The Journal of Socio-Economics 40 (2011) 335–346

Contents lists available at ScienceDirect

The Journal of Socio-Economics

journal homepage: www.elsevier.com/locate/soceco

Trust-based social capital, institutions, and development

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ARTICLE INFO

Article history:
Received 14 August 2009
Received in revised form
27 November 2010
Accepted 16 December 2010

JEL classification:
O11
O17
Z13

Keywords:
Contract-intensive money
Social capital
Institutions
Development
Africa

ABSTRACT

We estimate fixed-effects and Arellano–Bond GMM equations using panel data from a large group of developing countries and test whether trust-based social capital, proxied by *contract-intensive money*, complements the role of institutions in promoting development. The results we obtain provide robust evidence that social capital enhances the contribution of institutions when we focus on political institutions and weaker evidence when we use civil liberties. Both social capital and institutions have positive effects on income but the relationships these variables have with income tend to be non-monotonic. Moreover, social capital has a positive influence on the effectiveness of human capital.

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1. Introduction

After having been somewhat marginalized in development and growth literature in the 1970s and most of the 1980s, institutions became an important area of focus when examining the process of economic development and the success or failure of policy reforms in the 1990s. This was partly a consequence of the failure of many countries that had liberalized and privatized their economies to realize the expected benefits from such reforms. In the 1990s, some transition economies, and several Asian and Latin American countries experienced severe macroeconomic and financial crises in spite of undertaking policy reforms that were presumed by the so-called ‘Washington Consensus’ to be powerful cures for many macroeconomic problems. Recent studies have focused on the role of institutions as a major determinant of development policies and reforms, and as a primary factor of the state of backwardness of certain regions (Acemoglu et al., 2002, 2003; Rodrik, 2002; Rodrik et al., 2004; Addison and Baliamoune-Lutz, 2006; Iyigun and Rodrik, 2006; Baliamoune-Lutz and Ndikumana, 2007). Recent empirical evidence shows that once institutions are included in income (or growth) equations, trade appears to have no effect, and the effect of geography becomes much weaker (Rodrik et al., 2004).

Another recent strand of the literature has focused on the relationship between informal institutions (or social structure) and economic performance (MacKenzie and Millo, 2003; Mouw, 2003; Granovetter, 2005; Gomez and Jehiel, 2005). Some studies have focused in particular on the role of social capital in the form of cooperative behavior, norms and values in a society that serve to enhance trust among individuals and facilitate transactions by reducing (or even eliminating) costs associated with acquiring information and with monitoring (Coleman, 1990; Putnam, 1993; Knack and Keefer, 1997; Ostrom, 2000; Woolcock and Narayan, 2000).

The main goal of this paper is to empirically examine the role of social capital in enhancing the development effects of institutions. We estimate fixed-effects and Arellano–Bond Generalized Method of Moment (GMM) models, using panel data from 39 African countries for the period 1975–2001, and test whether trust-based social capital, proxied by contract-intensive money, complements the role of institutions in promoting development. The empirical results we obtain provide evidence that social capital enhances the contribution of institutions. We show that both social capital and institutions have positive effects on income but the relationship these variables have with income is, in general, non-monotonic. Moreover, social capital seems to enhance the development effects of human capital.

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doi:10.1016/j.socec.2010.12.004

The remainder of the paper is organized as follows. In the next section we discuss institutions and social capital and briefly review recent research on social capital in Africa. Section 3 presents the variables and the methodology we employ in the empirical analysis. Section 4 reports the estimation results and comments on the findings. Concluding remarks are provided in Section 5.

2. Institutions and social capital

2.1. Institutions

Among economists Douglas North is widely credited with the revival of interest in institutions and their influence on economic outcomes. North (1990) views institutions as "the rules of the game in a society or, more formally, [they] are the humanly devised constraints that shape human interaction" (North, 1990, p. 3). North distinguishes formal from informal rules (informal institutions). Similarly, Aron (2003) defines institutions as the sets of formal and informal constraints imposed on social, economic and political activities. Measures of institutional quality in the empirical literature include a host of indicators such as property rights (Knack and Keefer, 1995; Zak and Knack, 2001), bureaucratic structure (Rauch and Evans, 2000), and political rights and civil liberties (Kormendi and Meguire, 1985; Scully, 1988; Isham et al., 1997).[1]

Recent work on the role of institutions in economic development includes Knack and Keefer (1995), Kaufmann et al. (1999), Acemoglu et al. (2001, 2003), Rodrik (2002), Rodrik et al. (2004), and Dollar and Kraay (2003). Some empirical studies have shown that institutions can be crucial to the success of economic reforms (see, for example, Dollar and Kraay, 2003; Addison and Baliamoune-Lutz, 2006). However, the relationship between institutions and indicators of development may not always be positive. For example, Dasgupta and Weale (1992) report that per-capita income and life expectancy are positively correlated with improvements in political and civil liberties but literacy has a negative association with political and civil liberties. Moreover, at least from policy-making standpoint, the direction of causality should be an important area to research. Chong and Calderón (2000) show that there is reverse causality between economic growth and institutional quality and that the poorer the country, the stronger the influence of institutional quality on economic growth. It may be that the relationship and the direction of causality between economic development and institutions depend on the level of development and the level of institutional quality. It is also possible that interactions of institutions with the prevailing social structure affect this relationship.

