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Financial shocks and the erosion of interpersonal trust: Evidence from longitudinal data



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ABSTRACT

This paper evaluates the effect of financial shocks on interpersonal trust levels, exploiting longitudinal survey data from 22,112 Australians. Using within-individual level variation, we find that trust does not change meaningfully following a positive financial shock (e.g., winning the lottery or receiving an inheritance). However, trust falls sharply following a negative financial shock (e.g., bankruptcy). In terms of magnitude, this effect is approximately equivalent to the effect observed after one reports being the victim of physical violence or a property crime, but significantly larger than effects from a range of other individual-level shocks (e.g., being fired or getting divorced). We then explore locus of control, which relates to the extent to which people believe they are in control of their circumstances, as a potential explanation for our core results. Indeed, we find evidence consistent with this hypothesis as locus of control tends to change, and become less internal, following a negative financial shock. In turn, locus of control is closely associated with interpersonal trust levels.

1. Introduction

Trust has been described as the key component of social capital, which itself has been widely recognized as a necessary condition for economic and social efficiency and prosperity (e.g., see Glaeser, Laibson, Scheinkman, & Soutter, 2000; Newton, 2001). Trust serves a key economic function in society by lowering transaction costs, and economic prosperity relies on our ability to trust in those with whom we conduct economic transactions, and in the institutions which create and enforce the rules around these transactions (e.g., see Algan & Cahuc, 2010; Dearmon & Grier, 2009; Guiso, Sapienza, & Zingales, 2004, 2006; Horváth, 2013; Tabellini, 2010; Zak & Knack, 2001, or Forte, Peiró-Palomino, & Tortosa-Ausina, 2015). Thus, it is important to understand how trust is formed.

In the following pages, we use rich panel data from the Household, Income and Labour Dynamics in Australia (HILDA) Survey to evaluate the effects of large financial shocks (such as winning the lottery, receiving an inheritance, or experiencing bankruptcy) on interpersonal trust levels.¹ These types of life events are quite common. For example, in the US, 764,214 bankruptcy cases were filed in the fiscal year 2016 alone (Justice, 2017). In Australia, the annual number of bankruptcies peaked in the 2009/2010 financial year, with around 35,000 registered personal insolvencies (Justice, 2017). We believe this paper is among the first to exploit rich

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¹ Note that our research question differs from the hypothesis that income levels or social class could systematically be associated with trust levels (e.g., see Brandt, Wetherell, & Henry, 2015) since we explore shocks to a person's *wealth*.

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longitudinal survey data, allowing us to identify within-individual changes in trust levels in a fixed-effects framework. Accessing information for 22,112 individuals in Australia over up to six waves, this data structure allows us to circumvent several potential estimation issues.

Trust is a multi-dimensional concept. Some aspects of trust are cultural, often determined by historical events, and thereby representing learnt attitudes at the societal level that are slow to change. These aspects of trust are often transferred from parents to children (Ljunge, 2014) and can become deeply embedded in shaping societal attitudes across generations (Nunn & Wantchekon, 2011). Further, it seems important to distinguish between political trust (or trust in government and institutions), interpersonal or social trust (expressing acknowledged beliefs and attitudes toward others with whom we interact), and behaviors which convey trust and trustworthiness (Newton, 2001). Economists and social scientists are commonly most interested in the latter aspect of trust, and specifically in how changes in circumstances can affect trustworthy and trusting behaviors, and vice versa. However, the usefulness of any such analysis rests on the assumption that the available measures of trust, typically sourced from survey data, capture these dynamics.

