INSTITUTIONS, SOCIAL CAPITAL AND ECONOMIC DEVELOPMENT IN LATIN AMERICA

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ABSTRACT:

Economic theory has proposed and discussed a lot of possible factors or explanations that promote or foster economic development. One of these gathers specific discussions from other Social Sciences, incorporating social, cultural, religious, institutional and political dimensions – and among them, the idea of 'social capital'. Although the discussion held by Putnam on the benefits of association, civic involvement and interpersonal trust is extremely rich, this paper incorporates the discussion advocated by the World Bank, and the central ideas of Woolcock and Narayan papers, since they extend the scope of analysis, making what is called 'synergic vision' of social capital. These authors consider that "social capital does not exist in a political vacuum", ie there is no way to separate the elements that characterize the social and the political and institutional elements that surround it. The 'community social capital' of Putnam cannot be understood without the macro-environment in which it operates. This paper aims to explain the economic behavior in Latin America, considering the importance of the attributes directly related to social capital (interpersonal trust, which leads to the association and civic involvement, *pari passu* governance ie the formal attributes related to the action of the state, which establishes social, political and economic behavior. It wants to explain if these two dimensions are correlated in order to explain the behavior of agents in different economies in Latin America and their economic development.

KEY WORDS: social capital, economic development, Latin America

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Introduction

Countries have different conditions for economic growth and development, which are commonly linked to the availability of traditional production factors: physical, financial, human and natural capitals. More than half a century after the initial ideas proposed by Robert Solow,[2] the Theory of Economic Development has incorporated factors and variables that were originally outside the traditional model – because only purely economic explanations fail to explain development issues. Contemporaneously it is investigated the contributions of political, social, cultural and institutional conditions, incorporating the studies based on the role of social capital and institutional.

Social capital theory has been incorporated into economic literature from studies of non-economists. After the initial thoughts in the field of Sociology – by Pierre Bourdieu and James Coleman (1988, 1990) – the subject was handled by the political scientist Robert Putnam (1993, 1995). These authors introduced the theoretical basis for the incorporation of social capital as an important production factor and with effects and impacts on economic activity.[3] While the definitions are different, it is understood social capital as "[...] features of social organization, such as trust, norms, and networks, that can improve the efficiency of society by facilitating coordinated actions" (Putnam 1993:167).

The comprehension of institutions and their contribution to economics is contemporary to the debate about social capital, and is related to the original contribution of Douglas North (1989, 1990, 1991). The author summarizes the institutions as the 'rules of the game', which constitute a guide to economic activities and interactions.

At the intersection of these two concepts, there is the 'institutional' approach of social capital as recommended by the World Bank.[4] This approach highlights that the vitality of

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[2] Solow initial ideas were published in two articles: Solow, R. A Contribution to the Theory of Economic Growth. Quarterly Journal of Economics, v.70, n.1, p.65-94, 1956., and Solow, R. Technical change and the aggregate production function. Review of Economics and Statistics, v.39, n.3, p.312-320, 1957.

[3] The introduction to the book of Svendsen and Svendsen (2009) uses the analogy to a troika to describe the analysis of social capital: an intersection of knowledge derived from Economics, Sociology and Political Science.

[4] Especially from the papers of Woolcock and Narayan. These authors describe the 'evolution' of the concept of social capital, from the "community vision" advocated by Putnam to the vision of "network" and then extend it to the "institutional" approach and present their own understanding, translated in the "synergic vision" (Woolcock and Narayan 2000).

social relations is dictated by the institutional framework – political, institutional and legal systems in which personal relationships (and interpersonal trust) are established. The 'synergic vision' – an extrapolation beyond the institutional approach[5] – emphasizes the synergy and the feedback process between social capital and institutional environment. Structures, rules and regulations established by the State, through its institutions and political system, constantly interact with the dynamics of social organization of society, whether at horizontal or vertical levels, being constantly affected by it and affecting them in the same way. Likewise formal institutions need the involvement and social commitment, otherwise 'empty institutions' are useless to (eg: rules are not followed or the existence or prevalence of corruption to circumvent the legal system). This 'synergic' approach contemplates at the same time the conditions of reciprocity and trust (that are related to community level social capital) and institutional aspects, such as contract enforcement, rule of law and guaranteed civil and political liberties. Interpersonal trust and reciprocity are established in an iterative process with the institutional environment.

