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A replication of "Inherited Trust and Growth"

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Abstract

Algan and Cahuc (AER, 2010) find that inherited trust has a large impact on GDP per capita. I show that their estimates are possibly biased due to a difference between the lag structure of inherited trust and initial income in their econometric specification. The robustness checks in Algan and Cahuc (2010) potentially eliminate this bias, but suffer from data problems and a missing constant. When these problems are solved, the results do not confirm the main findings anymore, which suggests that the endogeneity issue might be serious. I then re-estimate their main specification with a consistent lag structure but fail to find a statistically or economically significant effect of trust on GDP per capita.

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1 Introduction

The paper "Inherited Trust and Growth" by Yann Algan and Pierre Cahuc (Algan and Cahuc, 2010), hereafter AC, is a significant contribution to the literature on the relationship between measures of social capital and economic performance (see the discussion by Guiso, Sapienza and Zingales (2011)). In their study, AC conclude that "[there is] a sizable causal impact of inherited trust on worldwide growth during the twentieth century" (Algan and Cahuc, 2010, p. 2060). Their point estimate implies that if the share of the population that generally trusts other people would increase by ten percentage points, GDP per capita would increase between USD 2,000 to 3,000.

When estimating the causal effect of trust on economic growth, the following problem arises: it is likely that trust towards others is influenced by income or that trust and income are driven by an omitted variable. AC overcome this problem by using the inherited part of trust, which should be uncorrelated with contemporaneous income shocks and variation in an unobserved variable, when initial income is controlled for. To do this, it is necessary to estimate historic trust levels from descendants of immigrants to the US from different source countries and arrival periods.

This paper argues that there are two problems in the econometric analysis of AC, which, taken together, challenge their main findings. First, there is an unsolved endogeneity problem caused by the fact that initial income is measured long before inherited trust. Second, the robustness checks, which should convince the reader that the mentioned type of endogeneity is not a problem, break down if data problems and a simple econometric mistake are solved.

Intuitively, the following problem emerges in AC's regression model: the identification strategy rests on the assumption that the trust level inherited from parents, who immigrated to the US, is uncorrelated with any income shock or omitted variable driving income growth in the country of origin between the time of immigration and today. In practice, however, AC form a dataset that is inconsistent with this logic. The outcome variable is GDP per capita in 2000, inherited trust is for the period 1910–1975, and the control variable of initial income is measured in 1935. Imagine a large shock in an unobserved variable in the 1950s that increases the trust level at that time, as well as GDP per capita. Since GDP per capita is persistent and trust is passed on to the next generation, a regression of income in 2000 on inherited trust from the period 1910–1975 and initial income in 1935 would produce a positive coefficient on the inherited trust variable, even if there is no causal effect of trust on income. In a nutshell, the main regressions in AC have an unsolved endogeneity problem.[1]

This endogeneity problem could be solved, if the initial GDP per capita control variable matches the period for which inherited trust is estimated. For example, if inherited trust corresponds to the period 1910–1950, then initial income should be measured in 1950. The robustness checks in AC do exactly that. These specifications impose a minimum lag between inherited trust and the outcome variable of 50 and 75 years, keeping the lag for initial income at 65 years, which reduces or eliminates the above described endogeneity problem. However, the highly significant results in the robustness checks suffer from two problems: GDP per

[1] AC actually form a panel with the outcome variable measured in 1935 and 2000, estimate inherited trust from immigrants arriving up to 1910 (period 1) and immigrants arriving between 1910 and 1975 (period 2), and initial GDP in 1870 and 1935. The authors then include country fixed effects in their regressions. The described endogeneity problem is, however, unaffected by these fixed effects.

capita figures are not measured at the same point in time for all countries and the constant term is suppressed. Solving these issues generates much smaller and insignificant estimated effect of trust on growth.

By comparing the main results and the robustness check after correcting the data and estimation problems, one can evaluate how serious the potential endogeneity problem is. The main results, which suffer from the endogeneity problem and the data/estimation problems, still show a positive and significant effect after correction of the latter. The robustness checks, which face the endogeneity problem to a much lesser extent, do not show such an effect after correcting the data/estimation problems. This pattern suggests, that the endogeneity problem discussed above might seriously bias the estimated effect.

