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Does trust favor macroeconomic stability?

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ABSTRACT

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This paper investigates the relationship between trust and macroeconomic volatility. An illustrative model rationalizes the relationship between trust and volatility. In this model, trust relaxes credit constraints and diminishes investment's procyclicality. I provide empirical evidence for the basic predictions of the model. Then, I show that higher trust is associated with lower macroeconomic volatility in a cross section of countries. This relationship persists when various covariates are taken into account. I use inherited trust of Americans as an instrumental variable for trust in their origin country to overcome reverse causality concerns. Using changes in inherited trust over the 20th century, I do not find clear evidence that increasing trust is also associated with decreasing volatility across time at the country level. *Journal of Comparative Economics* **xxx** (xx) (2012) xxx–xxx. Sciences Po, 28 rue des Saints Pères, 75007 Paris, France.
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1. Introduction

The cost of real macroeconomic volatility in terms of well-being has been shown by Wolfers (2003) to be important. Thus, all its potential sources deserve attention. This paper investigates the relationship between trust and macroeconomic instability. I first present an illustrative model linking trust to economic volatility through the procyclicality of investment and test its main prediction. Then, I show that higher trust is correlated with lower macroeconomic volatility in a cross section of countries. I focus on this relationship and show that it is robust to the introduction of various covariates. I address reverse causality by using inherited trust of Americans immigrants as an instrument for latent trust in their origin country. Then, using changes in inherited trust between 1910 and 1970, I show that there is little evidence that trust also reduces macroeconomic instability across time at the country level.

In Fig. 1, trust is measured in each country by the share of people who answer "*most people can be trusted*" to the following question of the World Values Survey between 1981 and 2008: "*Generally speaking, would you say that most people can be trusted or that you need to be very careful in dealing with people?*". Macroeconomic instability is represented by the standard deviation of real GDP per capita growth rate between 1970 and 2008. The negative relationship between these two variables is highly significant. Differences in trust explain up to a third of differences in volatility across countries.

The fact that cultural traits such as norms of cooperation, civic spirit or beliefs regarding the behavior of others have an impact on macroeconomic performance has been massively explored by the literature.[1] Most papers investigating the relationship between trust and economic performance from an aggregate point of view have focused on growth or economic development, emphasizing the role of investment. See for example Knack and Keefer (1997), La Porta et al. (1997), or Algan and Cahuc

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[1] See Fernández (2011) for a recent review.

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Fig. 1. Relationship between the standard deviation of real GDP per capita growth rate (1970–2008) and trust (1981–2008). *Sources*: World Values Survey and Penn World Table. Trust is the share of people who answer "*most people can be trusted*" to the following question of the World Values Survey between 1981 and 2008: "*Generally speaking, would you say that most people can be trusted or that you need to be very careful in dealing with people?*"

(2010) among others. In this paper, I depart from this literature by looking at macroeconomic stability, an unexplored economic outcome that may be partly explained by trust as suggested by the relationship presented above.

Trust is an indicator of social capital. This later concept has been defined by Putnam (2000) as "*the collective values of all social networks and the inclinations that arise from these networks to do things for each others*". Trust represents a set of beliefs that favor inter-personal cooperation within the society. Trust may thus favor economic performance, especially in decisions such as investment's decisions.

Trust may favor macroeconomic stability through three channels. First, since trust implies extended civic behavior, it may be associated with better economic management by the authorities if it reflects greater cohesion of the society. Indeed, it has been shown by Knack and Keefer (1997) that countries with higher trust have also better institutions. According to Acemoglu et al. (2003), countries with better institutions exhibit lower macroeconomic volatility. Hence, if trust deters the discretionary use of public expenditure it can thus implies weaker macroeconomic volatility due to less volatile policies. Second, the cohesion of society can also translate into social stability. As a consequence, civil conflicts, violence, and political instability in general are less frequent in high-trust countries. This may results in lower economic volatility since internal conflicts are a major source of shocks for any economy. Third, following Glaeser et al. (2000), trust, the most general dimension of social capital, is closely linked to trustworthiness.[2] Hence, individual trust can be considered as empathy or as an individual commitment to behave well with other agents. This decreases costs of interactions and allows to build expectations and plans with greater certainty. In line with this reasoning, Knack and Keefer (1997) documented a positive relationship between trust and the share of investment in GDP. In this paper, I present an illustrative model à *la* Aghion et al. (2010b) and Aghion et al. (2012) where credit constraints favor the procyclicality of investment. I then introduces trust as a way to relax credit constraints and thus to reduce investment's procyclicality. I test the main predictions of the model, i.e. that more trust allows deeper financial development, that trust favors long-term investment, and that private investment's procyclicality and volatility are lower in high-trust than in low-trust countries.

Although explaining the deep mechanisms of these channels at the micro-economic level is beyond the scope of this paper, these three explanations are tested throughout the paper. I show that channels running through the quality of institutions or social cohesion do not fully explain the negative relationship between trust and macroeconomic volatility.

The three channels mentioned above from trust, and social capital in general, to macroeconomic stability can be found under alternative and various forms in the literature that investigates the impact of culture and social capital on economic outcomes. In that dimension, this paper is closely related to all researches that document a link from social capital to economic outcomes.

After the seminal work by Putnam (1993), lots of evidence about the impact of social capital on economic performance have been raised by scholars. Knack and Keefer (1997) showed that countries with higher social capital have also better institutions, higher and more equal incomes, and a better educated population. Similar evidence have been provided by Tabellini (2010) in the case of European regions. Guiso et al. (2008a) and Guiso et al. (2008b) presented some evidence about the way

[2] This assertion has been discussed by Fehr et al. (2003), Sapienza et al. (2007), and Thöni et al. (2012) among others.

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