones and the institutional environment in which the two work. What is the chance that Jones will have the money? What legal sanctions can be applied, and at what cost, should Jones refuse to repay? What reason does Jones have to fear Smith's bad opinion, should the debt go unpaid? What sanctions can Smith and Jones agree to, prior to the loan, that give Jones the right incentives to repay the debt?

All of this is implicit, and sometimes explicit, in the game theory and information economics that now dominates most related discussions in economics. Given my argument it is curious that some of the most famous uses of such theory are often labeled parts of the "trust" literature when, as noted here, they have little in common with it. This is true, for example, of Avner Greif's analysis of the "coalition" formed by Maghribi traders in the Mediterranean region in the 10th-12th centuries (Greif 1989, 1994). The point of the coalition is to make information more available and sanctions more effective, thus encourage honest behavior. Greif actually explicitly denies an interpretation that would stress the moral qualities of those involved (1989, pp.862-863).

Note what we have not assumed. Our hypothetical partners care about the institutional context in which they live. They may be atoms, as in all orthodox economic theory, but the social context still matters. And nothing in what we have said requires perfect information about each other or anything else.[8]

2. The problem of credit for poor people

To see what "trust" can or cannot tell us about credit for people, we explore three different settings in the second half of the 19th century and early 20th centuries. The first, Germany, is justly famous for an institutional solution to the problem of providing credit for the poor. Germany's credit cooperatives thrived in that country and became the model for similar institutions in many other places. In the second, rural Ireland, reformers tried to transplant German credit cooperatives without success. Although based on the German model and supported by a variety of private and governmental organizations, Irish credit cooperatives stagnated after their inception in 1894. Third, we turn to the United States, where institutional attempts to provide credit to poor people have been based on different models and have never worked as well as advocates hoped. In each circumstance our purpose is to ask what trust can teach us about the success or failure of an institution that the economics of sanctions and information cannot.

The idea that credit in particular, or financial services more generally, is a serious part of the problem of poverty goes back at least to the late 18th and early 19th centuries. At that time social reformers in Europe began to advocate specialized savings institutions for poor people. The twin motivations were to inculcate in the poor habits of thrift, which

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[8] Our account is implicit in DasGupta (1988), which is a clear-headed application of the ideas of economics to the problem of trust.

were thought to promote a more forward-looking, settled lifestyle, and to encourage poor people to build up savings as buffers against the irregular incomes and vicissitudes that were their lot. The larger motivation was to reduce the fiscal burden of poverty by helping the poor to help themselves. One outgrowth of this thinking was the savings-bank movement that started in many European countries in the early nineteenth century.[9]

By the mid-19th century reformers in several European countries had identified credit as a more serious and vexing issue. Today economists and others tend to stress poor people's need for credit as a way to manage irregular incomes and shocks such as unemployment and illness. Most 19th-century advocates stressed instead productive loans, implicitly accepting the view that loans for consumption purposes were to be avoided. Low-cost credit, it was thought, would reduce the operating costs of enterprises such as farm, small producers, and shops, and also allow working-class people to acquire their own independent means.

Credit for poor people was and remains problematic because the information and sanctioning mechanisms used to support other loans do not work as well for loans to the poor. Most loans to poor people are relatively small, meaning that any fixed costs of investigation, monitoring, or enforcement are large relative to the loan. Poor people may also be problematic borrowers for other reasons, such as an unsettled lifestyle and irregular incomes. But the basic reason is that most poor people lack assets that are useful collateral to a lender. Collateral serves as an information device. Individuals who risk their own assets will not apply for a loan if they do not expect to be able to repay it, and once they have a loan, will take care to make payments. Collateral also serves as a way to enforce loan terms. If the borrower does not repay, then the lender can seize the

[9] Guinnane (2002a) discusses this issue in the German case.

collateral. Most lending institutions require collateral that the poor, by definition, lack. Pawnshops, which have long been reviled for their high interest rates, amount to an effort to lend on the basis of the only collateral that most poor people own: clothing, simple household articles, etc.[10]

