

de Jesus Pinsetta Pavarina, Paula Regina; Cella, Daltro

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Formal and informal institutions and the economic development in Latin America

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Formal and informal institutions and the economic development in Latin America¹

Paula Regina de Jesus Pinsetta PAVARINA²

Daltro CELLA³

Abstract

This paper aims to collaborate with the discussion about the factors that try to explain the economic behaviour in Latin America countries, considering the importance of some attributes related to social capital (i.e. interpersonal trust, which leads to association and civic commitment, performing what Putnam (1993) considers a 'civic community') *pari passu* the institutional behaviour, i.e. the 'rules of the game in a society' (North 1990). These two dimensions attempt to explain the behaviour of agents facing the rational economic decision of cooperate or not. It can be stated that this decision depends on two factors: (1) the expected behaviour of other agents ('I cooperate if the other will also cooperate') and (2) the existence of standards, patterns or rules that hinder or prevent opportunism (in order to avoid that cooperation seems a 'fool's choice'). The more generalized trust is more cooperation is expected. Furthermore, strong institutions that can enforce pre-established rules reduce the uncertainty and insecurity of the decision-making process. The key question when considering these two dimensions at the same time is if they are complementary or substitute to each other in Latin America context. In other words, it tries to understanding the relationship between formal and informal 'rules of the game' as well as high levels of social capital to the economic behaviour and economic actions. Then this study assesses the contribution of these two elements to the economic performance of Latin America, considering data provided by large international databases such as Latinobarómetro, World Values Survey, Index of Economic Freedom, Worldwide Governance Indicators, International Country Risk Guide, and Polity IV. Theoretically, it is easy to display the relationships established between these concepts but in practice, there is great methodological difficulty to quantify them. Thus, it was selected several indicators or proxies among the possible variables that exist in these databases. Social capital is represented by very subjective elements such as trust, values and assimilation of social norms. The same difficulty occurs when institutions are considered; since it is difficult to evaluate the effective contribution of formal institutions to economic performance. The simple existence of institutions, understood as formal 'rules of the game', does not guarantee that they are fulfilling their intended functions.

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² Professor at Sao Paulo State University (Unesp), campus Franca. Address: 900, Eufrasia Monteiro Petraglia Av., 14409-160, Franca, São Paulo, Brazil. E-mail: pavarina@franca.unesp.br.

³ Professor at Sao Paulo Technology College (Fatec), campus Catanduva; and Ph.D. candidate at University of Araraquara (Uniar), São Paulo, Brazil. E-mail: daltro_cella@yahoo.com.br.

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Introduction

Countries worldwide have different economic development conditions. After more than half a century of studies, conducted after Solow growth model, the theory of Economic Development incorporated factors and variables that were originally outside the traditional model, such as political, social, cultural and institutional conditions, because purely economic explanations fail to explain development issues of regions and countries.

The contribution of social capital to economics was incorporated after the studies conducted by sociologists as Pierre Bourdieu and James Coleman (1988, 1990), and the political scientist Robert Putnam (1993, 1995). These authors laid the theoretical basis for the incorporation of social capital as an important factor of production with effects and impacts on economic activity.

The study of the institutions and their contribution to economics is contemporary to the debate about social capital, being related to the original ideas of Douglass North (1989, 1990, and 1991). The author consider institutions as the “rules of the game”, which constitute a guide for activities and economic interactions.

However, is there consensus on the role of institutions and social capital on economic activity?

There are a plenty reasons to consider that social capital promotes cooperation among agents and reduces opportunism. High levels of social capital keep institutional conditions lubricated and in perfect working order: formal or informal restrictions will reduce the cost of interaction between agents and the impact on economic activity would be positive and welcome.

On the other hand, social capital can also have negative effects, creating ties and interpersonal trust among a few ones. This fact leads to the exclusion of “outsiders” (those who not belong to the group), the establishment of rules and requirements for entrance and maintenance inside the group and other actions restricting individual freedom. In addition, the excess of regulatory standards can lead to institutional rigidities and excessive formal barriers may hinder or prevent the access to economic benefits: “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 quoted in Putnam, 1993).