Governance is a broad term that covers the exercise of authority by the State in order to achieve the collective welfare. World Bank (1991:23) defines governance as resulted by the interaction of three aspects: "(i) the form of political regime [...]; (ii) the process by which authority is exercised in the management of a country's economic and social resources; and (iii) the capacity of governments to design, formulate, and implement policies […]". It covers items such as "[...] institutional quality of government, including the respect for civil and political rights, bureaucratic efficiency, absence of corruption, enforcement of contracts, and prevalence of law and order" (Loayza et al. 2005:41), since they are regarded as responsible for economic dynamism, along with more traditional factors and the political structures and institutions.

But is there consensus on the role of institutions and social capital on economic activity? This is the central subject of this paper that discusses the importance and influence of both concepts to economic development, focusing in Latin America environment. The purpose of the paper is to present a literature revision on the theoretical framework of social capital and institutions and the initial findings that investigate the relationship between both of them and economic performance in the region.

[5] Woolcock and Narayan believe that this approach could exclude people from the center of the analysis of social capital, incurring potential risk of a crowding out process: reinforcing the importance of formal institutions, this approach can undermine the importance given to the civil society behavior.

The theoretical framework

The Theory of Economic Development has highlighted the importance of traditional production factors for the generation of wealth in a country or region – natural, physical/financial and human capitals – opening an analytical scope for establishing relationships between them and among them and the real economic activity. However, "for more than forty years, then, the role of national and local institutions – political, legal, and social – were largely neglected" to understanding the growth and economic development (Woolcock 2001:66). Despite the valuable contribution of neo-classical theory, one should also consider its limitations:

> […] When applied to economic history and development it focused on technological development and more recently human capital investment, but ignored the incentive structure embodied in institutions that determined the extent of societal investment in those factors. In the analysis of economic performance through time it contained two erroneous assumptions: one that institutions do not matter and two that time does not matter (North 1993)[6].

Aware of these criticisms, other factors beyond strictly economical ones were highlighted and it was possible to study the contribution and role of social, historical, cultural, or political variables to the theory of development.[7] One theoretical approach incorporates the benefits and virtues of civic life, local associations and interpersonal trust, and another one covers the existence of some 'rules of the game' for economic activity.

The economic interests on social capital arises from the diffusion of works by James Coleman (1988, 1990) and Robert Putnam (1993; 1995), who extends and completes the former. Putnam (1993) presents the results of nearly twenty years of observations about the unequal economic conditions between the 'northern' and 'southern' Italy, confirming the positive effects of 'civic community' on economic activity. The 'bundle of virtues' of the civic environment includes placements beyond the simple pursuit of individual interests as stated by (1) civic participation, (2) political equality, (3) solidarity, trust and tolerance, and (4) associational life, a summary of what is called social capital.

Social capital, synthesized in the civic community, the associative involvement and social connections affect positively people's lives and improve them. The economic effect of

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[6] Prize lecture of Douglass North, when receiving the Nobel Prize in Economic Sciences in 1993. Available at: <http://nobelprize.org/nobel_prizes/economics/laureates/1993/north-lecture.html>.

[7] Indeed, the inclusion of social elements in economic theory and literature has always been present. In the middle of the eighteenth century, Adam Smith's work incorporates social concepts in his analysis on the behavior of agents and on the functioning of the economy, because "not all economic action derives from what are traditionally known as economic reasons" (Fukuyama 1996:33).

social capital can be understood this way: norms and networks of civic engagement "[...] foster sturdy norms of generalized reciprocity and encourage the emergence of social trust. Such networks facilitate coordination and communication, amplify reputations, and thus allow dilemmas of collective action to be resolved" (Putnam 1995). The incentives for opportunistic action by agents decrease because of the formal and moreover informal social rules, and interaction networks that are stated between them.

The analysis of potential contributions of social capital to economic growth and development does not compete with the institutional analysis.[8] Considering the 'rules of the game', Putnam believes that respecting them (or not) are not imposed, but are taught or learned from our own living community.

Living in society, around a broad array of social relations, implies the establishment and acceptance of rules, because "in social interactions, individuals deal with one another on the basis of some presumption of what they are being offered and what they can expect to get", ie "[…] on some basic presumption of trust" (Sen 1999). Trust and reciprocity arise out of interpersonal relationships – from social capital, therefore – or out of the institutional environment. Social interactions and economic activity take place in an environment of limited rationality and subject to opportunistic behavior, given the inability to understand, know or predict the behavior of other people.

Institutions have been defined by North (1990) as "[...] more formally, […] the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic." These rules are linked to the development of economic activities of any kind – production, distribution and exchange. The ultimate goal of existence of institutions is to constrain the opportunistic human behavior, collaborating to reduce transaction costs.

