

Social Capital Formation and Credit Access: Evidence from Sri Lanka

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Summary. — While previous studies evaluate the impact of social capital on development outcomes, there are very few empirical studies on determinants of social capital formation. We use unique long panel data from Sri Lanka to examine the mechanism of social capital formation in an imperfect credit market. We show that households facing credit constraints reduce investments in social capital. Furthermore, temporal declines in investment persistently reduce general trust, trust in villagers, and trust in business partners. While previous studies argue that social capital improves access to informal credit, we show the reverse causality. Combining these findings suggests a potential poverty trap.

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1. INTRODUCTION

Do the poorest of the poor, who are often excluded from formal credit and insurance market mechanisms, rely more on informal reciprocal arrangements through social capital than do the rich, or are they “too poor” to contribute to and benefit from the effective social safety nets generated by social capital? Using unique data from Sri Lanka, we aim to compare these two competing hypotheses empirically. More specifically, we investigate the nexus between social capital formation and accessibility to an imperfect credit market.

Social capital is defined as informal forms of institutions and organizations that are based on social relationships, networks, and associations that create shared knowledge, mutual trust, social norms, and unwritten rules (Durlauf & Fafchamps, 2005). Economists and sociologists recognize the important roles played by social capital in reducing poverty and facilitating rural development (Durlauf & Fafchamps, 2005; Fafchamps, 2004; Grootaert & Van Bastelaer, 2002; Hayami, 2009; Ishise & Sawada, 2009; Knack & Keefer, 1997; Putnam, Leonardi, & Nanetti, 1993). Narayan and Pritchett (1999) show that villages with more social capital are more likely to enjoy better public services, adopt advanced agricultural practices, and participate in communal activities, and that these in turn increase individual income. Fafchamps and Minten (2002) find that traders with a stronger social network earn higher profits by reducing transaction costs. Higher social

capital also helps solve the enforcement problem in risk-sharing arrangements, because it makes individuals creditworthy (Karlan, 2007; Paal & Wiseman, 2011) and helps recover from negative calamities quickly (Carter & Castillo, 2005).

Although a number of studies investigate these impacts of social capital, very few empirical studies establish a framework for social capital formation (Durlauf, 2002; Durlauf & Fafchamps, 2005; Miguel, Gertler, & Levine, 2006; Möbius, 2001). Moreover, related literature typically employs cross-sectional variations to identify determinants of social capital and uses time-invariant characteristics of households and communities, such as ethnicity and demographics (Alesina & La Ferrara, 2002; Charles & Kline, 2006). These studies, however, do not discuss how social capital is accumulated over time. As an exception, Glaeser, Laibson, and Sacerdote (2002) show that the patterns of participation in various groups, such as religious organizations and veterans' organizations, are consistent with investment behavior into social capital in the life-cycle framework. Since Glaeser *et al.* (2002) employ data from the United States, they assume a perfect

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credit market. However, in the context of developing countries, it is likely that the credit market is imperfect, and thus analyses that fail to consider heterogeneity in access to credit markets would generate misleading policy implications.

This study attempts to bridge this research gap by setting two goals. The first goal is to examine the impact on social capital investment of changes in opportunity cost caused by credit constraints. Such an analysis would be important because the opportunity costs of investments change over time (Glaeser *et al.*, 2002) and small changes in these costs can have large effects on the equilibrium level of social capital (Möbius, 2001). To capture the degree of social capital investment, we follow Anderson, Mellor, and Milyo (2004) and employ various participation measures of social capital, such as expenditure for ceremonies, participation in community work, and participation in irrigation maintenance.

The impact of credit constraints on the contribution to these activities is an empirical question.¹ On the one hand, credit-constrained households facing negative income shocks may cope with them by decreasing nonfood consumption (Behrman, 1988; Behrman & Deolalikar, 1990), and increasing labor supply (Heckman & MaCurdy, 1980; Jacoby & Skoufias, 1997; Kochar, 1999, 2004; Morduch, 1995; Rose, 2001). Therefore, credit-constrained individuals might spend fewer resources on social capital investments. If the declines in investment worsen bilateral relationships with other individuals in the community, it might cause a poverty trap, unless they can access credit outside the community. Lack of access to the credit market results in poor social capital, and this in turn leads to poor access to the informal credit market, as shown by Karlan (2007), thus exacerbating the credit constraints. As Möbius (2001) claims, this possibility of multiple equilibria underlines the importance of investigating the process of social capital formation.