Germany's credit cooperatives

The stress on credit issues was not confined to Germany, but Germany witnessed the first large-scale, institutional flowering of this concern.[11] The credit cooperatives that thrive in Germany today owe their origins primarily to three groups in the 19th century. The mid-nineteenth century was a period of rapid economic change in Germany. Occupational freedom and increasing intra-German and international competition meant new challenges for farmers, artisans and small trades people. Two of the first branches of German cooperatives owe their existence to efforts to deal with these challenges. Hermann Schulze-Delitzsch (1808-1883) founded several primarily urban cooperative associations during the 1840s and 1850s. Friedrich Raiffeisen (1818-1888) operated in rural areas, and was at first an imitator of Schulze-Delitzsch. He later broke with Schulze-Delitzsch over ideological and organizational issues. The number of Raiffeisen cooperatives at first grew rapidly, but was later eclipsed by cooperatives affiliated with a group formed by Wilhelm Haas in the 1870s. Both the Raiffeisen and Haas cooperatives were primarily rural.

The several groups of credit cooperatives advocated differences in internal organization and practice. But in many respects Germany's credit cooperatives were all

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[10] There is little economic analysis of pawnshops in the 19th century, and not much more for these institutions today. See Guinnane (2002b) for some thoughts on pawnshops in our period.
[11] This section summarizes material found in Guinnane (2001).

similar, in part because they were organized under common incorporation rules. After 1889 all new cooperatives were registered under a Reich law. Each had to have two management organs, an *Aufsichtsrat* and a *Vorstand*. Both organs were elected by the membership. The *Vorstand* made credit decisions and supervised the treasurer. The treasurer (*Rechner* or *Rendant*) was formally a bookkeeper but by virtue of his position often assumed a leading role in the organization.

Most individual institutions held loans to members as their major asset. The nature of their liabilities constitutes one source of institutional variation. Rural cooperatives tended to have nominal member shares and at least at first funded their loan portfolios almost entirely from deposits. Depositors could be members, but many were not. Urban credit cooperatives tended to have larger member shares and were thus less reliant on external sources of finance.

Cooperatives had the right to accept or reject new members. Similarly, the *Vorstand* could and did reject loan applications, or require better security or other changes in terms. Loan terms were a matter of discretion for each local institution. Rural cooperatives thought it was important to provide long-term credit, and usually did so, offering loans with durations of 10 years, 20 years, and even longer. Urban credit cooperatives were more concerned about liquidity and did not see their members as needing this kind of finance. Most urban cooperatives offered shorter loans, and in fact discounting bills of 30-60 days' maturity was a common means of providing credit. Nearly all loans required some form of security. The most common form of security for

rural credit cooperatives was at first simply a co-signer, although for larger loans it could be real property.[12]

The rural cooperatives especially amassed what seems like an astounding record of lending successfully to borrowers that other institutions had spurned. Default on individual loans was rare, and the failure of an entire credit cooperative was extremely rare. The credit they provided was as cheap as it was convenient: most credit cooperatives charged at most 1 percent more than the Reichsbank's Lombard rate. Some charged fees in addition to interest, but these fees were always modest. For many of their borrowers, alternative sources of credit were either non-existent or limited to moneylenders and others who would demand much higher interest rates and shorter loan durations.

This record has, not surprisingly caused some to invoke trust as an explanation. In fact, in a nice twist, Ute Frevert has interpreted my own writings on these cooperatives as a situation evincing trust.[13] The fact that Germany's credit cooperatives could make small loans that were secured by co-signers (who in most cases would not have been acceptable security to other lenders) invites this kind of interpretation. Rural credit cooperatives saw it as important to deal only with people the managers and other members could know well. Some groups had formal rules that limited a single cooperative's operations to a small district (such as a parish). Depositors, too, came mostly from the same area as the other members. This meant the institution was less well-diversified than it might want to

[12] These lending practices created liquidity problems. The cooperative "Central banks" were one institutional response to this problem (Guinnane 2004).