In initial stages of economic development trust can be considered only in interpersonal way, as people are required to establish personal and personalistic relations with their frequent economic interlocutors. With the evolution of economic activities is demanded more than interpersonal trust – it is needed general confidence. This depends on both personal attributes (honesty and integrity, for example), motivators of social nature (social rules of conduct, enforced by informal ties that are established between individuals) or institutional nature (rules imposed by the formal apparatus). It is fundamental the emergence and maintenance of

[8] On the contrary: the book 'Making democracy work' of Robert Putnam begins with comments about institutions! The initial chapters of the book deal with the 'Changing the rules: two decades of institutional development' and 'Measuring institutional performance'. The author states however that institutions are considered as resultants from the process of social interaction and social capital construction.

institutions that guarantee or induce compliance to contracts and cooperative behavior, while restricting opportunistic behavior.

It makes sense to think of social capital as complementary to the institutional environment (Fukuyama 2000). Nowadays it is not possible to establish economic relations based on interpersonal trust, ie on social capital solely. Although the economic effects of social capital are evident, and perceived in decreasing transaction costs, in any society it is necessary to have formal institutions, since cooperation mechanisms do not develop automatically as suggested by the theory of "invisible hand of the market":

> No one will volunteer to work for a neighborhood organization if the police cannot guarantee public safety; no one will trust the government if public officials are immune to prosecution; no one will sign a business contract with a stranger in the absence of tort law and enforceable contracts (Fukuyama 2002).

On the other hand, understand institutions isolated of the social capital can lead to the 'institutional temptation' of having a unique solution despite of the social and cultural contexts.

The economic environment is permeated by a broad spectrum of formal and informal rules. On one hand, it can be understood that "when economic and political dealing is embedded in dense networks of social interaction, incentives for opportunism and malfeasance are reduced" (Putnam 1995). In other hand economic activity is linked not only to economic institutions, but also to political ones. These are responsible in last stand for the institutional framework, once they design property rights and the legal system and rules to manage and coordinate economic action and ensure contract enforcement. Economic performance – growth and development – are influenced or shaped by institutions that are defined, ultimately, out of economic activity.

Given that economic institutions are shaped in the political sphere, it is possible to understand the position of North (1990): "in a zero-transaction-cost world, bargaining strength does not affect the efficiency of outcomes, but in a world of positive transaction costs it does and given the lumpy indivisibilities that characterize institutions, it shapes the direction of long-run economic change". On the opposite shore, institutions can be ineffective in reducing opportunistic behavior, since there may be individuals who get benefits derived from free-rider behaviors or rent-seek activities. In this case, institutions would not be designed to attend a public good, but to attain the interests of exclusive groups or 'cliques'.[9] The net impact of this behavior can be disastrous, because "poor governance increases transaction costs, encourages unproductive activities such as lobbying and reduces transparency.

[9] Borner, Bodmer and Kobler (2004) emphasize that the existence of institutions that do not ensure rule of the law are characteristic of many developing countries.

Therefore, it leads to an erroneous allocation of resources and discourages new investment"(World Bank 2009).

On one side there are reasons for believing that social capital promotes cooperation among agents, contributing to the design of networks and social interaction, and thus reducing opportunism. There is evidence that good institutions and good governance remain in "the effective functioning of bureaucracies, regulatory frameworks, civil liberties, and transparent and accountable institutions for ensuring the rule of law and participation matters for growth and development" (Thomas et al. 2000:XXIX).

By maintaining the institutional conditions lubricated and on proper functioning as well as the interpersonal trust, the consequences on economic activity would be positive and welcome. Social restrictions formally or informally bounded reduce the cost of interaction between agents, and forego the individual assessment of partners with which they establish economic transactions.

On the other hand social capital can also have negative effects, in order to create or force ties and interpersonal trust among just a few people – which leads to the exclusion of 'outsiders', the establishment of rules and requirements for entrance and permanence in the group, and restrictions to individual freedom. The excess of regulatory standards can also lead to institutional rigidities and formal barriers in order to hinder or prevent the access to economic benefits of a notorious portion of the population. The trust maintained only through the use of formal institutions can be potentially harmful to economic output as well. Faced with potentially problematic situations, "societies which rely heavily on the use of force are likely to be less efficient, more costly, and more unpleasant than those where trust is maintained by other means" (Gambetta 1988, apud Putnam 1993:165).[10] This is because the motivators of State and society are different: while the government seeks for claim through coercion, civil society – through social capital – can do it via voluntary cooperation.

