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## ABSTRACT

We explore the relationship between transaction costs and generalized trust. Using panel data from 2100 households in 135 poor rural communities of the Philippines, we show that where costs of interactions are reduced there is an increase in generalized trust. These results have implications for the literature on the links between trust and growth. Indeed, rather than being an input to economic growth, trust might be a product of reduced costs of interactions which also favors growth. Specifically, we find that the individuals most likely to engage in exchange exhibit an increase in trust after road construction.

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## 1. Introduction

It is often argued that, *ceteris paribus*, exchange is more frequent in more trusting countries and communities, as there is less need for costly enforcement mechanisms. (Knack and Keefer, 1997; Henrich et al., 2001). Consistent with this argument, generalized trust (*i.e.*, of people in general) has been shown to positively impact a wide range of economic phenomena. Countries with higher levels of generalized trust tend to, among other things, experience higher rates of GDP growth (Knack and Keefer, 1997; Zak and Knack, 2001), have better institutions (La Porta et al., 1997), and be less corrupt (Uslaner, 2002). Similarly, public goods are more widely available and better maintained in more trusting communities (Ostrom, 2000).

In light of those findings, researchers have become interested in the determinants of trust.<sup>1</sup> A first school of thought treats trust as a predetermined characteristic and focuses on historical factors, such as religion and ethnic diversity, to explain variations in trust levels. Cross-country regressions indicate that generalized trust tends to be lower in countries

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<sup>1</sup> This is especially important since, as noted by Sobel (2002), there is still some confusion between the causes and consequences of so-called 'social capital'.

where hierarchical religions are dominant. Similarly, in more ethnically diverse countries and communities, trust is lower (Alesina and La Ferrara, 2002; Leigh, 2006).

A second school of thought, which can be traced back to Montesquieu and Stuart Mill,<sup>2</sup> acknowledges that trust is not stable through time and has looked at the role of social and market interactions in building trust (Bohnet and Huck, 2004). In this vein, it is argued that the spread of television (i.e., an increase in the opportunity cost of time) erodes trust levels (Putnam, 2000; Olken, 2006). Further, this might explain why suburbanization was responsible for part of the decline in social capital in America, trust being one of its components (Putnam, 2000), as it increases the cost of participating in social activities. Recent evidence from trust games suggests that trade frequency, even when games are played anonymously, positively influences trust (Henrich et al., 2001; Huck et al., 2006). Further, using household panel data from South Africa, Haddad and Maluccio (2002) show that group membership generates trust. Following this line of argument, a potential avenue for building generalized trust is to increase both social and market face-to-face interactions with people outside one's immediate circle. This could be achieved by reducing costs associated with those activities.

In this paper we analyze the relationship between a reduction in transaction cost and generalized trust. We use road construction as a proxy for reduction in costs of interactions. We improve upon previous research on the determinants of trust by using panel data collected from 2100 households in 135 rural communities of the Philippines in 2003 and 2006. As a result, we provide more reliable estimates by controlling either for household or community-fixed effects in our regressions. It is important to note that our sample is not nationally representative and covers some of the poorest municipalities in some of the poorest provinces of the Philippines: about 72 percent of the sampled households were engaged in farming in 2003.

The Philippines is a very low trust environment. In 2001, only 8.4 percent of Filipinos declare trusting people in general.<sup>3</sup> Among the countries for which similar data is available, only two countries (Brazil and Lesotho) have lower levels of generalized trust. For comparison, in neighboring Indonesia 41.7 percent of individuals declare trusting others.

Our analysis shows that road building is associated with an increase in generalized trust. The most conservative estimate indicates that building a road is associated with a 4.5 percentage point (62.5 percent of the baseline mean) increase in generalized trust. Those results are robust to allowing for selection on observables. There is, however, no relationship between road construction and bonding trust (i.e., towards community members), presumably because roads increase interaction with outsiders, but they have no effect on the ease of interaction with community members. While we cannot directly test if increased interactions led to more trust, we show that access to markets improved in villages in which a road was built. Further, we find that, after road construction, individuals most likely to engage in exchange have larger increases in trust levels.

Our evidence suggests that the literature on the positive impact of trust on growth (e.g., Zak and Knack, 2001) might have overlooked the potential endogeneity of trust. Our paper points to a different causal chain. We posit that, to some extent, trust can be a by-product of growth-promoting investment. Indeed, road construction leads to reductions in costs of interactions, which will promote trade and, as a result, generate both growth and trust-building interactions. This is consistent with findings from Indonesia where, over the period 1985–1997, industrialization was associated with stronger social networks (Miguel et al., 2006). Future research on the relationship between trust and growth will need to account more carefully for the potential endogeneity of trust.

In addition, our paper contributes to the literature on the impact of membership in associations and generalized trust. Indeed, while association members tend to exhibit higher levels of generalized trust, the direction of the causality is contested. Some authors argue that trust promotes membership (e.g., Uslaner, 2002) while others argues that membership generates trust (Haddad and Maluccio, 2002; Putnam, 2000). Highlighting how interactions build trust, our results provide a mechanism through which trust can be enhanced by membership in associations.

The paper is organized as follows. Section 2 presents some hypotheses on the determinants of trust. Section 3 describes the datasets used. General results are presented in Section 4. Section 5 empirically explores mechanisms through which roads increase trust. Section 6 concludes.

## 2. The formation of trust

Theoretically, the links between trust and growth depend on assumptions about how trust is built. If one treats trust as a predetermined characteristic, trust cannot be affected by growth and the causal link (if any) suggests more trust leads to more growth. However, if one acknowledges the role of interactions in building trust, growth can promote trust (or at least factors generating growth can also lead to more trust). For example, Glanville and Paxton (2007) argue that: “encounters with persons who do not share one's sociodemographic characteristics could be particularly important in gauging how much to trust people in general.”

We now briefly discuss some testable hypotheses that arise from assuming that trust is built through interactions. Individuals live in a country composed of communities and various socioeconomic groups. We assume that one can easily distinguish between members of the various groups and that diversity is more pronounced between than within communities.

<sup>2</sup> For a review of the impacts of market development on social norms, see Hirschman (1982).

<sup>3</sup> Data retrieved from <http://www.worldvaluesurvey.org> (accessed on 04.02.2008).

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