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Endogenous growth, decline in social capital and expansion of market activities

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Abstract

We model in an endogenous growth set-up the hypotheses that the expansion of market activities weakens social capital formation and that firms can invest in formal mechanisms of control and enforcement to substitute for social capital (trust, work ethics, honesty). The model shows that the economy tends to grow faster when it is relatively poorer in social capital and that perpetual growth can be consistent with the progressive erosion of social capital. These results may help to reconcile Putnam's claim that social capital has declined in the U.S. with the satisfactory growth performance of the U.S. over the same period.

JEL classification: O13; O41; Q20; Z13

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1. Introduction

Defining social capital as those features of social organizations that facilitate coordination and cooperation (specifically, values and norms of reciprocity inherent in one's social networks), we should expect that members of communities with high stocks of social capital would be more able to monitor one another's behavior costlessly, reach informal understanding and agreements, enforce contracts, and resolve disputes amicably. In such communities, the incidence of litigation, corruption, conflicts and crime should be low, transaction costs should be reduced, and market activities should be facilitated.

This claim that social capital is important for market efficiency is linked in this paper to the idea that the greatest danger to the social capital arises from the market itself. This idea has a long history, and some authors went so far as to maintain that the decline of the values (honesty, business ethics, trust, etc.) that prevent the spread of the opportunism generated by a market society will end up destroying the latter (Hirsch, 1976; Hirschman, 1982).[1] According to them, the

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[1] Fukuyama (1995) fully embraces the idea that capitalism tends to erode social capital but offers an optimistic view of its ability to regenerate that capital. The perception that there is a conflict between a development strategy advocating a stronger role for social capital and an agenda emphasizing market incentives and material values is present also in current policy debates (see, e.g., Heyer et al., 2002). At the same time, the idea that any development process brings destruction of social capital has been recently challenged by studies focusing on specific episodes and

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progressive weakening of the cultural and ethical base of a market economy is a consequence of its evolution and success since the individualistic and competitive values system connected with the expansion of a market economy is the greatest threat to the efficient functioning of markets. A complementary thesis is that in a society that becomes more complex and differentiated, impersonal relations increasingly replace face-to-face interactions, thus undermining the possibility of founding economic transactions on interpersonal trust (see Hardin, 1998). Also Putnam (2000) links the marked decline in social capital that he documents to have occurred in the United States in the last decades to socioeconomic transformations that one can consider by-products of the process of marketization.[2] Indeed, he identifies some possible determinants of this decline in the rising female participation in the labor market, in the increase in geographical mobility, in "the replacement of the corner grocery by the supermarket" and in the "privatizing" or "individualizing" of the leisure time (mainly due to the TV and to the diffusion of other home-entertainment technologies). More generally, some have argued that as income rises and the size of the middle class expands, many retreat from highly motivated social idealism and civic engagement to pursue personal objectives.[3]

However, some striking evidence presented by Putnam (2000) to support his claim that social trust has steadily declined in the U.S. in the last decades (i.e., documenting the explosive increase in the society's expenditures in formal activities of social control and dispute resolution)[4] is consistent with the hypothesis that the erosion of social capital stimulates the rapid growth of those sectors of the economy which provide services that economic agents use to protect themselves against increasing opportunistic and defiant behavior by others. The growth of these sectors is surely related to the long-term rise in the "transaction cost sector" that was illustrated by Wallis and North (1986) for the U.S. economy.[5] Moreover, this growth, which is paralleled by the decline in peer monitoring and informal sanctioning, can be considered a symptom of the increasingly explicit nature of norm enforcement that proceeds with modernization (see Bowles and Jayadev, 2006).[6]

Summarizing, the progressive "marketization" of social life, namely the process through which market relations become more pervasive, contributes to the diffusion of values, attitudes and behavior that do not favor the formation of social capital. In turn, the decline in social capital induces the economic agents to use more market services as substitutes for the diminished flow of services provided by it.[7] The resources devoted to this use are subtracted from other productive uses, but at the same time they counterbalance the negative effect of a lower social capital on the productivity of inputs such as labor, human and physical capital.

It should be clear from the previous discussion that in analyzing the impact of a decline in social capital on economic growth, one must consider not only its depressing consequences for factor productivity but also its stimulus to the expansion of market activities. One should also account for the self-feeding process whereby this expansion has a further negative effect on the formation of social capital. The original model presented in this paper contains all these features. Furthermore, taking for granted that there has been a decline in U.S. social capital, it may help to explain why, especially in the 1990s, this fall in social capital does not appear to have been paralleled in the United States by a disappointing growth performance. Indeed, this stylized fact seems at odds with Putnam's statement that social capital produces "aggregate economic growth" (Putnam, 2000, pp. 322–323). Also Durlauf and Fafchamps (2004, pp. 12) stress this point: "Putnam (2000), focusing on the U.S. experience since the 1950s, argues that social capital, defined as membership in formal and informal clubs, has declined monotonically since the 1950s. This is true for all states, all decades and all measures of social capital. However, he finds no relationship between the speed of the decline of social capital and economic performance across U.S. states or across time periods. Further, the relationship between

experiences (see, e.g., Miguel et al., 2006).

[2] The general thesis that social capital has declined in the United States, documented by Skocpol (1999) and Putnam (2000), was already presented by Putnam (1995), raising a critical debate. Some researchers (see, e.g., Ladd, 1996; Paxton, 1999) contested Putnam's conclusions. Subsequent studies tend to confirm Putnam's main thesis (see, e.g., Costa and Kahn, 2003; Kolodinsky et al., 2003; Keele, 2005).

[3] This point was suggested by a referee, who interprets this modification of attitudes and ideologies as a consequence of the evolution of the "shared mental models" that individuals construct to make sense of the world around them (see Denzau and North, 1994).

[4] Putnam (2000) emphasizes that during the 1980s spending on security rose rapidly as a share of U.S. GDP. Moreover, he observes that by 1995 America had 40% more police and guards and 150% more lawyers and judges than would have been projected in 1970, even given the growth of population and the economy (see Putnam, 2000; 146).

[5] Wallis and North estimated that the transaction cost sector (private plus public) amounted to 26.1% of U.S. GDP in 1870 and to 54.7% in 1970.

[6] Bowles and Jayadev document that supervisors and guards (police, corrections officials and security personnel) were 17.9% of the U.S. labor force in 2002, while the corresponding figure was 10.8% in 1966.

[7] The expenditures for these market services can be interpreted as defensive expenditures.