Being social and historical constructions, existing institutions may not reflect collective interests, but respond to concerns of individual or dominant groups. This can occur in societies where there is a system of 'castes', 'tribes', 'neighborhoods', privileged social classes, or patrimonial patron-client relations or difficulties in accessing education, financial resources and minimal conditions for citizenship. These perceived limitations on economic mobility and social institutions can work to serve a few privileged groups and exclude others.

[10] Gambetta, Diogo. 1988. “Can we trust trust?” In *Trust: making and breaking cooperative relations*, edited by Diogo Gambetta, 221. Oxford: Blackwell.

This disadvantaged 'background' and individual behaviors can drain effort, time and resources from productive activities, and legitimate economic purposes, to rent-seeking activities.

From North's ideas one can conclude his eminent concern in understanding why the institutions of a country are positively related to good economic conditions, while in others the past didn't developed institutions that ensures or guarantees economic results. Despite this paper walks in an opposite direction to North, its concerns is about economic development and growth conditions in Latin America and what relationship can be established together with social capital and institutional governance. Specifically when looking at Latin America, the findings in this regard are of two natures. The region gets the lowest levels of interpersonal and institutional trust among all democratic economies, ie, it has low social capital, based on the terms proposed by Putnam. On the other hand it is also noted that "a unique culture of transgression exists in Latin America" (Sorj and Martuccelli 2008:158), based on 'legalistic tradition' of the continent, the existence of institutions that distinguish citizens – often on economic basis – and the acceptance or tolerance to the disregard of legal norms. Thus, both interpersonal trust and institutional governance in Latin America seem weak.

The context being examined: interpersonal and institutional trust in Latin America

Latin America, in broad lines, can be understood as an unreliable region and part of its economic performance – growth and development conditions – may be related to it or explained by this subject.

Results of opinion polls that study the region stress that it has low levels of interpersonal and institutional trust,[11] including lack of confidence in judiciary, police, political parties and Congress. If social capital is understood as "an individual sacrifice (time, effort, consumption) made in an effort to promote cooperation with others" (Oxoby 2009:5), one can easily conclude that Latinos are not willing to forsake personal interests because they understand this 'sacrifice' as in vain as there is a huge suspicion that they will not find reciprocity of this altruistic behavior in the future.

Latin America has a common heritage of mistrust, and low interpersonal trust is at the heart of the problem of low trust in institutions: "if not even people are trusted, how can institutions be trusted" (Lagos 1997)?

[11] Rennó (2001) is one of the authors that stress this fact, and so are Lagos (1997), Lopes (2004), Ottone (2007), Calderón (2008) and Moisés (2010). All of them argument about the lack of confidence in Latin America, based on results of public opinion polls.

The existence of low confidence may be related to historical conditions. It is observed relationship between the institutional behavior in Latin America and the Iberian colonial past. While the United States knew how to strength institutions originally developed in Great Britain – especially those related to property rights – Latin America institutional structures remained linked to the metropolitan origin; conditions present in the XVI-XVIII centuries in Portugal and Spain have been reproduced in Latin America (North 1989; North et al. 1999).

Bureaucratic structures of governance that existed in former Portugal and Spain in order to manage the colonies businesses can be summarized in the personalistic political and economic relations, state regulation, and property rights poorly defined. This behavior induced and maintained rent-seeking activities in the colonies, which may have been perpetuated in XXI century Latin America (Bjørnskov 2009). Once these activities are linked to specific groups, that represent the 'exclusive groups' advocated by Olson (1974), the potential benefits can be restrained to people who are part of the selected group. Maybe the assimilation and the unequal appropriation of the benefits generated in colonial times are still contemporary and responsible for intrapersonal low confidence in Latin America?

There is a gap "[…] – if not the abyss — between the *de jure* country and the *de facto* country, or between what the law prescribes and the social reality actually allows (the famous 'it is respected but not obeyed' from the colonial era)" (Sorj and Martuccelli 2008:126). This dissociation between the *de jure* and the *de facto* may explain part of the interpersonal and institutional distrust. This flexible and moldable behavior of people results in the 'Latin America way', a double-edged sword, at the same time a vice and a virtue. It also underlies the understanding of a transgressive behavior, in which the disregard for legality is rewarded and not punished. Whereas the "equality is a legal standard and a value, not a fact; is not an assertion, but rather a prescription" (Ottone 2007:23), breaking rules and not obeying the laws is an assumption almost 'natural', and people who comply their obligations are considered 'fools'.