[13] Frevert (2003) is a wide-ranging survey of the contexts in which trust might be relevant. She cites Guinnane (2001). Her paper is a stimulating and thought-provoking effort, but also illustrates the qualms that lie at the heart of the present essay: any concept that can be relevant to as many issues as she mentions cannot be of much use to understanding any of them.

be, but in return, it had another set of stakeholders who were both well-informed and interested in the institution's future. Even in the absence of such a rule most members lived in or near a small village or perhaps a group of nearby villages. This ensured that actual and potential members knew each other well, and that all were easily cognizant of each other's social and economic activities. This seems like precisely the environment that would evince high degrees of social capital.[14]

But is "trust" the right way to think of the cooperatives' success? Many of their practices suggest that the members did *not* trust each other. Consider the lending decision. The manuscript business records I have consulted suggest that the *Vorstand* considered all security with a jaundiced eye. Real property was sometimes judged to be too hard to sell to make useful security. More interestingly, proposed co-signers were sometimes rejected or deemed inadequate. An applicant might be instructed to keep one co-signer but get another one as well. Another example concerns the cooperatives' internal management and record-keeping. Far from a simple reliance on each other's goodwill, the credit cooperatives demanded elaborate, formal internal controls. Just as in the very largest corporations of the day, the functions of the *Aufsichtsrat* and *Vorstand* were strictly separated, with the former acting as a sort of internal auditor for the latter, among other things. The most serious controls surround the activities of the treasurer. Most had some sort of financial bond, posted either by themselves or another member of the cooperative. They had to present summaries of their books at the monthly meetings of the *Vorstand* as well as to the *Aufsichtsrat* when it met, which was less often.

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[14] Put differently, German villages had all four of the features that are held to generate trust among network members: shared norms, swift information transmission, effective sanctioning, and efficient collective action in pursuit of the shared norms. See Ogilvie (2004b).

None of this sounds like a situation in which everything worked fine because the good folk all shared the same values. In fact, it sounds like the sort of auditing and control systems that would make a large corporation proud – which was precisely what the cooperatives wanted. The external institutional controls were even more elaborate. In addition to the internal auditing and supervision, each credit cooperative had to undergo external audits. These had been a feature of some cooperative federations since the 1860s, but became mandatory with the 1889 law. Most cooperatives joined a special cooperative auditing association that hired and trained specialist auditors to inspect the cooperatives. These inspections were thorough and the reports sometimes harsh.[15]

Pointing out these formal controls is not meant to deny that these institutions functioned differently from formal lenders, and were able to lend successfully in situations where other lenders could not. But the focus should be on the *institutions*, and how the institutions induced the behaviors that were needed for success. We could stand back and just say "trust," but this would teach us little about the cooperatives, the context, or how credit really works.

Why did they work? My argument echoes a growing literature on the development of micro-lending in developing countries today. The credit cooperatives were not the same as most micro-lenders now. Today's micro-lenders are usually not mutual organizations, as were the cooperatives, and modern micro-lenders usually offer different loan terms. The common theme, however, is that the cooperatives operated in environments where people (1) knew a great deal about each other and (2) could cheaply and easily impose sanctions on borrowers who might default on a loan or otherwise

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[15] Guinnane (2003) details the cooperative's management and auditing systems. The cooperatives never did find a perfect solution to one continuing problem, which was embezzlement by cooperative treasurers.

endanger the institution's health. The information made it simple to determine who was a good risk (that is, who was a careful borrower) and to evaluate the quality of the co-signer(s), who were often the only security offered. The ability to rely on co-signers was especially important. Few loan applicants had assets suitable for a loan from a more formal financial institution, so being able to tell which borrower's co-signer would ensure repayment was important to the cooperative's ability to reach its clientele. The sanctions capability meant that borrowers thought carefully about taking a loan and were more cautious with its use. This saved the cooperative the expense of legal proceedings to enforce repayment. The cooperatives used this information and this capability to make low-cost loans to people who might otherwise be denied credit.

Here we see precisely Williamson's point: the cooperative members did not trust each other in the sense of feeling assured each would do the right thing just because they were good people. Far from it: they demanded explicit, written guarantees, formal bonds, and multiple controls as a condition of operating. Credit decisions were based on meaningful security (although, perhaps, security different from that usually acceptable to banks). This apparent paradox raises two questions in the context of the trust literature. First, would we characterize these credit cooperatives as operating in "high trust" or "low trust" environments? Their success might justify the former claim. But why then did they insist on all the institutional checks? Those checks could just as easily suggest a lack of "trust," if we followed much of the literature. But then it would be awkward to explain their lending patterns and success at difficult lending. We will return to this theme in the conclusion, but for now it is worth registering the sense that this apparent paradox

reflects a problem in the meaning of "trust" as it is used – not in our understanding of the cooperatives.

