



Social capital and entrepreneurial activity: A pseudo-panel approach



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ABSTRACT

This paper uses a pseudo-panel approach at an age-based cohort level to investigate the extent to which social capital accounts for differences in entrepreneurial activities. The findings suggest that trust measured by trust either in strangers or in public institutions facilitates entrepreneurship. We also find that parents' emphasis on individual achievement relative to interpersonal relations in raising their child is positively associated with entrepreneurship. Evidence suggests that both social norms and networks influence entrepreneurship. These results do not change when we use social capital measured at the national level.

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1. Introduction

Economists have long been interested in finding the factors that determine economic performance across countries. Among these factors, the notion of social capital has attracted much attention, especially since the publication of Putnam's *Making Democracy Work* (1993) (Knack and Keefer, 1997; La Porta et al., 1997; Narayan and Pritchett, 1999; Lindbeck et al., 1999; Zak and Knack, 2001; Glaeser et al., 2002; Akcomak and ter Weel, 2009; Dearmon and Grier, 2009). Coleman (1988) defines social capital as an element of human capital that allows members of a certain society to trust one another and to cooperate in the formation of new groups and associations. Putnam (1993) explicitly considers social norms as part of social capital: "Social capital is the features of social life – networks, norms, and trust – that enable participants to act together more effectively to pursue shared interests".

Trust, norms, and networks may make economic transactions more efficient by reducing uncertainties and information asymmetry between parties engaged in transactions. Furthermore, they enable parties to coordinate their activities for mutual benefits and to reduce incentives for cheating. Thus, social capital is expected to be conducive to economic growth. Following this reasoning, Knack and Keefer (1997) use the indicators of trust, civic norms, and networks from the World Values Survey (WVS) to understand whether these indicators account for differences in economic growth across countries. They find that trust and civic norms are positively correlated with economic growth, but the effect of networks on growth

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is not precisely determined. Narayan and Pritchett (1999) focus on social networks and find a positive association between dense social networks and household income by looking at cross-sections of Tanzanian villages.¹

A large body of recent literature confirms the findings of Knack and Keefer (1997) on the positive effect of social capital on growth (Glaeser et al., 2002; Beugelsdijk and van Schaik, 2005; Akcomak and ter Weel, 2009; Dearmon and Grier, 2009; Bjørnskov, 2012). Nevertheless, the channels of social capital that lead to economic growth have not yet been fully explored. One of the suggested channels is the quality of institutions. For example, La Porta et al. (1997) document a strong positive correlation between trust and a number of measures of government performance, such as the effectiveness of the judicial system and the quality of bureaucracy. Using Japanese data, Yamamura (2012a) finds that Putnam-type associations exert positive influences on public information-disclosure ordinances by local governments. Knack and Keefer (1997) suggest that investment is another important channel that leads to growth: social capital increases the confidence of investors in the enforcement of contracts. This finding is in accordance with the prediction of a general equilibrium model by Zak and Knack (2001), in which low-trust environments reduce investment. Other channels including education, financial development, and innovation are also suggested. For example, ample evidence suggests that social capital increases human capital by positively affecting schooling and academic achievement (Bjørnskov, 2009; Papagapitos and Riley, 2009; Yamamura, 2011, 2012b). Guiso et al. (2004) assert that social capital contributes to financial development. Finally, using the regional data of the European Union from 1990 to 2002, Akcomak and ter Weel (2009) show that social capital fosters innovation.

One less explored channel of social capital toward growth is entrepreneurship. Entrepreneurship is arguably one of the driving engines of economic growth (Schumpeter, 1934; Baumol, 1990; Murphy et al., 1991). One of the major problems in promoting entrepreneurship is its associated risk because the effort to become an entrepreneur can be regarded as a risky investment. However, such a risk can be reduced by social capital through its effects on uncertainty about entrepreneurial returns. Social capital can prevent the selfish behavior of relevant parties involved in transactions through the enforcement of informal norms. In other words, trust and social norms are reflected in public perception, in which others will act cooperatively in the prisoner's dilemma context instead of acting opportunistically at one's expense. This perception creates and develops an environment wherein businesses can start and expand more easily. However, despite the importance of entrepreneurship in economic growth, only a few attempts have been made to investigate this issue. For example, Bauernschuster et al. (2010) recently provide evidence that individual memberships in private associations and clubs have causal influence on entrepreneurship.

We evaluate the effects of various kinds of social capital, including trust, social norms, and networks, on entrepreneurship. We further categorize trust into trust in strangers and trust in public institutions. Social norms include attitude toward civic morals and parents' emphasis on interpersonal relations or individual achievements in child rearing. Civic morals measure the extent of morality, and parents' educational emphasis reflects important values shared by citizens. Following Knack and Keefer (1997), network is classified into Putnam type and Olson type. The former tends to pursue public interest, whereas the latter puts private interest at the expense of public interest.²

While examining the effect of social capital on entrepreneurship, we aim to improve the literature as follows. First, we use a pseudo-panel approach instead of a cross-country one, which is often used in the literature, to determine the impact of social capital on economic performance. A pseudo-panel tracks the cohorts of individuals over repeated cross-sectional surveys. This panel set-up enables us to use an estimator, such as a fixed-effects estimator and Generalized Methods of Moments (GMM), that is more reliable than a cross-sectional set-up. Second, we estimate the effects of the comprehensive components of social capital on growth in one equation for entrepreneurship. The elements of social capital, such as trust, social norms, and social networks, may be correlated with each other. Hence, using these variables in the same regression with a small sample is likely to cause multicollinearity. At the same time, using each variable in a separate equation will result in omitted variable bias. This study benefits from a larger sample size compared with earlier studies because of the use of the pseudo-panel approach, which helps avoid such a dilemma.

We use cohort panel data derived from the WVS to investigate whether and to what extent social capital accounts for differences in entrepreneurial activity.³ The data from the WVS cover five periods: 1981, 1990, 1995, 2000, and 2005. We exploit the feature of repeated cross sections to convert the data from the WVS into a pseudo-panel dataset. In other words,

¹ By contrast, Miguel et al. (2005) fail to find a positive correlation between social capital and industrialization in Indonesia. However, whether the social capital used by Miguel et al. (2005) measures generalized trust instead of particularized trust differentiated by Uslaner (2002) remains unclear. Issues on the definitions, robustness of the results, and endogeneity are still serious problems in empirical research on social capital (Paldam, 2000; Durlauf, 2002; Sobel, 2002; Beugelsdijk et al., 2004; Berggren et al., 2008).

² A dense social network may help in establishing a business because a social network facilitates repeated interaction between parties (Coleman, 1988). However, whether all social networks intend to promote public interest is unclear. Putnam (1993) attributes better economic performance in Northern Italy (compared with that in South Italy) to its denser social network. Annen (2003) suggests that inclusive social network contributes to growth by combining low enforcement costs with high gains from trade. By contrast, Olson (1982) argues that some associations undermine economic activities by preventing outsiders from entering the market and by lobbying for preferential policies that hurt others disproportionately. Thus, the effect of social network on economic performance is an empirical matter.

³ We use integrated WVS data available from <http://www.wvsevdb.com/wvs/WVSData.jsp>. The countries that participated in the survey are also listed on the website.

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