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# **Social Capital and Entrepreneurship**

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**Phillip H. Kim and Howard E. Aldrich**

*Department of Sociology,  
University of North Carolina at Chapel Hill,  
NC 27599-3210, USA*

*pkim@unc.edu  
howard\_aldrich@unc.edu*

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# 1

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## Introduction

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In 2002, Friendster launched a web-based social networking tool that allowed individuals to take advantage of the internet by actively managing their own social connections. Backed by venture capital investors from Kleiner, Perkins, Caufield & Byers and Benchmark Capital, Friendster built upon a simple idea: give users a tool to leverage their social ties so that they could reach distant others who might have similar interests. Friendster accomplished this by creating a visual representation of a user's social network and by providing capabilities for storing relevant information, thus giving users the ability to find and create ties to other users.

The creators of Friendster knew that individuals keep in touch with their strong ties on a frequent basis. However, if people rely only on their strong ties, their networking prospects are severely limited. Given time and geographic constraints, most individuals have very few strong ties, typically ranging from five to twenty relationships ([30]; [57]). In contrast, people have many weak ties, but managing these relationships is much more difficult than managing strong ties. Without frequent and reciprocated contact, people find it difficult to keep track of changes in the lives of their contacts, such as career moves or the birth of a child. Friendster made it easy to monitor such changes by

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automating the tie management process. Additionally, Friendster's users can increase their network reach by "meeting" other users through their direct ties.

Entrepreneurs have also recognized the possibilities of translating social network principles into practical and accessible solutions. Websites, books, articles, seminars, and voluntary associations have sprung up to serve the perceived networking needs of individuals wishing to start new firms or expand existing businesses. Consequently, the population of networking websites has grown rapidly since Friendster's inception in 2002. As of early 2005, there were at least 30 online networking sites (as listed by [friendsurfer.com](http://friendsurfer.com)). This population contains two niches: social- and business-oriented networking. Ecademy, Ryze, and Open Business Club are leading sites oriented towards cultivating business and professional relationships. The website run by 5MinuteNetworking offers evening "meeting events" at which people can meet other business people.

In addition to the upsurge of online networking sites, traditional networking formats continue to thrive. For example, Gray Hair Management hosts structured networking events that enable participants to meet and exchange information with other participants. Since its establishment in 1995, the Silicon Valley Area of Startup Entrepreneurs has provided a forum for local entrepreneurs to interact with other professionals, as well as sponsoring networking events. College and professional schools sponsor local clubs to facilitate regional exchange among their alumni. Books such as *Nonstop Networking* [65] and *Achieving Success through Networking* [8] offer specific advice on how to build and maintain productive professional networks. Seminars costing several hundred dollars continue to attract interested individuals wanting to learn about developing relationship skills.

### 1.1. Why do people need networking help?

The growth of so many organizations and associations devoted to helping people create and maintain social networks poses a puzzle for social scientists. Why do people need any help? Social relations seem fundamental to everyone's life and would appear to follow naturally

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from growing up in organized social settings. Throughout their life course, people are embedded in social situations that put them in touch with others, such as kin reunions, gatherings of friends, workplace teams, and voluntary association meetings. Nonetheless, we suggest that cultivating and maintaining valuable relationships through one's social network requires skills that cannot be generated by habitual social behavior. We argue that, left to follow its natural course, everyday networking comes up against a set of significant social constraints that renders its use problematic for many entrepreneurs.

To convey a sense of the inherent constraints on social networks, we offer a simple scenario in Figure 1.1. Consider a situation in which an entrepreneur seeks resources from resource providers beyond his or her immediate set of direct ties – people known directly on a face-to-face basis. Assume that the entrepreneur (“ego”) has 100 direct ties with other individuals (“alters”) in his or her network. Then assume that each of the 100 alters has 100 direct ties in their networks. At this point, ego can access 10,000 additional individuals indirectly through the 100 alters with whom ego has a direct tie (i.e.,  $100 \times 100 = 10,000$  ties). If we assume each of the 100 first-order alters also has 100 direct ties with a second-order alter, ego can access an additional one million individuals indirectly (i.e.,  $100 \times 100 \times 100 = 1,000,000$  ties). Thus, by leveraging their direct ties, entrepreneurs can reach out within two steps to one million potential resource providers!

This simple example illustrates how increasing the reach of their networks can motivate users on Friendster or similar networking services to examine and sustain their personal networks. Rather than being limited to a small set of persons known directly, entrepreneurs can, in theory, gain what they need by taking advantage of the wider social network in which their direct ties are embedded. Our example illustrates why entrepreneurship researchers have responded so favorably to the concepts and principles of social network analysis and the associated concept of social capital.