In the last part of the paper, I re-estimate the model with an appropriate lag structure, ie. time of measurement of inherited trust and initial GDP per capita match each other. I use a lag of 50 years to capture long-run economic growth, but still get a sufficient number of observations to estimate the inherited trust level precisely. In a wide range of specifications, I fail to find any statistically or economically significant relationship between trust and economic growth.

The findings in this paper do not imply, however, that there is no growth-enhancing effect of trust. There are a number of other papers that show evidence for an economic payoff to a trusting society (Knack and Keefer, 1997; Tabellini, 2010; Algan and Cahuc, 2014). The paper by AC is celebrated as a valuable addition to this literature, because it finds a way to estimate historic trust levels and thus include country fixed effects to rule out time-invariant unobserved country heterogeneity. This paper simply shows that the large effect of trust on growth found in the estimation framework in AC should be considered with care. However, one should keep in mind that a zero effect of trust on growth could also be unavoidable in a fixed effect framework: the stock of social capital might not change over time and the exploited variation in trust levels over time would then be entirely due to measurement error.

The paper is organized as following: Section 2 discusses the unsolved endogeneity problem in detail, Section 3 fixes some simple mistakes in the main result and robustness checks, while Section 4 replicates AC and solves the endogeneity problem of Section 2. Section 5 concludes.

2 Identification and Estimation

The primary challenge when estimating a causal relationship between trust and income is that either trust and income are correlated with an omitted variable or that income influences trust. AC propose an identification and estimation strategy that has the potential to solve this problem. Their key insight is that the inherited part of historic trust levels can be estimated for a number of countries from immigrants to the US, which in turn can be used to solve the endogeneity problem in a growth regression.

Assume the data generating process is given by the following equations:

$$Y = \alpha_0 + \alpha_1 S + \alpha_2 L1.Y + \varepsilon \quad (1)$$

$$S = \gamma_0 + \gamma_1 L1.S + \gamma_2 L1.Y + \nu \quad (2)$$

where Y is income per capita, S stands for trust towards others, ε is an income shock, and $L1$ indicates a lagged variable by one period. The problem in estimating equation (1) comes from the fact that $Cov(\varepsilon, S) \neq 0$, that is an omitted variable might drive income and trust at the same time. To facilitate the analysis, let $\varepsilon \perp L1.S, L1.Y$. This assumption means that current income shocks are independent of the past.

The novel strategy by AC to identify the parameter of interest α_1 is to use the inherited part of trust $\gamma_1 L1.S$ as exogenous variation in S. However, AC run into a problem in their regression model when they use a higher lag in initial income than they do for inherited trust. Let me illustrate the problem of this strategy by examining a regression model where the control variable of initial income has a lag of two periods, while inherited trust has a lag of only one period as in equation (3):

$$Y = b_0 + b_1(\gamma_1 L1.S) + b_2 L2.Y + e. \tag{3}$$

Using equations (1) and (2) one can show that

$$E\left[\hat{b}_1\right] = \alpha_1\left(1 + \alpha_1\frac{\gamma_2}{\gamma_1} + \frac{\alpha_2}{\gamma_1}\right) + c_1(\alpha_1\gamma_2 + \alpha_2), \tag{4}$$

where c_1 comes from the hypothetical auxiliary regression $L1.\varepsilon = c_0 + c_1(\gamma_1 L1.S) + c_2 L2.Y + e$ according to the omitted variable bias formula (Greene, 2008, p. 133). Note that c_1 has the same sign as $Cov(\varepsilon, S)$.

First, even if there is no endogeneity problem (ie. $Cov(\varepsilon, S) = 0$), and hence $c_1 = 0$, the parameter of interest α_1 is not identified because γ_1 and γ_2 are unknown. This is an omitted variable problem because $L1.Y$ is not included in the regression equation and $L1.S$ has a direct effect on $L1.Y$ as has $L1.Y$ on S.

