Trust and Economic Reforms

Elena Besedina, KEI at KSE
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This brief discusses the importance of trust in economic development. In the aftermath of the 2008 financial crisis, many countries experienced a decline in the level of both general trust and trust and confidence in the government and market institutions. Trust is important for economic growth as it facilitates economic transactions by reducing uncertainty and risk. A lack of trust in the government hinders implementation of structural reforms needed for economic development. Hence, policies aimed at rebuilding trust in the government and institutions become especially important for countries like Ukraine.

Recent events in Ukraine have highlighted an acute crisis of trust in the Ukrainian society (such as trust in the government, politicians, institutions, etc.). Over the past two decades, in the absence of a fair and transparent legal and court system, Ukrainians have become accustomed to relying on informal and often corrupt ways of living and doing business. According to a poll conducted in December 2013, less than 20 percent of the Ukrainian population said that they trust the government, police and courts.

A low level of trust in society is not, however, limited to Ukraine; this problem is also pronounced in many other parts of the world. According to the 2012 Edelman Trust Barometer survey, the general level of trust in most countries surveyed decreased compared to 2011. The most notable decline was in Brazil (36.3%), Japan (33.3%) and Spain (27.5%). These countries also experienced large drops in the level of confidence in the government: Brazil went down by 62.4%, Japan by 51% and Spain by 53.5%. According to the OECD report, generally, less than half (40%) of the citizens trust their government (OECD, 2013).

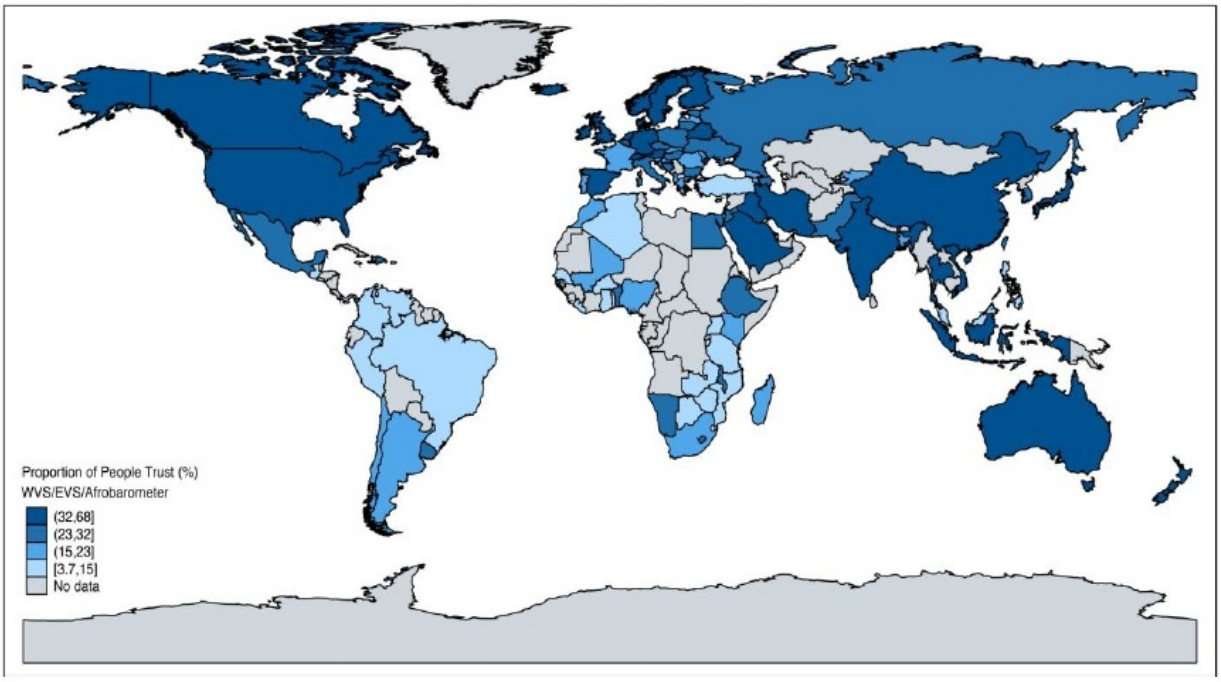
General trust is important for economic life as it reduces uncertainty and costs associated with economic transactions. Trust affects the functioning of businesses, financial markets, and government intuitions. The level of general trust varies significantly across countries (see Figure 1). While only 3.8 percent of people in Trinidad and Tobago fully trust most people, the Scandinavian countries' share of trusting people exceeds 60 percent (Algan and Cahuc, 2013).