The role of property rights, for example, may be particularly important when countries are implementing reforms, as many African countries have been doing in the late 1980s and throughout the 1990s. As argued by Addison and Baliamoune-Lutz (2006, p. 1031).

> Property and contract rights are crucial to the investment response generated by changing relative product prices through trade reform (increasing the relative price of exportables to importables through the elimination of import quotas and the reduction of tariff rates) and by improving the allocation and availability of credit through financial reform (including interest-rate liberalization, the elimination of directed credit, bank privatization and the overhaul of bank regulation).

2.2. Social capital

Coleman (1988) is widely credited for introducing and formulating the concept of social capital. He defines social capital as "obligations and expectations, information channels, and social norms" (Coleman, 1988, p. S95). Coleman (1990, p. 304) defines social capital as "some aspect of social structure that enables the achievement of certain ends that would not be attainable in its absence". On the other hand, Putnam (1993, p. 167) defines social capital as "those features of social organization, such as networks of individuals or households, and the associated norms and values that create externalities for the community as a whole." Similarly, Fukuyama (1999, p. 16) argues that "[t]rust acts like a lubricant that makes any group or organization run more efficiently."

The role of social capital in economic activities is a recent but rapidly growing research area in economics. Indeed, citations of the term 'social capital' in the *EconLit* database were lower than 10 in the first half of the 1990s but expanded to 153 citations in 2000 (Isham et al., 2002). As of yet, there is no unique definition of 'social capital'. The terms that are usually used in the definition are cooperative norms (Coleman, 1988; Putnam, 1993, 2000; Knack and Keefer, 1997; Woolcock and Narayan, 2000), trust (Putnam, 1993; Knack and Keefer, 1997), and networks that allow people to act collectively (Putnam, 1993, 2000; Woolcock and Narayan, 2000; Sobel, 2002). However, most definitions include one or more of the concepts of networks, cooperative norms, trust, and associational activity (see Knowles, 2006).

In a recent paper in the *Journal of Economic Perspectives*, the sociologist Mark Granovetter presents an interesting discussion of the effects of social structure on economic outcomes. Although the author does not focus explicitly on social capital, he does analyze elements that are often associated with the concept of social capital. Granovetter argues that "social networks affect the flow and the quality of information. . .[S]ocial networks are an important source of reward and punishment. . .[T]rust emerges, if it does, in the context of a social network" (Granovetter, 2005, p. 33). The author also points out that social networks play a vital role in most labor markets, and that "employers and employees prefer to learn about each other from personal sources whose information they trust" (Granovetter, 2005, p. 36).

The empirical literature on social capital emphasizes networks, associational activity (Putnam, 1993) and trust (Knack and Keefer, 1997) as indicators of social capital. Putnam (1993) uses membership in groups and clubs as a measure of social capital and concludes that the Italian North developed faster than the Italian South because the North had higher social capital. Similarly, Guiso et al. (2004) study the effects of social capital (as defined in Putnam, 1993) on financial development in Italy and show that households located in regions where social capital is high (mainly Northern Italy) make less use of informal credit and more use of formal financial markets and tend to invest less in cash and more in stock. Moreover, they show that the effect of social capital is stronger among less educated people and in regions where legal enforcement is weaker. These findings suggest that social capital could substitute for institutions (and may also substitute for human capital) and underscore the importance of the interaction between social capital and institutions. Knack and Keefer (1997)

[1] There are various sources of data covering diverse measures or indicators of institutional quality. The Heritage Foundation publishes data on several institutional indicators pertaining to five main areas (1) size of government, (2) access to sound money, (3) legal structure and security of property rights, (4) regulation of capital, labor, and business, and (5) exchange with foreigners. Kaufmann et al. (1999) include in their governance measures the rule of law, voice and accountability, political instability and violence, government effectiveness, and regulatory burden. The indexes of freedom published by Freedom House include political rights and civil liberties. The indicators by the International Country Risk Guide (ICRG) comprise corruption in government, law and order tradition, and bureaucratic quality. Business Environmental Risk Intelligence (BERI) includes measures of bureaucratic delays, contract enforceability, nationalization risk, and policy stability. Finally, the World Competitiveness Yearbook (WCY) includes measures of bribing and corruption, tax evasion, public service exposed to political interference, and personal security and private property.

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