Second, if there is endogeneity (ie. $Cov(\varepsilon, S) \neq 0$) and therefore $c_1 \neq 0$, then the estimator $\hat{b}_1$ is potentially more biased. The term $(\alpha_1\gamma_2 + \alpha_2)$ is the effect of $L1.\varepsilon$ on Y, where at least α_2 can be plausibly assumed to be positive and sizable, since positive income shocks in the past should increase income today. The effect of an income shock in the past on today's trust level is $\alpha_1\gamma_2$. The sign and magnitude of this effect is unclear, but it is unlikely that it will exactly offset the bias caused by the persistence of income shocks. The result suggests that the estimator $\hat{b}_1$ from (3) is biased except in very special cases.

The inclusion of country fixed effects does not solve this problem. Those fixed effects account for time-invariant factors of a country, which might be correlated with the trust variable. A temporary shock between the time of measurement of initial income and inherited trust would still bias $\hat{b}_1$.

Almost every regression in AC results in a sizable positive coefficient for initial income, which suggests that income shocks are persistent ($\alpha_2 > 0$), resulting in an upward bias. The results in AC should therefore be interpreted with caution since the endogeneity problem is not solved and the estimates might be severely biased. In addition, the estimated effect would not be the causal effect of trust on GDP per capita, even if there is no endogeneity between trust and income shocks.

3 Robustness Checks in AC

The authors seem aware of the described problem in their estimation strategy and provide a number of robustness checks. In particular, they increase the lag of the inherited trust variable to 50 and 75 year, while keeping the lag of initial income at 65 years. The estimates of the effect of trust on growth are surprisingly similar to the baseline model. I show that those estimates suffer from two mistakes.

The first issue is an inconsistency in the time of measurement of GDP per capita. Income per capita is not measured in the years stated in the paper, but for different country groups at different points in time. For instance, the variable "initial income in 1870" is measured for some countries as the difference to Sweden in 1820, while for others it is the difference to Sweden in the period 1900-1909.[2] Table A.1 in the Appendix lists the periods of measurement of GDP per capita in AC. It is not only initial GDP per capita in 1870 that is measured inconsistently, but also other variables (eg. GDP per capita in 1935-38) have its flaws.

The second point concerns an omitted constant in each regression.[3] In the regression models with country fixed effects there are N-1 country dummies included, but no constant. However, in a fixed effects regression there should be either N-1 dummy variables and a constant or N fixed effects without a constant. Because all variables are measured as the difference to Sweden, it would be possible to suppress the constant if Sweden would be the base country. However, the default option in Stata is to choose the country with the lowest country code as the base group, which is Africa in this case.[4]

Given the missing constant term, Africa receives a special position in the estimation of the effect of trust. One can think of fixed effects estimation in two steps: first, the fixed effects deduct the country mean from all observations and, second, the within-country data is used to estimate the effect of trust on income. While for all other countries than Africa the country fixed effects reduce the data to within-country deviations from the mean, the missing constant leaves the data for Africa in its original form (the difference to Sweden). Because Africa has low income and trust levels in both periods, these observations significantly bias the estimated effect of trust on income.[5]

3.1 Replication

I now replicate the main results and robustness checks of AC by sequentially eliminating the two aforementioned problems. For this task, I use the estimated measure of inherited trust from AC and focus on the regressions with country fixed effects and a control variable for initial income, since in these specifications both issues come into play. The new data of GDP per capita is constructed just as AC describe it in their paper, which is the difference to Sweden of the average of GDP per capita in 1935-38 (2000-03) and initial income is measured in 1870 (1935-1938), with the exception of Africa, where GDP per capita is only available for 1940, which is used instead of 1935-38.

Table 1 shows the results of the replications. Panel A replicates the main result of AC of

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[2]A lack of data for the year 1870 can be ruled out as the reason of this inconsistency as GDP per capita is available for all countries in 1870 in the Maddison database.

