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Accumulated social capital, institutional quality, and economic performance: Evidence from China

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ABSTRACT

This paper provides evidence from China that historically accumulated social capital affects the current economic performance by improving contemporary institutional quality. Using historical data, we employ the Elites Studying Abroad rates of the years 1847–1949 for each Chinese province as a proxy for accumulated social capital. Our empirical investigation shows that historically accumulated social capital strongly and significantly affects the current economic performance because it can improve current social capital and institutional quality. This argument is strongly robust across multiple controls such as geography information, climates, natural resources, historical economic conditions, and economic policies.

1. Introduction

A mounting literature on second-generation fiscal federalism (Oates, 2005; Weingast, 2014) is enriching our understanding of the impacts of formal institutions, through jurisdictional competition (Tiebout, 1956) and regional reform experiments (Xu, 2011), on economic outcomes at the subnational level. Nevertheless, the influence of informal institutions on economic performance at the subnational level remains underexplored. Recent studies have investigated the impacts of exogenously enforced informal institutions (Acemoglu et al., 2011; Chen et al., 2014; Jia, 2014), whereas the stylized fact that informal institutions are naturally accumulated over long periods has been largely overlooked. In this study, we attempt to fill this gap in the literature. Using empirical evidence from China, we investigate the influence of historically accumulated social capital, subject to external shocks, on contemporary institutional quality and thus on the current economic performance.

Economists increasingly believe that informal institutions [interchangeably, culture (Guiso et al., 2006) or social capital (Knack and Keefer, 1997)] are significant determinants of economic performance. Particularly, social trust is a core value of social capital. Arrow (1972, p. 357) writes that "virtually every commercial transaction has within itself an element of trust; certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic

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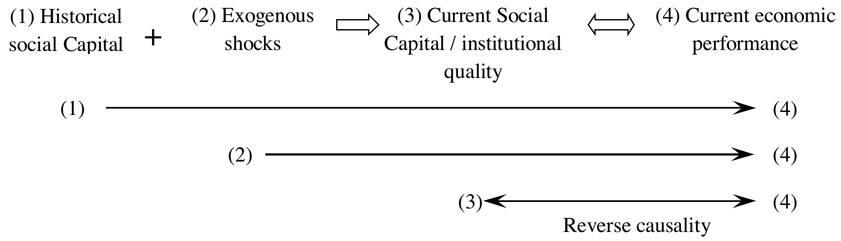

Fig. 1. Transmission mechanism from historical social capital to current economic performance.

backwardness in the world can be explained by the lack of mutual confidence." Comparable theories are presented by Coleman (1990),Putnam (1993), Fukuyama (1995), Woolcock and Narayan (2000), Williamson (2000), and Pejovich (2008). In the branch of empirical research, Knack and Keefer (1997, p. 1251) highlight "the relationship between interpersonal trust, norms of civil cooperation, and economic performance, and some of the policy and other links through which these dimensions of social capital may have economic effects." Similar empirical findings are reported by Besley and Burgess (2004), Guiso et al. (2006, 2015), Bhaumik et al. (2009), and Bai and Kung (2015). Despite the general consensus that social capital affects economic performance, the literature does not convincingly answer the critique of Solow (1995), which is cited in the study by Knack and Keefer (1997, p. 1255): "If social capital is to be more than a 'buzzword' its stock 'should somehow be measurable, even exactly,' but 'measurement seems very far away'." In our study, we attempt to answer this question by using evidence from China. We employ the Elites Studying Abroad (ESA) rates of the years 1847–1949 for each province, which are predetermined geographically and correlated with open-minded spirit and social trust in the historical period, as a proxy for historically accumulated social capital at the subnational level.

More specifically, we identify two gaps in the current literature. First, studies (Williamson and Manthers, 2011) have adopted subjective survey data (in particular, World Values surveys) to measure social capital. However, as Knack and Keefer (1997, p. 1255) concede, survey indicators are limited by "translation difficulties, sampling error, and response bias."

Second, researchers "study whether historical shocks can generate long term persistence in development by fostering a better culture" (Guiso et al., 2015). For instance, among China-focused studies, Jia (2014) examines the impacts of treaty ports, Chen et al. (2014) investigate the effects of historical exposure to missionaries, and Bai and Kung (2015) the influence of Protestant missionaries on historical economic outcomes. Although these studies perform excellent work in offering advanced methods (e.g., differences-in-differences estimates in Jia, 2014), they do not discover a valid variable that represents long-term accumulated social capital. As indicated by Williamson (2000), culture and social capital are the most persistent institutions, formal or informal, and exhibit no clear mechanism of amendment. It is thus intriguing to explore the channels through which long-term accumulated social capital affects the economic performance.

Fig. 1 illustrates the transmission mechanism between historically accumulated social capital and the current economic performance. Starting from the far left, historical and geographical factors are shown to determine durable social capital such as trust, civil cooperation, and open-mined spirit. Subsequently, exogenous shocks (e.g., the French Revolution according to Acemoglu et al., 2011) more or less affect social capital in a society, leading to improved institutional quality. After all these historical events, the concern of reverse causality (Guiso et al., 2006) exists between the short-term determinants of social trust/institutional quality and economic performance. To avoid the typical concern of reverse causality between institutions and economic performance as revealed by Davis (2010), we examine the causations between historical social capital (measured using the ESA rate as a proxy) and the current economic performance, for which transmission mechanisms are channeled through current social trust and institutional quality.

Section 2 outlines our hypotheses and provides a historical background clarifying why ESA is a plausible proxy for accumulated social capital, which is supported with graphical guides of key correlations. Section 3 presents data descriptions and basic estimations as well as the mechanism check. Section 4 investigates the robustness of our results, and Section 5 provides the conclusion.

2. Hypotheses and historical background

We hypothesize that the ESA rate represents variations in historically accumulated social capital at the provincial level. Residents in a province with a higher ESA rate might have accumulated more social capital in the past and/or received more exposure to beliefs from trustful societies. Consequently, one might reasonably expect that current social trust and the degree of marketization in these provinces would be higher, and that their market institutions would correspondingly be more robust. In a Williamsonian-Coasian sense, social trust would "reduce the transaction costs of identifying and exploiting all exchange opportunities [allocative efficiency], and also encouraging the acceptance of risks associated with creating new opportunities for exchange [entrepreneurship]" (Pejovich, 2008).[1] In this section, we discuss and substantiate this

[1] See Section II of Knack and Keefer (1997) for detailed coverage on how trust can affect economic performance.