In this Section, we define *social capital* broadly as the resources available to people through their social connections ([20]; [53]).<sup>1</sup> In our

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<sup>1</sup> Our aim in this Section is to highlight and apply relevant social network principles to entrepreneurship research. We acknowledge that ongoing debates surrounding the definition of *social*



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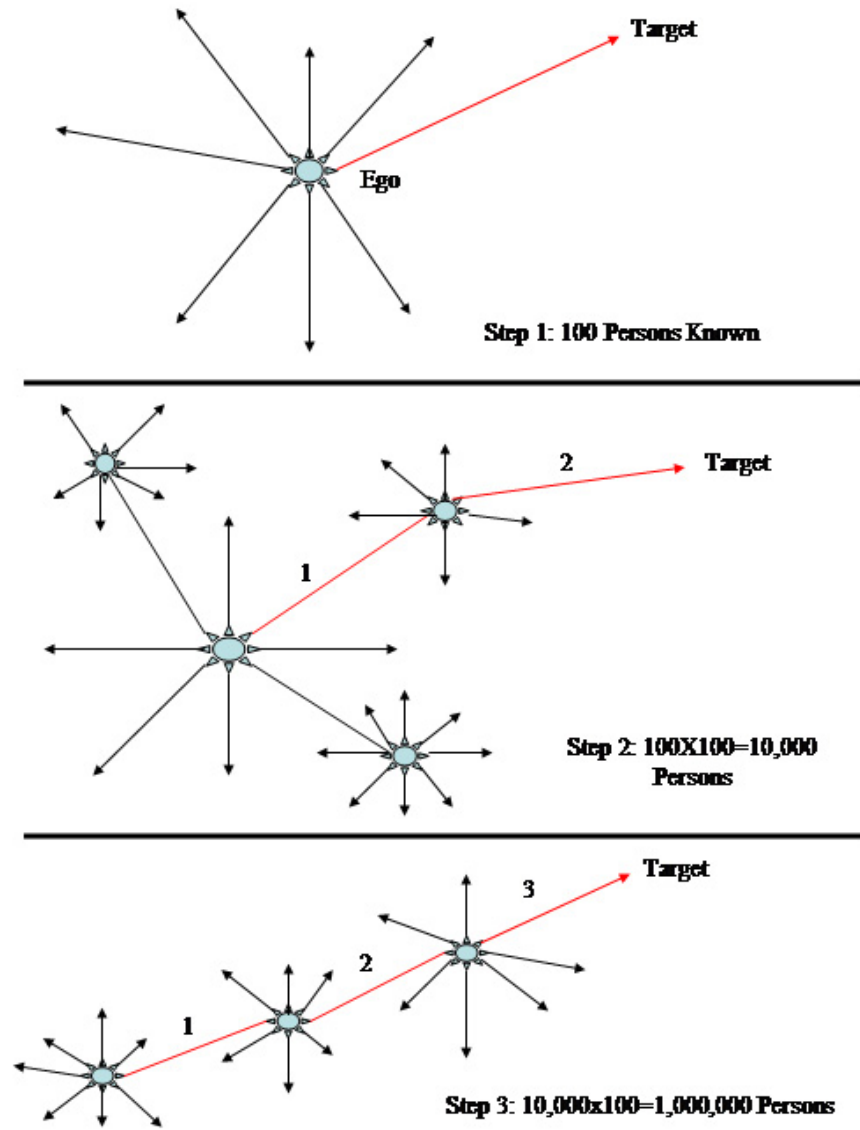


Fig. 1.1 The Potential of Indirect Ties

example, an entrepreneur holds out the dream of an expansive playing field. With a perceived unlimited personal reach, entrepreneurs pursue their needs as they please, limited only by their ability to recognize opportunities within the social network. Using their social ties skillfully, entrepreneurs can apparently reap substantial returns on their social capital and boost their chances of commercial success. However, a comparison of this dream to social reality reveals serious flaws in its logic.

## 1.2. Socio-cultural constraints on social networks

We offer three explanations for why our optimistic example of an entrepreneur's network reaching almost a million people, starting from those directly known to him or her, cannot be fully realized by most individuals. First, individuals' networks often lack significant *diversity*. Instead, individuals' networks, as well as networks within associations, organizations, and communities, are often homogenous along key dimensions, such as race, age, and sex. In our example, we assumed that each first-order alter had 100 unique direct ties with second-order alters which thus created an exponential effect of increasing indirect ties. Because individuals with similar backgrounds and interests are more likely to associate with one another, rather than with people with dissimilar backgrounds, social networks are typically characterized by a lack of diversity ([11]; [62]). In the language of social networks, the friends of our friends are already our friends, rather than strangers.

