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Trust, welfare states and income equality: Sorting out the causality

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ABSTRACT

The cross-country correlation between social trust and income equality is well documented, but few studies examine the direction of causality. We show theoretically that by facilitating cooperation, trust may lead to more equal outcomes, while the feedback from inequality to trust is ambiguous. Using a structural equation model estimated on a large country sample, we find that trust has a positive effect on both market and net income equality. Larger welfare states lead to higher net equality but neither net income equality nor welfare state size seems to have a causal effect on trust. We conclude that while trust facilitates welfare state policies that may reduce net inequality, this decrease in inequality does not increase trust.

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1. Introduction

The cross-country correlation between social trust and national income equality is well documented, but few studies examine the direction of causality. It is often assumed that inequality leads to lower trust (Alesina and la Ferrara, 2002; Uslaner, 2002; Delhey and Newton, 2005; Bjørnskov, 2007, 2008), but the theoretical mechanisms involved are still subject to debate (as shown in overviews by Jordahl, 2008 and Nannestad, 2008), as are those between inequality and economic development (e.g. de Dominics et al., 2008).

A mechanism supporting a causal link from trust to equality is suggested by findings in Bergh and Bjørnskov (2011) and Bjørnskov and Svendsen (2013), which show that historical trust levels explain current welfare state size. If larger welfare states lead to an increase in income equality, trust may impact equality through an expansion of the welfare state. Moreover, if the correlation between equality and trust indicates that equality causally increases trust, positive feed-back dynamics may take place, such that equality increases trust, and trust facilitates the implementation of welfare state redistribution, further fostering equality. Such dynamics are even more likely if universal welfare state policies have a positive effect on trust, as suggested by Barr (2004) and Kumlin and Rothstein (2005). On the other hand, if the cross-country correlation between income equality and social trust is driven only by the fact that deeply rooted trust levels explain both trust today and the degree of welfare state redistribution, there is no feed-back dynamic from redistributive welfare state policies to trust.

The possible causal relations are illustrated in Fig. 1, where full arrows show causal relations argued for in previous literature. This paper investigates the causality between trust and equality, and the potential role of welfare state policies as mediators of the causal associations. We do so by exploring two central questions, not dealt with before. First, do welfare states have an independent effect

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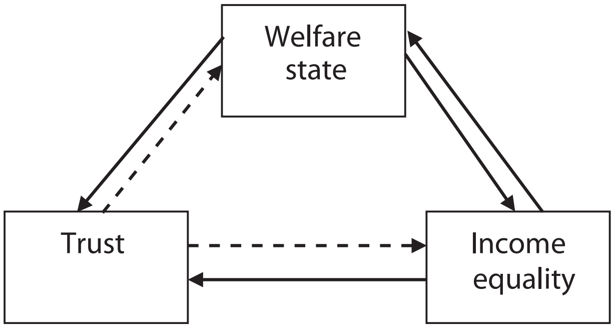

Fig. 1. The correlations between welfare state size, social trust and income equality.

on income equality, or is the correlation between welfare state size and income equality spurious, in the sense that trust explains both welfare state size and income equality? Second, if welfare states do increase equality of income, does this further increase trust, suggesting positive feedback dynamics?

Departing from a standard cooperation game, we show that the overall type of cooperation facilitated by trust and trustworthiness will under plausible circumstances increase equality. We then estimate structural equation models that account for potential feedback effects between income equality and social trust. The results document a two-way causal relation between market (pre-redistribution) income inequality and social trust, but no feedback from net inequality to trust. Furthermore, the effect from trust to inequality is substantially stronger than the feedback. Our findings thus suggest that welfare state policies do increase equality in disposable income but do not increase trust.

We start the paper by discussing potential theoretical links between social trust and inequality. In Section 3, we describe our empirical strategy to sort out the causal directions. Section 4 describes the data used in Section 5 to estimate the relation. Section 6 discusses our findings and concludes.

2. Links between social trust, cooperation and inequality

From a game-theoretic perspective, human interaction can be modeled as a number of repeated games of various types, as suggested by Binmore and Samuelson (1994). Some situations are best represented by zero-sum games, others by positive-sum games while problems such as rent-seeking are best represented by negative-sum games. In some cases, interactions take place among people who know each other and are likely to meet again, in other situations people interact with strangers that they are unlikely to meet again. As noted by many authors, trust and trustworthiness are beneficial for society precisely because they help groups reach cooperative outcomes in positive-sum games.[1] This holds for interactions in pairs, such as two people trading with each other, but also for large-N social dilemmas. In psychological research, the attitude of trust has long been viewed as beneficial for cooperation by helping to solve the conflict between one's own interest and the interest of the others (Dawes, 1980). Pruitt and Kimmel (1977: 375) noted that trust can be viewed as “the expectation of cooperation”. More recently, experimental evidence has shown that high-trusting individuals are more cooperative in social dilemmas (De Cremer and Stouten, 2003; Sønderskov, 2011).

As argued by Rothstein (2001), the welfare state can be seen as a large scale social dilemma, explaining why trust and trustworthiness are central for understanding the sustainability of the welfare state. For example, there are potential efficiency gains from cooperation deriving from social insurance arrangements in the welfare state, as emphasized by for example Barr (2004). Trust and trustworthiness help sustain and protect these social insurance arrangements against free riding.[2] From this perspective, it is not surprising that Bergh and Bjørnskov (2011) have demonstrated that more trusting populations are able to sustain larger welfare states. The welfare state may thus be seen as a mediator in the link from trust to equality.

At a broader level, Arrow (1972) noted that the vast majority of commercial transactions require an element of trust. Yet, when delivering homogenous goods in personal business transactions, social trust may not be relevant. Knack and Keefer (1997) define ‘trust-sensitive transactions’ as a class of transactions in which there is limited immediate monitorability. For example, when trading heterogeneous goods, sellers will need to trust that the quality of the goods delivered by a number of often anonymous agents is up to the contracted standard.

Likewise, in the public sphere, Dahl (1971) stressed that people need to trust one another if they are to associate together in the achievement of those objectives, which they cannot gain by their own individual action. For example, most bureaucratic transactions are anonymous and thus likely to be sensitive to trust differences, as are assessments of political actions and politicians (Bjørnskov, 2010).

Summing up, there is consensus that cooperation resulting from trust and trustworthiness helps societies make efficient use of their resources. Yet, although previous research focused on explaining cooperation, there has been little analytical work on the distributional consequences of trust-aided cooperation. A simple analytical framework for investigating such issues is provided below.

1 See, among many others, Knack and Keefer (1997), La Porta et al. (1997), Putnam (1993), Schelling (1960), and Svendsen and Svendsen (2008).

2 Cf. Fong et al. (2006). Trust and trustworthiness are important not only for the formal social insurance systems of modern welfare states, but also for more informal sharing arrangements. For example, Zhang et al. (2006) demonstrate how trust aids the implementation of community based health insurance in rural China.

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