Second, do we learn anything by talking about "trust" in the context of these loan contracts? Suppose Müller takes a loan from the cooperative, with Schmidt as his co-signer. The members of the cooperative *Vorstand* that made the credit decision have probably known Müller all their lives, and know his farm equally well. They can form judgements about his abilities as a farmer, and the likelihood of success for the project he wants to finance, based on that knowledge and their own knowledge of local conditions. They know just as much about Schmidt. Müller knows that if he defaults on his loan he will annoy Schmidt and likely be ejected from the cooperative, which would annoy the rest of his neighbors and be a bad public signal. Knowing all this, the cooperative makes the loans to people who it thinks will use the credit wisely and who will repay it, if for no other reason than out of fear for ruining their relationships with their neighbors.

What more do we learn about the cooperative's operations if we say the cooperative trusts Müller, or that Müller is "trustworthy?" Why not just say that the cooperative leaders know a great deal about Müller, and has structured the loan contract such that it is in Müller's interest to repay?

Raiffeisen's cooperatives in Ireland

We now turn to an environment in which the credit cooperatives did not work well, at least not at first.[16] In 1894 Horace Plunkett's Irish Agricultural Organization Society (IAOS) introduced German-style credit cooperatives into rural Ireland. They received a great deal of advice from German and other cooperative leaders. Some aspects

[16] This section draws on Guinnane (1994).

of German cooperative practice could not be transplanted for legal reasons, but it is fair to say that on the whole, the IAOS credit cooperatives were accurate, even slavish, imitations of Raiffeisen's rural credit cooperatives in Germany. Plunkett and his circle had high hopes for the credit cooperatives in Ireland, and their expectations did not seem unreasonable. The credit cooperatives in Germany thrived among an energetic and commercially-minded rural population who were not able to secure reasonable credit from banks and other financial institutions. Irish farmers complained bitterly about their treatment at the hands of Ireland's banks, and seemed prepared to put less expensive credit to good use.

Almost from the first there were signs of trouble. Most credit cooperatives had little trouble attracting members and borrowers, and the number of institutions grew at a healthy clip. But by other measures they were doing badly. Many rural German credit cooperatives gathered significant excess deposits, and had to find some place to invest those deposits safely. The Irish cooperatives never did. The near absence of depositors harmed the Irish cooperatives in two ways. First, it meant that the Irish cooperatives were essentially re-lending money they had borrowed from a government agency, the Department of Agriculture and Technical Instruction (DATI). This degree of state involvement was unknown in Germany, and obviated, in least in the eyes of their critics, the cooperatives' entire claim to being "self-help" institutions.[17] Perhaps more importantly, the inability to gather deposits showed that most rural Irish people thought their money was safer in other depository institutions. The specifics of management also

[17] State assistance to German credit cooperatives prior to World War I was not significant. The urban cooperatives complained that the Prussian Central Cooperative Bank, a state institution, was a significant source of state aid to rural credit cooperatives. This claim has also appeared in the scholarly literature. At best the claim is badly exaggerated (Guinnane 2004).

suffered badly in Ireland. German auditors complained about sloppy bookkeeping or poor attendance at the annual meeting of members, but these were complaints about departures from a very high standard. Irish inspectors found that books were hardly kept at all in some cooperatives, and that annual meetings did not even take place.

Why was the Irish experience so disappointing? My study of the Irish cooperatives was limited by lack of sources. Unlike the German case, I was unable to locate manuscript business records for individual cooperatives or for the IAOS itself. To some extent I was forced to rely on the IAOS's own criticisms, or on those of outsiders such as the officials of DATI. But three problems are clear. First, rural Ireland had a number of depository institutions, including for-profit banks, savings banks, and the ubiquitous Post Office Savings Bank. The latter especially was convenient and perfectly safe. Every Post Office was in effect a banking office, and the Post Office Savings Bank's assets consisted nearly entirely of British government debt. This was in contrast to much of rural Germany, where the nearest depository institution could be quite some distance. Raiffeisen and other cooperative leaders had to convince people that their deposits were safe in credit cooperatives, but these people had few alternatives. His Irish counterparts had a much harder case to make. As a result, the Irish institutions lacked a set of local stakeholders that were important in Germany. Second, the IAOS never developed the formal external auditing structures that the Germans had. The reasons for this are many, but in the end it meant that Irish cooperative leaders could not count on the training, inspection, and discipline that came from well-informed, hard-nosed outsiders.