Second, social boundaries create obstacles that inhibit the emergence of social relationships. Much of a person's social life is lived within the boundaries of family and kinship relations, religious and ethnic communities, language groups, and other limits to unfettered social action. Strong boundaries deflect social relationships back upon themselves, thus fostering highly concentrated social networks. Although most of these boundaries are quasi-permeable, surmounting them requires work that people are often discouraged from undertaking.

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*capital* continue. Adler and Kwon [1] compiled a list of definition under three categories (external, internal and combination of both). For reviews of these debates, including alternative definitions, we refer readers to Burt [18], Fine [29], Kadushin [44], Lin [53], and Portes [70].

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Interacting across social boundaries may require learning a new language and new customs, as well as tolerating a high level of ambiguity. Additionally, people's own groups often actively discourage contact with dissimilar others.

Third, because individuals lack clairvoyance and thus cannot know the full potential of pursuing indirect network ties, ignorance and uncertainty limit their activities. Ignorance and uncertainty, in turn, leave people with only *bounded rationality*, rather than hyper-rationality, in their pursuit of new relationships. The Carnegie school tradition of March and Simon [54] noted two features common to all social behavior: first, people operate within the constraints of *bounded rationality* and second, much of human behavior is driven by *opportunism*. Most people are intendedly rational but cannot achieve textbook rationality because of human cognitive deficiencies and peculiarities, limits on information availability, and constraints on information processing. Information search costs, in particular, lead most people to choose satisfactory, rather than optimal, alternatives. People must also contend with the tendency of others to behave opportunistically, self-centeredly pursuing their own self-interest. Without mechanisms for reducing uncertainty, such as endorsements or relying on brokers, individuals hesitate to initiate new relationships.<sup>2</sup> Entrepreneurs will forfeit potentially valuable relationships because they have no clue as to which network paths they should pursue.

Underlying all three constraints, people face an issue of lack of *trust* whenever they go beyond relationships with people already known to them. According to theories of transaction cost economizing, people tend to lie, cheat, and steal to further their own ends [89]. They withhold information or distort it, conceal preferences, and practice a variety of other deceptions. Relationships characterized by trust between persons require an environment in which social norms can be enforced and reciprocated. Socially embedded relationships reduce the potential of opportunistic behavior by either person ([36]; [85]). In our example,

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<sup>2</sup> Podolny [68] described this dilemma in terms of ego- and alter-centric uncertainty. For a relationship to form between ego and alter, both actors need to overcome substantial uncertainties. For example, an entrepreneur faces ego-centric uncertainty when evaluating potential suppliers with whom to conduct business, while a selected supplier experiences alter-centric uncertainty when evaluating the creditworthiness of a new customer (i.e., an entrepreneur).

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reaching beyond the initial circle of 100 direct ties would expose entrepreneurs to persons about whom they know little or nothing. Going beyond their known world, facing uncertainty and social boundaries, their easiest path is to fall back upon familiar contacts. In strategic terms, entrepreneurs who find ways to get around the problem of trust, e.g. by finding substitutes for it, will have an advantage over others.

Thus, despite the great promise of earning high returns on their social capital, entrepreneurs' efforts often fall short. Even though their social ties potentially link them to dissimilar others at great remove and thus enhance their access to opportunities and resources, the constraints we have just noted make problematic purely instrumental action within networks. Instead, the embedded nature of social networks means that entrepreneurs' attempts to start and grow their organizations often come up against significant socio-cultural constraints. Understanding the association between social capital and entrepreneurship thus requires that we investigate more thoroughly the social and cultural context of entrepreneurial networking. From this inquiry, a more nuanced and thorough understanding of entrepreneurial actions emerges.

In the remainder of this text, we analyze three empirical observations about social networks, show how the concepts of homophily, social boundaries, and bounded rationality provide a framework for understanding the observations, and present examples of each from the entrepreneurship literature. We discuss three observations: (1) relationships are often based on people with similar characteristics and the resulting lack of diversity limits people's access to opportunities and resources; (2) not all relationships are valued the same way, with some bridging gaps between diverse locations and others merely serving as dead ends; and (3) some people are sought out more than others, with their centrality giving them power and prestige they use to their advantage. We also introduce relevant social network tools to study these observations.

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