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Corporate stakeholders and trust

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ABSTRACT

To my knowledge, this is the first paper that investigates the links between trust, the institutional setting (in terms of employment protection legislation (EPL) and investor rights) and studies the impact of all three on economic performance. In line with the previous literature (e.g. Knack and Keefer, 1997; Zak and Knack, 2001), we find that trust has a positive impact on GDP per capita growth. Our novel results are twofold. First, we find that EPL and investor rights have a negative relationship and that both (although the latter to a lesser extent) are substitutes for trust. Second, all three variables have a positive effect on economic growth.

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1. Introduction

La Porta et al. (1997a, p. 333) define trust as '[the] propensity of people in a society to cooperate to produce socially efficient outcomes and to avoid inefficient noncooperative traps such as that in the prisoner's dilemma'. This definition suggests that, contrary to the assertion of game theory that cooperation, fostered by trust, is not a rational strategy, people tend to trust others, including people they have never met, and expect them to cooperate even so they may never meet them again. The need for trust arises when there is asymmetric information, i.e. when the principal is unable to observe directly the actions of the agent. Trust is important when dealing with complete strangers or persons that one does not interact with on a regular basis. In contrast, regular dealings between parties are much less reliant on trust as such dealings enable each party to build up a reputation based on past interactions and also to punish each other for opportunistic behaviour. Hence, trust is more important in large organisations, such as large firms or bureaucracies, where dealings between people are less frequent and reputations cannot therefore be built up and punishments meted out.

Knack and Keefer (1997) argue that trust has economic benefits given that it reduces the costs of the principal dealing with an agent required to carry out some activities at a future date. Such dealings include the sale on credit of goods and services, investments that can be easily expropriated by the investee or the government and actions of a worker which cannot be easily monitored by the manager.

The existing literature suggests that trust increases economic growth and improves investment and institutional performance. It also suggests that particular societal and cultural characteristics, i.e. income inequality, ethnolinguistic and ethnic diversity as well as the percentage of a country's citizens following hierarchical religions, reduce trust. This paper goes beyond the analysis of the economic effects of trust and the determinants of the latter by analyzing how trust impacts on the institutional design, i.e. investor and employment rights. This paper finds strong evidence which suggests that it is important to analyse jointly shareholder rights and employment protection legislation. Indeed, while there is a negative relationship between the two, the regression results also suggest that they both affect the economic outcome in a positive way.

This paper has a companion paper (Goergen et al., 2013). While the present paper focuses on trust at the country level the companion paper also considers trust at the level of individual firms in each country. Although the inclusion of firm-level trust has certain advantages, it also makes the analysis, including the measurement of economic performance, firm performance to be more precise, more difficult. Indeed, the data required for the calculation of firm trust include sensitive data about employment practices that firms

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are not required to disclose. These data are sourced from the Cranet surveys. One of the limitations of the Cranet surveys is that firm performance is self-reported and not certified by third parties as this is the case with audited performance figures. As firms are anonymized in the Cranet surveys there is no way to remedy this. In contrast, the present paper uses GPD per capita growth, which is a less contentious measure of economic performance.

The rest of the paper is structured as follows. Section 2 reviews the literature on trust, investor rights and employment protection legislation. The following section focuses on the development of the hypotheses and discusses the methodology and data sources. Section 4 is on the empirical analysis. Finally, Section 5 concludes.

2. Literature review

This section starts with a review of the literature on trust and economic performance, followed by a review of the literature on investor rights and economic efficiency. It then turns to the theory and the empirical evidence on the effect of employment protection legislation on economic performance.

2.1. Trust and economic growth

Putnam's (1993) study of the effects of the 1970 constitutional reform in Italy suggests that civic engagement, which creates trust, improves economic and institutional performance. This reform created local governments in charge of individual regions in Italy. While these local governments proved to be relatively efficient in the North, they failed in the South. Putnam argues that the reason why the new governments succeeded in the North is its long tradition of civic engagement. This civic engagement creates trust between the members of the civic community even though the members may not always have the same opinion on key issues. In particular, Putnam argues that flat or horizontal organisations create trust whereas hierarchical or vertical organisations, including hierarchical religions such as Catholicism, reduce trust.