A third explanation for Irish credit cooperatives' problems was favored by many contemporaries, and while harder to evaluate, it was clearly an issue. German cooperative

leaders were perfectly willing to enforce loan terms, even when they knew that their actions meant damage to a recalcitrant borrower. Problems in the German cooperatives were rare, but their records contain instances of members ejected from the cooperative for failure to repay, as well as threats of court action. Several sources claimed that Irish cooperatives were not, on average, willing to force recalcitrant borrowers to repay; that rural Irish people were too easy-going and sympathetic to their neighbors. The IAOS itself complained that the "natural kindliness" of Irish people led them to a "mistaken kindness to unthrifty borrowers." One former cooperative treasurer advocated enlarging the area of a credit cooperative's operations on the grounds that a borrower's immediate neighbors could never bring themselves to forcing a debtor to repay.[18] This amounts to saying that the cooperatives could not enforce loan terms unless they gave up on the information advantages that made the entire institution work in the first place. At one level this lack of toughness is connected to the deposits question. Borrowers were not risking their neighbor's savings, as in Germany. A faulty borrower was only risking the cooperative's ability to repay a loan to a government he and his neighbors did not much like. The only real consequence was the possible failure of the cooperative, which would be the end of cheap credit.[19]

All of these issues were problems, and my own view is that the first, the competition from alternative depository institutions, is, if not the most important, then the easiest to overlook. None of them have anything to do with trust as the idea is used in the

[18] The IAOS' remark is in their annual report for 1902, quoted in Guinnane (1994, p.56). The treasurer was testifying before a Parliamentary inquiry, quoted in Guinnane (1994, p.57).

[19] Members in Irish credit cooperatives had unlimited liability, which was also the practice in most rural cooperatives in Germany. I cannot say what happened when DATI did not get its money back, but most cooperative members must have found it implausible that the government would seize their holdings to satisfying liabilities arising from cooperative membership.

literature. The Post Office Savings Bank was simply another institution that got there first. The lack of external auditing institutions has more to do with the IAOS's own failings, and perhaps the small size of the movement overall.

The final observation, that Irish cooperatives could not work because rural Irish people were too kind-hearted, is worth a close look because it illustrates the vagueness of the idea of trust. There are several ways to understand this claim, and all of them presume that Irish people valued other aspects of their ties to one another more than the repayment of any given loan. What can "trust" tell us about this behavior? There is some sense in which rural Irish people had less information on one another than did their German counterparts. Rural houses in Ireland tended to be spread about the countryside instead of arranged in nucleated settlements, which means people saw less of each other and had a less clear sense of who their neighbors were. But the salient difference seems to be the capacity to enforce loan terms. Suppose a cooperative lends to Murphy, with O'Brien as the co-signer. If Murphy thinks the cooperative leaders would be unwilling to take steps to force him to repay, then he will see the loan as a form of grant, and O'Brien will view his co-signatory role as a formal matter rather than anything that entails potential obligations on his part. The cooperative would probably not, as already suggested, be making such loans at all were it not for the DATI credit. But how do we interpret this situation in the light of trust? In Germany cooperative members trusted each other to repay loans. *In Ireland they trusted each other not to be too adamant about repaying loans.* Trust in one circumstance led to a financial institution that worked, while in the other it led to nearly the same financial institution's virtual failure. We learn nothing from labeling one or the other of these societies "high trust" or "low trust." And if we did

so we would miss an essential lesson: the wrong kind of trust, as in the Irish case, can doom a valuable institution. What matters are the incentives to act in particular ways.[20]

Small-scale credit in the United States

Our third example comes from a context where cooperative credit institutions did not work very well either.[21] The situation was not so dramatic as in Ireland, but the credit union movement in the US, which was modeled indirectly on the German credit cooperatives, never grew to have anything like the relative importance of cooperatives in Germany. There are, again, reasons that do not bear directly on our subject. One is the long history of unit banking and general incorporation statutes for US banks. The US had many, many small banks, some of whose customers would be among the more prosperous credit cooperative members in Germany. The other reason has to do with competition between two foundations, the Twentieth Century Fund (which pushed credit unions) and the Russell Sage Foundation (which advocated an alternative approach detailed below).