[3]For instance, the Stata command used in regression (2) of Table 7 in AC is:
"`xi: reg gdpk_diffswd_good trustgss50yearslag i.cty, noconstant`", where `gdpk_diffswd_good` is GDP per capita, `trustgss50yearslag` is the measure of inherited trust, and `cty` is the country code. All the variables are measured as the difference to Sweden, so a time fixed effect is not necessary.

[4]See Table A.2 in the Appendix for an explicit demonstration of this point.

[5]Figure B.1 in the Appendix demonstrates this point.

column (4) in Table 6.[6] Column (1) shows the results from AC for reference. The estimates become smaller once income data are measured consistently for all countries in column (2) or when a constant is included in column (3). Column (4) solves both issues together. The estimated effect of trust on growth remains large and significant at the 5-percent level. Bear in mind, however, that this specification suffers from the potential endogeneity problem discussed in Section 2.

Panel B shows the robustness check with a lag of 50 years (column (3) in Table 7 in AC), while Panel C shows the results of the replication of the model with a lag of 75 years (column (3) in Table 15 in AC). Again, column (1) shows the results from AC for reference. The two issues are resolved separately in columns (2) and (3), in which the point estimate of inherited trust already decreases. After both issues are resolved in column (4), none of the estimates remain significantly different from zero at traditional confidence levels. For the robustness checks with a minimum lag of 50 years between the measurement of inherited trust and the outcome variable, the point estimate is even negative. But also the point estimate of the model with a 75 years lag decreases by about 55 percent.[7]

The pattern of the results is the following: the main findings, which are subject to the endogeneity problem discussed in Section 2, remain significant and positive, while the robustness checks, which at least partly solve the endogeneity problem, fail to find a significant effect. Taken together, this suggests that the endogeneity problem caused by the inconsistent lag structure of the model could indeed drive the main results.

4 Effect of Inherited Trust on Growth

In this section I attempt to learn about the causal effect of trust on economic growth in this estimation framework. To this end, I re-estimate a version of the model with a consistent lag structure of 50 years, for both, inherited trust and lagged income. I use a lag of 50 years to have a sufficient number of observations of immigrants to the US to estimate inherited trust at two points in time, but still focus on growth over a long period of time. The outcome variable is measured in 1960 and 2010.

The estimation of the inherited trust levels follows AC: with individual-level data from the General Social Survey I regress a trust indicator on country-cohort of immigration dummies and individual control variables. The estimated coefficient of the country-cohort of immigration dummies is used as the inherited part of today's trust level. For details see Appendix C.

4.1 Trust and Economic Growth

Given the estimates of the inherited part of historic trust levels, I now proceed to the growth regression to estimate the causal impact of trust on growth. The GDP per capita data come from the *Maddison Project Database* (Bolt and van Zanden, 2014). To ensure some

[6] Table A.3 in the Appendix shows a replication of the main results in AC without country fixed effects (Table 5 in AC).

[7] OLS standard errors, as used in AC and here, may lead to a too high rejection rate of the null hypothesis in panel data models (see Bertrand, Duflo and Mullainathan, 2004, for Difference-in-Differences estimators). Table A.4 in the Appendix replicates Table 1 with standard errors that are clustered at the country level.

comparability to AC, I show estimates with *GDP per capita in nominal 1990 US Dollars* as the dependent variable in Panel A of Table 2. Following the growth literature more closely, I also use the *log of GDP per capita* in Panel B. The main finding is the same in both specifications.

In column (1) of both panels, GDP per capita (nominal or in logs) is naively regressed on inherited trust and a time dummy for the period of 2010. The results indicate a strong positive correlation: a high trust level is associated with high income 50 years later. But this does not imply a causal relationship of trust on income, as relatively rich countries tend to remain rich and hence causality could run the other way or a third factor could drive both, trust and income. Column (2) tackles this problem by including initial GDP per capita to control for relative initial prosperity, while column (3) includes country fixed effects to take out the effect of time-invariant cross-country differences. In both columns the point estimates are greatly reduced or even negative and loose statistical significance.