On the other hand, households with poor access to a formal credit market may constantly invest in social capital to secure access to informal credit sources, because social capital improves credit market accessibility through social enforcement and social collateral mechanisms (Besley & Coate, 1995; Karlan, 2007; Karlan, Mobius, Rosenblat, & Szeidl, 2009). Indeed, many studies have shown the importance of social networks in making available informal credit and other types of mutual insurance (Carter & Castillo, 2005; Fafchamps & Gubert, 2007; Fafchamps & Lund, 2003; Ligon, Thomas, & Worrall, 2002; Murgai, Winters, Sadoulet, & de Janvry, 2003).

The second goal of this study is to investigate the persistent effects of temporal change in social capital investments—caused by credit and/or insurance market imperfections—on the level of social capital stock. Previous studies have shown the persistent impact of credit and insurance market imperfections on physical and human assets (Banerjee, Duflo, Postel-Vinay, & Watts, 2010; Dercon, 2004; Hoddinott, 2006; Quisumbing, 2006). This study is one of the first attempts to examine the long-term impacts on social capital.

For this purpose, we estimate the impact of previous social capital investments on five types of stocks: general trust, trust in villagers, trust in business partners, availability of mutual assistance, and fairness. One important distinction among them is whether they measure the relationship with the entire community or bilateral relationships within the community. While trust in villagers and business partners could involve relationships with particular individuals within the community, the other three indicate general attitudes to others. Contribution to community activities may play various roles in enhancing social capital. First, it gives the community

members the impression that the contributor is cooperative and wealthy enough to devote his/her resources to the community. This, in turn, establishes the reputation for trustworthiness and altruism (Posner, 1980). Second, it generates a dense social network among individuals and increases the possible punishment against selfish behavior.

To preview our empirical results, we show that credit-constrained households tend to reduce their resource allocation for social capital investment, such as expenditure for ceremonies and participation in irrigation maintenance. Moreover, the negative impact of the temporal decline in social capital investment persists: those who invested in social capital less are less likely to build bilateral and general trust even five years later. The impact of social capital on the perception of fairness and availability of assistance are rather negative and ambiguous, respectively. Anderson, Mellor, *et al.* (2004) find correlations between the contribution in the public goods game and various trust indicators, although they are not unidirectional. In contrast to Anderson, Mellor, *et al.* (2004), we study the nexus between previous contributions to public goods in the real world and social capital, showing the unidirectional impact across the types of social capital.

The rest of the paper is organized as follows. Section 2 first describes the study site and then discusses the dataset. Section 3 examines the short-term impacts of credit constraints on social capital investment, while Section 4 considers the persistent impacts on social capital stock. Finally, Section 5 concludes the paper.

2. STUDY SITE AND DATA DESCRIPTION

(a) *Social capital formation in Sri Lanka*

Previous case studies of Sri Lanka show that social capital among geographical community members plays important roles in economic development: it improves community participation in public services (Isham & Kähkönen, 2002) and encourages better maintenance of communal resources (Uphoff & Wijayarathna, 2000). In general, social capital is accumulated through informal organizations such as social networks and associations (Durlauf & Fafchamps, 2005, p. 1644). In light of these features, we consider three types of activities as investment in social capital: expenditure toward community ceremonies, participation in community work, and participation in communal irrigation maintenance. These activities can be considered to be investments in the community as a whole rather than bilateral relationships with particular individuals within the community as discussed below.

In Sri Lanka, villagers interact with each other by attending formal and informal meetings, such as farmer organization meetings and *Shramadana*, and devote time to community activities. *Shramadana* refers to the free supply of labor; these meetings involve in activities such as cleaning communal roads and irrigation canals, or making preparations for religious festivals.² Another way to socialize with community members is through farmer organizations, which are established in each branch water-distribution canal (D-canal). These organizations aim to resolve conflict among farmers, operate and maintain irrigation facilities, carry out cooperative purchasing of farm inputs and marketing of products, make provisions for loans to farmers, carry out social activities to help villagers, and so on. While residents in each area are required to join the respective farmer organization, the frequency of participation in the meetings varies. Participation in these activities can benefit all community members as a contribution to public

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