The few successful credit unions that were formed in the US in the early twentieth century shared a number of features that imply a restricted potential. They tended to be associated with a firm or an industry, instead of serving all those who lived in a locale, as was the case in Germany. In some cases this limitation reflected the requirements of enabling laws, but it also reflected deliberate choices within the movement. The credit unions were also over-represented among the employees of governments – local, state

[20] As Ogilvie (2004b) argues, social capital can be put to bad uses as well as good. One might say, in this case, that the Irish used their social capital to agree – effectively – not to pressure each other to repay loans.
[21] This section is based on a project with Bruce Carruthers. The project is still in its early stages, and there is little extant work on this issue to date, so the discussion here is more tentative. For more detail on the matters raised here, see Carruthers and Guinnane (2003).

and federal. The literature gives several explanations for this fact, but perhaps the most important reason was that these people had a steady paycheck.

The Russell Sage Foundation (RSF), which from its inception in 1907 was very interested in the issue of credit for poor people, at first pushed the idea of credit unions but then concluded they had only limited usefulness. The RSF thought that credit unions would never work for the urban poor and working classes who were most in need of reasonable loan terms. The Foundation thought it better to alter the legal environment to encourage the entry of for-profit lenders. To this end the RSF pushed its Uniform Small Loan Law (USLL), succeeding in getting the law passed in about 2/3 of the 48 states by 1940, when the Foundation lost interest in the issue.

Uniform laws were and remain a vehicle in the United States for achieving near-uniformity in legal codes across states. After some preliminary research in the first decade of the 20th century, the Foundation came to the view that credit conditions for poor people were unsatisfactory because the loans they sought were, by their very nature, expensive to make. Most states had usury laws that capped legal interest rates at levels much lower than those charged by lenders dealing with the poor, usually not more than 6 percent per annum. As a result, the only lenders operating in this market used a variety of stratagems to conceal the total cost of their credit from the law and sometimes from borrowers. Others operated outside the legal framework entirely. The USLL has several features, but all can be summarized in two phrases: transparency and the uncapping of interest rates. The law established a new class of lender, a so-called small-loan broker, who had the right to lend small amounts (less than $300 in most versions of the law) at rates that far exceeded most state usury limits. The RSF recommended a rate of 3.5 per

cent *per month*. In return for this higher rate, the lender had to adhere to strict standards governing the simplicity of charges (no fees, that is), disclosure of terms, etc.

The law was successful in that in every state that passed it, brokers quickly set up new small-loan businesses and issued thousands of loans. The law even led to the creation of extensive chain operations, some of which (like Household Finance) became large, publicly-traded companies. But the USLL embroiled the RSF in a range of disputes, most of which centered on its somewhat startling notion that the way to help poor people was to allow lenders to charge them *more*. Credit-union leaders were scathing in their criticism of the RSF on this point, and a wider public grew to know the Russell Sage Foundation as the "3 and one-half percent foundation."

Whatever the merits of the Foundation's arguments, underlying its proposals was an intellectually coherent analysis of the relevant credit market prior to the enactment of the USLL. According to the RSF's leading researcher, Rolf Nugent, providing small loans was an inherently expensive business. The USLL was motivated by the view that the only sensible way to proceed was to recognize the high costs inherent in the business, and relax the legal constraints that made it impossible to make small loans honestly and profitably.

The RSF's analysis bears careful consideration. Although it paid lip service to rural areas, most of its discussions pertain to urban areas of the United States. In Nugent's view, the central problem was the fluid, anonymous social context of these cities. People moved to and from the city, and changed jobs frequently. Lenders knew little about borrowers (most business was generated by advertisements placed in newspapers), and the sanctions a lender could apply to a borrower were weak or

expensive. Some lenders restricted their business to "salary loans," which means loans to men earning salaries. Employment could be verified, but beyond that lenders knew little about their customers. Most loans were secured only by the borrower's future income, or by household property. This security might be very effective – many employers would fire someone for taking a loan from such lenders, so the mere threat to attach the borrower's wages could be effective – but in any case it was typically expensive to collect. The entire idea of the USLL was to allow "honest capital" to earn a return sufficient to bring sound business practices into the field.