In Latin American politics one can see a lot of examples of the presence of oligarchs and political centralization. Overflows and spillovers are inevitable in the economic area, once institutions can have traces of this conduct, responding to concerns of certain groups. There are visible hints of patronage, nepotism and private usage of public patrimonial structure. Lagos (1997) proves her thesis in reverse way: instead of having institutional distrust, Latin America has the "institutionalization of distrust" (a plethora of licenses, certificates and formal evidences of goodwill that are necessary in order to establish economic exchanges). In Latin America there is a tangle of personal and bureaucratic connections that go beyond the formal structure. Establishing these personal relationships – or 'connections' – contributes to enable the access to public benefits or services, once without these connections the formal system is perceived as intangible to ordinary people. These 'opens gates' in the functioning of State make the ground fertile to the flourish of illegal or unlawful activities (Sorj and Martuccelli 2008).

This understanding is supported by Fukuyama (2000), that uses the idea of 'radius of trust' to present his findings. Latin America would have two parallel systems, with different 'radii of trust': one valid for close friends and family and another for other people (generally called the 'others'). As a result, social capital would reside only in the family and groups of friends; 'strangers' fall into another category. The excessive concern with private and/or nuclear family and the reluctance to engage with public or collectives issues would lead to an excessive individualism. It's the idea behind the concept of 'amoral familism': a person feels morally bounded only to his/her family, excluding any cooperation possibility derived from impersonal social interactions. Social relations are undermined and consequently the possibility of establishing economic relations – then institutions are 'less able' (or have less power) than 'family and friends'.

Booth and Richard (2009) observed positive correlation between the existence of formal groups and democratic institutions over time, and that informal groups are inversely correlated with the longevity of democracy.[12] The authors propose that the years of political repression – including also civil wars – may have contributed to the establishment of informal groups, limiting the public exposure needed to constitute formal networks.

Political regimes in Latin America that used repression and individual surveillance over time may have held political activity within strict limits and tried to destroy participatory culture (Klesner, 2004). It is possible to correlate low confidence with some marks of political authoritarianism, and the lack of confidence of the population is considered a response, "a form of survival compared to the past and history" (Lopes 2004).[13] Interpersonal and institutional distrust that characterize low social capital in Latin America seems to have emerged from and been fostered through formal institutions. The attitude to remain silent and the passivity in face of political, economic and social environments would be some consequences of this mistrust.

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[12] Considering eight Latin American countries: Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua and Panama.

[13] Evans (1996: 1120) examined the impact of political regimes on social capital. He concluded about the process of trust destruction in Latin American countries motivated by years of totalitarian regime. This fact led to an "[…] 'angry atomization' of society, which leaves no space for self-organization at the bottom". Political regimes also change the conditions for generating synergy between State and society.

Finally, another possible explanation for the low interpersonal and institutional trust is related to income inequality that characterizes Latin America, given that "in highly unequal societies, people will stick with their own kind" (Uslaner 2009). Perhaps this structural deficiency of Latin American economies reinforce exclusionary conducts because "perceptions of [social] injustice will reinforce negative stereotypes of other groups, making trust and accommodation more difficult" or enable the understanding of attitudes such amoral familism, since 'others' are seen as potential 'enemies'.[14]

Final considerations

The common historical origins of the Latin American countries can contributes to a possible explanation for the distrust and disbelief in public activities, once public space is understood as being of 'no one' rather than being of 'all the people'. It also enables the comprehension about the avoidance of involvement with political activities.

Latin America presents great risks associated with the low representation and political mediation and the low involvement of its inhabitants with collective nature issues.[15] Interpersonal and institutional distrust presents statistically significant relationships with the disadvantageous terms of economic activity in Latin America: "clearly, there can be no political stability without economic growth, and sustained growth is impossible without a solid democratic institutional basis" (Lagos 1997). The consequences of mistrust and problematic social capital confirm the thoughts that Adam Smith developed centuries ago:

> Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. Commerce and manufactures, in short, can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government.

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[14] Also Jordahl (2009) relates social capital through trust and less income inequality, concluding that "society is seen as a zero-sum game between conflicting groups and this is reflected in lower levels of trust" (p.325).

[15] One of the most classical studies in this area concludes that a significant part total factor productivity growth rate found in Latin American economies in the 40 previous years, "can reflect a drop in efficiency in the private and public sectors as a result of misguided policies and weak institutions" (BARRO, R. 1999. Notes on growth accounting. *Journal of Economic Growth* 4(2) apud Loayza et al. 2005). Also Fukuyama (2002) notes that one of the reasons that could explain the low growth in Latin America when compared to East Asian countries is the quality of the institutions present in both regions because in societies where people cooperate and work together can emerge powerful and efficient state institutions.

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