Institutions are social and historical buildings, and may not reflect the collective interest but respond to concerns of isolated groups or dominant groups. In this case, difficulties of

access to education, financial resources and minimum conditions of citizenship are likely to occur in societies where there is a “caste” system, or “tribes”, or “neighbourhoods”, or privileged social classes. This disadvantageous context drains efforts, time and resources from productive activities or legitimate economic purposes to rent-seeking activities.

In order to begin an empirical investigation, the major research behind this paper presents and discusses the impact of social capital and institutions on economic development of countries in Latin America. The hypothesis is that there is a positive relationship between social capital and institutions with the growth and development of the region. Considering someone else's idea, the hypothesis of this research is that “there is no possible stability without economic growth, and sustained growth is impossible without solid institutional foundations” (Lagos, 2000).

This paper is a work in progress that wants to present the methodological pattern followed by the main research, and wants to point and discuss the importance of some existing variables to assess the social capital and institutional conditions in Latin America.

Social capital, institutions and economic development

***If the misery of our poor be caused not by the laws of nature,
but by our institutions, great is our sin. (Charles Darwin)***

When institutions are mentioned, the main author remembered is Douglass C. North. He defines institutions as the “rules of the game” in a society or “[...] more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic” (North, 1990). These “rules” are consisted of both “informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, rights property)” (North, 1991:97).

Institutions are designed to allow or facilitate cooperation between public and private actors, conforming rules of the game or “legal, administrative, and customary arrangements for repeated human interactions” whose “major function of which is to facilitate exchange through predictable human behaviour in a world of uncertainty and incomplete knowledge” (North, 1990). Thus, economic agents - thousands, millions in some cases - may have support to make contracts, agreements and decisions, since the institutions can provide stability in collective choices that would otherwise be chaotic.

Putnam (1993) presents the results of nearly twenty years of observations about the unequal economic conditions between the ‘northern’ and ‘southern’ Italy. He conducts the

reader though a synthesis of Italy unification process and the contemporary consequences of the unequal conditions that were established centuries before and confirms the positive effects of ‘civic community’ on economic activity. Putnam considers the ‘civic community’ as a ‘bundle of virtues’ that includes (1) civic participation; (2) political equality; (3) solidarity, trust and tolerance; and (4) associational life, a summary of what is called social capital. Then, the author considers 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).

Civic participation is considered as participation in public affairs, ie spontaneous involvement in issues that concern public or communal causes. Another virtue is political equality, which includes equal rights and duties for all citizens. Solidarity, trust and tolerance are also present in the civic community, ensuring conditions of living and fruitful coexistence between individuals. Finally, Putnam highlights the usefulness and value of associations and emphasizes the importance of membership in horizontally organized groups.

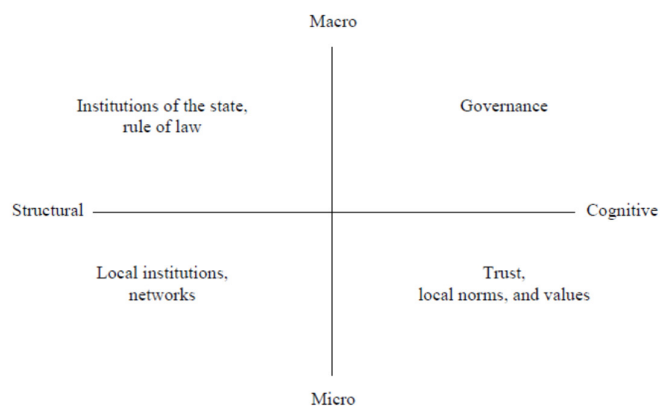
Social capital, synthesis of this ‘civic community’, has been historically accumulated in the ‘northern’ Italy leading generation after generation to a social organization based on coordinated action between individuals, to the establishment of rules of cooperation and mutual trust, and to good institutional performance and efficiency.