This assumption may be challenged by the notion that trust reflects fundamental psychological identity (e.g., see Cattell, 1965). However, Rotter (1966) relates trust to learning behaviors and how individuals' interactions with the world around them affect their perceptions, attitudes and, thereby, their behavior. Considering the relevant evidence, Newton (2001, p. 203) concludes that "trust seems to be less of an expression of an internal and unvarying personality trait, than a response of individuals to the changing external world around them." Further, evidence from experimental studies suggest stated attitudes of trust may not translate into observed behavior in the way we expect, although it seems clear that these reinforce one another (see Nee, Opper, & Holm, 2018). Glaeser et al. (2000) find that survey data on interpersonal trust predict trustworthy behavior much better than they predict trusting behavior. This information can have important bearings on how results based on such survey data are interpreted and should be kept in mind when interpreting our findings.

More generally, the analysis of survey data raises the possibility of bias from measurement error, omitted variables, and reverse causality. A valid concern in survey responses is the subjective attitude with which one respondent may classify themselves differently than another respondent (e.g., see Bertrand & Mullainathan, 2001). Since our results are derived from longitudinal data (i.e., following the same people over time) and rely on within-individual variation only, any such differences between people in measuring trust attitudes are controlled for. This panel data structure also allows us to alleviate concerns about omitted variables. Individual-level fixed effects account for any unobservable differences *between* individuals in terms of beliefs, preferences, early-life experiences, endowments, and any other characteristics that do not change over time for a person. In addition, we control for a number of covariates that may independently affect trust levels and the likelihood of experiencing a financial shock, such as income levels, educational attainment, civil status, the number of children, as well as state- and time-fixed effects. Finally, reverse causality is unlikely to drive our findings since trust levels at time t are compared with responses about whether one experienced a financial shock in time $t-1$. This addresses the concern that a person experiences a decrease in trust levels first (potentially for another reason) and then suffers a financial shock thereafter.

Our analysis provides evidence of a remarkably consistent and statistically significant negative effect from negative financial shocks to trust levels. However, we find no qualitatively or quantitatively meaningful link between *positive* financial shocks and trust. In terms of magnitude, the decrease in trust following a negative financial shock is equivalent to (and, if anything, marginally *greater* than) the loss in trust from being the victim of physical violence or a property crime. Further, the effect is statistically more powerful in explaining trust levels than effects from (i) being fired, (ii) a divorce, (iii) a separation, or (iv) an illness, among other major life events. Results are consistent when exploring trust-related outcome variables, such as believing other people (i) keep their word, (ii) succeed by stepping on others (reversed), (iii) make agreements honestly, (iv) try to be helpful, or (v) mostly look out for themselves (reversed).

Finally, we consider locus of control as a potential mechanism via which a negative financial shock could influence one's trust in others. Locus of control refers to the degree to which people believe they have control over their lives (e.g., see Rotter, 1966, 1990), and has been considered as part of the same broad construct as trust in the psychology literature. In the context of life events, the link between locus of control and trust may be exacerbated by self-serving bias, whereby people tend to attribute positive events to their own efforts, but negative events to the failings of others or ill luck (the discovery of this phenomenon is often attributed to Miller & Ross, 1975; see Blaine & Crocker, 1993, for a survey of the relevant literature). While we are unable to directly evaluate a causal path from financial shock to trust via locus of control due to a lack of data, we do find evidence that is consistent with such a transmission mechanism: A negative financial shock correlates strongly with a fall in a person's perceived degree of control over their life. This effect is, again, significantly larger than those from a range of other individual-level shocks. In turn, locus of control is closely associated with trust levels.

Overall, this paper aims to contribute to our understanding of whether and how major individual life events can affect our propensity to trust in others. Our findings are particularly relevant in terms of how significant financial events affect attitudes and beliefs about the risks and rewards of cooperative and non-cooperative behavior at the individual level. Ultimately, our findings hint at potentially large, wider costs to society from financial shocks at the individual level. Consequently, the extent and duration of economic downturns may be exacerbated by the erosion of trust and social capital, with potentially significant consequences to economic and societal prosperity.

The paper proceeds with a description of our data and methodology, followed by a discussion of our main results in Section 3 and a conclusion in Section 4.

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