The preferred specification in column (4) includes both, initial GDP per capita and country fixed effects, and even shows negative point estimates in both panels. Column (5) excludes outlying countries (Africa, Greece, and India) to rule out that a few countries drive the result. The point estimates increase in magnitude, but remain statistically indistinguishable from zero. So far, each observation was treated with the same weight as if inherited trust was estimated with the same precision. But some of the estimates of historic trust levels are based on few individuals. The next column deals with this issue by using the number of individuals of each country as weights. The resulting effect of trust on growth is large and negative in both tables, but remains insignificant.[8] In the last column I use parsimonious estimates of inherited trust as described in Appendix C. This is to rule out that biased estimates of inherited trust due to endogenous person characteristics drive the results. However, the results in this specification show a similar effect of trust on growth than the baseline specification of column (4).[9]

A word of caution is necessary before coming to a conclusion: these results do not necessarily imply that the causal effect of trust on economic growth over a 50 year period is zero. The sample size is small because the estimation of historic trust levels is only possible for a limited number of countries. The standard errors of the results are large relative to the point estimates and a few observations may highly influence the findings. The econometric problem of dynamic panel data estimation is unsolved, as only two time periods are available. What the results do show, however, is that we do not learn about the causal effect of trust on growth through the approach of AC.

5 Conclusion

In this article based on "Inherited Trust and Growth" (Algan and Cahuc, 2010), I argue that the main results of the original paper should be considered with care. First, I show that the large and significant effect of inherited trust on GDP per capita during the twentieth century can not be interpreted as a causal relationship. The estimation faces an unsolved

[8]Upon closer inspection, this is the effect of Africa with a large number of observations and its poor growth performance. However, dropping Africa leaves the effect statistically indistinguishable from zero.

[9]Table A.5 in the Appendix replicates Table 2 with standard errors that are clustered at the country level.

endogeneity problem. In their regressions AC also introduce further problems by using inconsistent data and omit the constant in their regression models. The correction of these problems invalidates most of the robustness checks in their paper, including the specification that would actually solve the endogeneity problem.

I re-estimate the model of AC with a consistent lag-structure that avoids the bias present in AC. I do not find evidence for the existence of a statistically significant causal relationship between trust and economic growth. These findings suggest that the approach taken by AC does not shed light on a possible growth-enhancing effect of trust in the long run.

Although the paper by AC is considered an important contribution to the growing literature on the relationship between trust and economic outcomes, this paper encourages the reader to consider those results with care.

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Tables

Table 1: Replication of Main Results and Robustness Checks in AC

Panel A: Main result (Table 6, column (4) in AC)	Dependent variable: GDP per capita in 1935 and 2000			
	(1) [AC replication]	(2) [new]	(3) [new]	(4) [new]
Inh. trust in 1935/2000 (min. 25 years lag)	28,230.15***	21,023.20**	24,069.24**	20,194.51**
	(7,350.49)	(7,648.12)	(9,502.23)	(8,778.69)
Initial GDP per capita in 1870/1935	2.81**		2.21	
	(1.03)		(1.35)	
Initial GDP per capita in 1870/1935 (new)		2.67***		2.51**
		(0.77)		(1.09)
Political institutions in 1930/2000	−149.35	−39.81	−235.95	−68.32
	(89.41)	(84.41)	(152.72)	(161.69)
No. observations	46	46	46	46
R-squared	0.87	0.90	0.85	0.87
Panel B: Robustness check (min. 50 years lag) (Table 7, column (3) in AC)	Dependent variable: GDP per capita in 1935 and 2000			
	(1) [AC replication]	(2) [new]	(3) [new]	(4) [new]
Inh. trust in 1935/2000 (min. 50 years lag)	14,903.50**	3,291.79	9,620.18	−755.54
	(6,905.16)	(7,681.39)	(9,408.99)	(8,357.42)
Initial GDP per capita in 1870/1935	4.44***		3.45**	
	(1.04)		(1.58)	
Initial GDP per capita in 1870/1935 (new)		3.96***		2.95**
		(0.86)		(1.22)
Political institutions in 1930/2000	−71.63	15.61	−223.12	−182.45
	(123.88)	(117.11)	(220.02)	(206.62)
No. observations	32	32	32	32
R-squared	0.82	0.84	0.81	0.83
Panel C: Robustness check (min. 75 years lag) (Table 15, column (3) in AC)	Dependent variable: GDP per capita in 1950 and 2000			
	(1) [AC replication]	(2) [new]	(3) [new]	(4) [new]
Inh. trust in 1950/2000 (min. 75 years lag)	24,195.65***	17,068.33*	15,285.88*	10,712.32
	(6,824.92)	(8,787.95)	(8,593.23)	(8,449.07)
Initial GDP per capita in 1870/1935	3.64***		1.86	
	(0.79)		(1.35)	
Initial GDP per capita in 1870/1935 (new)		2.88***		0.15
		(0.78)		(1.46)
Political institutions in 1950/2000	−25.74	42.97	−224.37	−358.00
	(91.15)	(107.75)	(152.39)	(211.70)
No. observations	34	34	34	34
R-squared	0.89	0.86	0.88	0.87
Country FE	Yes	Yes	Yes	Yes
Consistent GDP per capita measurement		Yes		Yes
Constant included			Yes	Yes