Economists have in their studies repeatedly appealed to the problem of trust because there are several channels through which trust may influence economic development. First, trust creates favorable conditions for long-term investment and financial market development (Algan and Cahuc, 2013). Second, a higher level of trust in various regulatory authorities increases the level of compliance with the rules and regulations if citizens believe in the fairness of such rules and regulations (Murthy, 2004). In Tabellini (2010), the level of economic development (measured by GDP per capita) of different regions of the EU member countries is compared to their level of trust (defined as in the Figure 1) and respect (defined as the proportion of people who mentioned the quality “tolerance and respect for other people” as being important). Using data from the World Value Survey rounds conducted in the 1990s, he shows that regions with a high level of trust and respect are also the regions that are the most economically developed.

In his Master thesis, the graduate of the Kyiv School of Economics Oleksii Khodenko (Khodenko 2013) analyzed the relationship between the level of trust in the government and the attitude towards market economy (in particular, the attitude towards competition and private property). For this purpose, he used data from the World Values Survey and the European Values Survey. His results have different implications for developed and less developed countries. While a lack of trust in the government in developed countries is transformed into a desire to see more market mechanisms in the economy, this mistrust of the government in developing countries (including Ukraine) undermines the faith in the entire market economy.

Khodenko’s results highlight important policy implications for transition countries: people who grew up in a centrally planned economy tend to underestimate the benefits of the free market and, therefore, only puts confidence in the government and the state as a whole to achieve the development of market mechanisms. Thus a lack of trust hinders, or even prevents implementation of structural economic reforms, which are often "painful" for some groups or for society as a whole. In countries with a low level of trust, the long-term promise of the implemented reforms to improve the lives of people is not perceived as credible. Instead of being viewed by the general public as a today’s sacrifice in the name of future prosperity, they are rather viewed as a deadweight loss (Györffy, 2013).

Figure 1. The Level of Trust in the World



Source: Yann and Cahuc (2013), Figure 1.

Note: Trust is computed as the country average from responses to the trust question in the five waves of the World Values Survey (1981-2008), the four waves of the European Values Survey (1981-2008) and the third wave of the Afrobarometer (2005). The question regarding trust asks: *"Generally speaking, would you say that most people can be trusted or that you need to be very careful in dealing with people?"* Trust is equal to 1 if the respondent answers *"Most people can be trusted"* and 0 otherwise.

Moreover, low levels of trust affect all types of structural reforms. Elgin and Garcia (2012) show that the effect of the tax reform on the economy can significantly differ depending on the level of trust in the government; under low levels of trust the announced tax cuts do not lead to exit from the informal sector.

The question is then how to revive or rebuild trust? Knack and Zak (2003) argue that the most efficient policies for building general trust are policies that (1) reduce income inequality since people in countries with more equal income distribution tend to have higher levels of interpersonal trust, and (2) strengthen civil society to increase government accountability. Income inequality often resulting from unequal opportunities can be reduced via increases in educational attainment and income redistribution programs. The presence of a strong civil society with free press ensures that the government is accountable and responsive to its citizens. A government needs to be reliable, open and transparent to effectively address citizens' demands (OECD, 2013). All these policies cannot be implemented without a fair legal system that guarantees equal treatment of all citizens.

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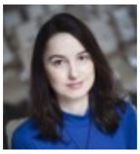
Elena Besedina

Kyiv School of Economics (KSE)

lbesed@kse.org.ua

http://www.kse.org.ua/en



Elena Besedina is a Senior Economist at the Kyiv Economics Institute (KEI) and an Assistant Professor at Kyiv School of Economics. Besedina holds a Ph.D. in Economics from Bocconi University. Her main research areas are international trade, political economics, and development economics.