Fukuyama (1995) studies the decline of sociability in the USA, i.e. the growing distrust among American citizens. He reports that, compared to other developed countries, the US spends significantly more on police protection and has a significantly higher proportion of its population locked up in prisons. The US also has a much more pronounced culture of litigation, with its citizens spending significantly more on lawyer fees than for example Europe or Japan. He argues that, similar to its savings deficit, the US has been living off its accumulated trust or social capital for a while without investing further in it. However, contrary to the ongoing political debate in a series of industrialised countries, he does not claim that a return to family values, which have been gradually eroded over the last decades, will improve sociability. He cites the examples of China and Italy where family ties are important. While strong family or blood ties (which Fukuyama refers to as *familism*) in themselves may not be detrimental to economic growth, they nevertheless put severe limits to the type and especially the size of firms that can proliferate under such circumstances and the sectors firms will operate in.

Zak and Knack (2001) study the impact of trust on economic performance. They first develop a theoretical model and then test the validity of its predictions on 44 countries. The model deals with transactions between investors and their investment brokers. Trust is the total amount of time economic actors spend on production rather than on monitoring others. The model predicts that rich investors will spend more time monitoring their brokers as they have more wealth to protect. However, taking time off work to monitor one's broker becomes a less attractive proposal as one's earnings from production increase. The level of monitoring is also reduced when formal and informal institutions are strong enough to reduce cheating. Wage inequality will result in more monitoring that is a less trusting society, as the effort the poor will spend on monitoring will be higher than the reduction in monitoring caused by the higher wages of the rich. To sum up, Zak and Knack predict that higher trust increases investment and economic growth. As to the determinants of trust, more societal homogeneity and less income inequality increase trust.

Zak and Knack (2001) main data source is the World Values Survey (WVS). They measure trust by the percentage of respondents in each country agreeing that 'most people can be trusted'. They find the following:[1] (i) investment is higher in countries where incomes are higher and where there is more trust; (ii) there is a positive relationship between growth and trust; (iii) there is relatively little variation of trust across time compared to the cross-country differences in trust; (iv) trust has a quadratic, U-shaped relationship with ethnic homogeneity suggesting that trust is lowest in countries where there are several sizeable groups[2]; (v) trust depends positively on the government's attitude towards property rights and negatively on income inequality and land inequality; and (vi) while growth is positively related to the strength of property rights trust remains significant. Zak and Knack explain the latter result by the fact that property rights proxy for the people's trust in their government whereas the trust index is a proxy for the level of trust between individuals.

While Zak and Knack (2001) argue that trust and property rights measure trust towards two different types of economic agents (individuals and the government, respectively), Knack and Keefer (1997) hypothesise that trust between citizens can be a substitute for property rights and law enforcement in countries where these are weak. They also predict that high-trust societies will have longer investment horizons than societies where trust is low. In the former, incentives will also be higher for employers to invest in their staff and for employees to acquire firm-specific skills. Citizens will be prevented from opportunistic behaviour by norms of civic cooperation and the sanctions imposed for breaking these. These sanctions are internal (such as guilt) and external (such as ostracism and shame). If civic norms manage to prevent opportunistic behaviour, economic actors will have more time to spend on producing rather than on monitoring other economic actors. Civic norms of cooperation also help citizens reduce expropriation by politicians and other government officials. Indeed, if civic norms are such that citizens are expected to be involved in politics, this will overcome the classical free-rider problem. Knack and Keefer investigate the impact of trust[3] and civic norms[4] on growth and investment. They find that economic growth – measured by the average annual growth in per capita income during 1980–92–and investment – measured as a proportion of GDP – are positively related to trust and the strength of civic norms. Further, the impact of trust is higher in poorer countries where formal institutions and the quality of law are likely to be weaker suggesting that trust does indeed act as a substitute for the latter two. They also find strong negative correlations between income inequality

[1] For the sake of brevity, all of these effects are statistically significant.

[2] Zak and Knack (2001) state that this is e.g. the case in Fiji, Guyana and Trinidad. They also give the example of Tanzania which is a country with lots of small groups, but neither of these groups being large enough to dominate the political scene.

[3] As in Zak and Knack (2001), trust is proxied by the percentage of respondents agreeing that 'most people can be trusted'.

[4] The strength of civic norms of cooperation is also taken from WVS and is measured by the respondents' reply whether a series of actions 'can always be justified, never be justified or something in between'. The actions are: 'claiming government benefits which you are not entitled to', 'avoiding a fare on public transport', 'cheating on taxes if you have the chance', 'keeping money that you have found', and 'failing to report damage you've done accidentally to a parked vehicle'.

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