Too little is known about credit conditions for poor people in this period in US economic history to make firm statements about why the credit unions did so poorly, or whether the USLL was the right approach. But let us consider the Russell Sage Foundation's analysis, which is clear enough from the various internal reports and memos we have been studying. In their view, lending was expensive because the social environment implied that lenders knew little about borrowers, and could not cheaply apply the sanctions that supported repayment in the rural German case. The Foundation's pessimism about credit unions implied that it was not convinced urban Americans could form themselves into financial institutions that could have better information or better sanctioning mechanisms than for-profit lenders.

If we wanted, we could claim that US cities had little social capital, or that lenders were operating in a "low-trust environment." But this would (if we adopt the ways of the trust literature) be difficult to square with the overall success of the American economy in this period. More directly, this is precisely the society and period that features as the central success case in the entire trust parable: before Americans started to bowl alone,

they lived in dense networks of civic associations that generated large amounts of social capital.[22] There is an empirical literature on trust that thinks it has devised ways of measuring trust and characterizing societies in this way. But would such claims enhance our understanding of how credit markets worked, or why certain lending institutions were never very successful in the US?

3. Conclusions

For the past ten years or so, scholars have discussed and applied the concepts of social capital and trust. Much of this literature is theoretical, trying to define and refine these concepts and decide when they are relevant. But much is empirical: the authors of these studies hold that labeling some societies or contexts "high trust" or "low trust," or arguing that they had a great deal or very little social capital, is analytically useful.

Williamson argues that in commercial contexts, trust is at best a new label for something that has long been understood. This practice is not always pernicious in itself. Many intellectual movements are, at least in part, a re-discovery of something older, and sometimes giving something a new name and trying to apply it to a broader range of social phenomena stimulates scholars to see connections that might otherwise be lost. Something like this has probably happened in the recent literatures on trust and social capital, and essays like Frevert (2003) make up in breadth much of what they might lack in analytical rigor. Before accepting this kind of logic, however, we must balance any gains against the two costs implicit in literatures built around buzzwords. Over-use of terms can amount to unintentional obfuscation, as the terminology implies connections that have never been demonstrated. And buzzwords can crowd out more specific research

[22] Or so Putnam (2000) says.

aimed at understanding the particulars of institutions or a society. We would better understand some institutions and societies if scholars pushed harder to appreciate the concrete details of life in the past, and worried less about fitting their research into trendy paradigms.

This paper has argued that in the context of lending to poor people, and by extension in commercial matters more generally, the concept of trust is at best superfluous. There is no useful sense in which we can label something a "high trust" situation, or someone a "trustworthy" borrower. There are only social contexts in which lenders know and can cheaply acquire information on potential borrowers, and social contexts in which lenders have effective ways to enforce the repayment of loans. The mechanisms of information and enforcement may be as banal as credit registries and lawsuits, or as complex as kinship ties and the adjudication of disputes by village elders. Borrowers may repay because they fear the law or because they fear alienating the community in which they work, live, and worship. The trust literature would have it that credit registries and lawsuits are evidence of the lack of trust, while reliance on kinship ties or village elders is trust incarnate. But this illegitimate distinction just illustrates my point: the very term "trust" has been hijacked to make warm noises about certain types of institutions and interactions, and has been robbed of much of its analytical value.

More worryingly, focus on "trust" can obscure a crucial question raised in the Irish case: trust to do what? An institution that worked in one place was done-in by the rural Irishman's well-placed confidence that his neighbors would not pressure him to repay loans. This attitude might promote some types of collective action, but it undermined the very basis of the credit cooperatives. Trying to figure out whether

Ireland was a "high trust" society would tell us nothing. Understanding the incentives built into the German credit cooperatives as they appeared in Ireland tells us a great deal. The importance of information and enforcement, which is the core of the useful notion of trust, has been recognized in economics for decades. Giving it another name, as Williamson argues, will not accomplish anything.

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