At the intersection of these two concepts, there is the approach of social capital stated by the World Bank (Woolcock and Narayan, 2000). These authors describe the “evolution” of this concept, from the *communitarian view* to the *networks* view, then amplify it to an *institutional* approach and present their own understanding, reflected in the *synergy* view. The authors believe that the *institutional* approach could exclude people from the center of the analysis about social capital, incurring in a potential risk of crowding out: in reinforcing the importance of formal institutions, this approach could minimize the importance of civil society. *Synergy* view on the other hand highlights the relationship between social capital and the institutional environment; the structures, rules and regulations established by the State constantly interact with the dynamics of social organization, being constantly affected by it and affecting them in the same way. Formal institutions need involvement and social commitment; otherwise, they can be understood as “empty institutions” (rules that exist formally but are not respected). The *synergic* approach considers at the same time reciprocity and trust conditions (social capital) and institutional aspects, such as contract enforcement, rule of law and guarantee of civil and political liberties.

Fukuyama (1995) also argues that there is a reasonably complementary relationship between social capital and institutions. It is not possible the existence of relationships based solely on interpersonal trust, ie in social capital. In any society, it is necessary to establish formal institutions, once cooperation mechanisms cannot automatically develop it. It can be stated that nothing matters having good ‘idealized’ institutions, if people involved with them use them to achieve individual interests or for their own benefit, or in a fraudulently and corrupt way. Nor is it possible for people to develop individual trust mechanisms, with strong public spirit and ethical behaviour, if there is no formal institutions where they can apply their virtues.

Grootaert and Von Bastelaer (2000), as shown in Figure 1, also defend the relationship between institutions and social capital. The horizontal axis of this figure considers the structural dimension of social capital, formed by formal social structures - networks, associations, standards and procedures - and the cognitive, more subjective elements, such as trust, norms of social conduct and reciprocity, and socially shared values. The vertical axis considers the levels in which social capital is obtained: micro, meso and macro. The micro level considers the relations within households and among individuals; meso evolves regions or communities; and the macro, the environment in general. In the intersection of these two dimensions comes a third, comprising the outputs derived from the interaction between social capital and institutions: trust, local norms and values; local institutions and networks; conditions related to formal institutions - such as the political and judicial system, the rule of law, enforcement of contracts; and, finally, governance.

Figure 1. Dimensions of social capital



Source: Grootaert; Von Bastelaer (2000: 20).

Chang (2011:28) points out this complementary relationship. This author identifies the risks of “institutional imitation” in transposing institutions from one country or region to another: “if this is the case, importing the formal institution is not going to produce the same

outcome because the importing country may be missing the necessary, supporting informal institutions”. If institutions are considered isolated from social capital it can incur the temptation of a single ‘institutional’ solution that permeates cultural and social aspects. In order to formal institutions lead to positive economic effects, it is needed the concurrent development of informal institutions or rules of cooperation characteristics of social capital in a visible complementary relationship.

The complementary approach is also justified by the fact that if there is distrust in formal institutions, following the rules is a ‘foolish thing’. People can have the perception that laws are made to be unfulfilled, since “[...] nearly everyone expects everyone else to violate the rules. It seems foolish to obey the traffic laws or the tax code or the welfare rules, if you expect everyone else to cheat” (Putnam, 1993:111). Thus, the creation of institutions top-down is not a sufficient condition for development – more than created they needed to be respected and supported by the population. Putnam (1993) ponders that external or top-down incentive to engage people in civil society associations are more ineffective than spontaneous solidarity mechanisms. Strong formal institutions, in an environment where social capital is weak, may generate perverse effects that undermine a possible individual propensity to engage in collective action. Ie the internalization of informal social norms, interpersonal trust and the rules of reciprocity and tolerance are more effective as mechanisms for stimulating participation in collective actions than is institutional formalization.

A methodological approach

**Not everything that can be counted counts,
and not everything that counts can be counted. (Albert Einstein)**

This study aims to assess the contribution of two elements to the economic development: social capital and institutions. Theoretically, it can be discussed the relationships that can be established between these concepts, as outlined in advance, but in practice there is a great methodological difficulty to quantify these aspects.

Measuring development is a huge task as there are several indicators that can be used to represent it. Also measuring social capital can be complex because it involves very subjective elements such as trust, values and social norms. The same difficulty occurs when considering the role played by the institutions; since there may be difference between the design of the institution and its practical behaviour, it is difficult to evaluate the effective contribution of formal institutions to economic performance.