Notes: The dependent variable is mentioned in the column heading. The variable “Inh. trust in 1935/2000 (min. 25 years lag)” is an estimate of the inherited part of trust from ancestors who immigrated to the US at least 25 years before the mentioned year. The control variables in each specification are listed. All variables are measured as the difference to Sweden. In addition, country fixed effects are included. The variable “Initial GDP per capita in 1870/1935” uses the data from AC, while “Initial GDP per capita in 1870/1935 (new)” uses the corrected and self-collected data. OLS standard errors are in parentheses below. *, ** and *** indicate statistical significance at the 10% level, 5% level, and 1% level, respectively.

Table 2: Inherited Trust and Growth with a Consistent Lag of 50 Years

Panel A: Nominal GDP per capita	Dependent variable: GDP per capita in 1960 and 2010						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Inh. trust in 1960/2010 (min. 50 years lag)	23,724.4***	4,885.8	9,932.5	−512.7	6,218.7	−13,219.2	−2,037.5
	(7,093.3)	(4,409.3)	(7,399.9)	(6,184.5)	(9,062.4)	(15,115.1)	(6,039.0)
Initial GDP per capita in 1910/1960		2.1***		2.3***	1.8***	1.9*	2.3***
		(0.2)		(0.5)	(0.6)	(1.1)	(0.5)
No. observations	52	52	52	52	46	52	52
R-squared	0.60	0.87	0.83	0.91	0.92	0.91	0.91
Panel B: Log GDP per capita	Dependent variable: log GDP per capita in 1960 and 2010						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Inh. trust in 1960/2010 (min. 50 years lag)	2.71***	0.10	−0.50	−0.48	0.28	−1.36	−0.52
	(0.80)	(0.44)	(0.38)	(0.41)	(0.56)	(0.98)	(0.41)
Log initial GDP per capita in 1910/1960		0.98***		−0.03	−0.19	0.01	−0.01
		(0.08)		(0.21)	(0.25)	(0.41)	(0.21)
No. observations	52	52	52	52	46	52	52
R-squared	0.54	0.89	0.95	0.95	0.95	0.94	0.95
Time FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Country FE			Yes	Yes	Yes	Yes	Yes
Africa, Greece, and India dropped					Yes		
Weighted regression						Yes	
Parsimonious estimate of inh. trust							Yes

Notes: The dependent variable is mentioned in the column heading. The variable "Inh. trust in 1960/2010 (min. 50 years lag)" is an estimate of the inherited part of trust from ancestors who immigrated to the US at least 50 years before the mentioned year. The control variables in each specification are listed. Weights in column (6) are the number of observations the inherited trust variable is based on. The parsimonious estimates of inherited trust come from an estimation of inherited trust without any control variables. OLS standard errors are in parentheses below. *, ** and *** indicate statistical significance at the 10% level, 5% level, and 1% level, respectively.