Beyond the theoretical clash regarding these three elements, with different understandings, concepts and views, there are also difficulties to measure them. The most common solution is the use of proxy data, which summarize the understanding of these concepts. Several studies have already identified good proxies using different methods of qualitative and quantitative comparative research, which are useful for the purposes of measurement and comparison. It must be emphasized, however, potential difficulties about endogeneity of variables.

With this in mind, this section will present proxies that can be used to summarize economic development, social capital and institutions, focusing in variables and existing databases that investigate the countries in Latin America. The sources consulted come from suggestions observed in literature, contain information that reflect or indicate different aspects regarding the social capital and institutional quality, and has been used in other studies that deal with this theme.

It should be noted that each institution has a different methodology for obtaining and compiling data. Some of them use surveys, others rely on information gathered from experts on the subject and others, in turn, present indicators that summarize existing information, transforming them into other indicators considered as synthesis. It should also be noted that some variables are presented in the cardinal way, other obey the ordinality, but in both cases, institutions provide them with credibility, statistical rigor, timeliness in data collection and minimal analytical bias.

Databases

Before presenting and justifying the variables used in this paper it is needed a synthetic comment about the databases consulted.

The *World Values Survey* (WVS, created by World Values Survey Association), is a survey that includes a representative sample of the population of 97 countries (about 90% of world population), gathering opinions on subjects ranging from personal and labour relations to the welfare of democracy governance and political, associative and social participation. Focused specifically in Latin America, the *Latinobarómetro* brings together the opinions of about 19,000 people in 18 countries in the region, about important social, political, economic and cultural issues in a survey conducted since 1995. The *Americas Barometer*, database created by the Latin American Public Opinion Project, evaluates opinions about trust in institutions; political tolerance; participation in civil society; perceptions on the economy;

support for democracy; political legitimacy; voting behaviour; participation and attitudes towards local government in 26 countries.

The Heritage Foundation presents the *Index of Economic Freedom*, which aims to evaluate the interference of the state in economic activity in 185 countries. It is considered that ‘freedom’ is fundamental to economic relations and any State intervention in the economy is frowned upon, since it is presupposed as based on discretionary attitudes, personalist criteria or is less efficient than those obtained through the market.

Other index is calculated for 144 countries by the Economic Freedom Network and Fraser Institute and is called *Economic Freedom of the World - EFW*. This index considers that there is economic freedom when the citizens of a country are free to set voluntary economic relations with each other, safeguarding the property rights.

A database called *Freedom in the World*, calculated by Freedom House, considers on the other hand freedom as access to civil liberties and political rights, as stated by the International Declaration of Human Rights, regardless of geographic location or political orientations, ethnic, religious or economic locations.

A large database called *Worldwide Governance Indicators (WGI)* is calculated by the World Bank for 215 countries, considering that as “traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them” (World Bank, 2012).

The Group Political Risk Services (PRS) presents a general index of risk for 140 countries, as well as three others indexes of political, financial and economic risk, in a database named *International Country Risk Guide (ICRG)*.

Finally, the *Polity IV* database is part of a larger project, called Polity Project - Political Characteristics and Transitions Regime of the Center for Systemic Peace, which summarizes information returning to 1800. It is commonly used for data evaluation and comparison of the governance attributes political regimes and regime change.

Variables

The main objective of this paper is to present databases and variables that summarizes attributes related to social capital and institutional quality.

Social capital is comprehended following Putnam (1993), as features of a location such as association environment, civic engagement and trust. Although it is not possible to use

identical variables proposed by his book “Making democracy work”, it is proposed by this paper the usage of similar variables that can synthesize these attributes. Then, selected variables represent proxies to those one stated by Putnam, and represent interpersonal and generalized confidence as well as the civic respect and associative participation.

An important role is played by the trust, which promotes a healthy environment for the establishment of subsequent cooperative relations, once it can lead people to a non-opportunistic behaviour.

Three variables represent ‘interpersonal trust’, a traditional measure of social capital: the percentage of people that answered that in general, they “can trust people”. Information about ‘generalized trust’ can be summarized by confidence in specific institutions or groups: (1) public institutions – the government, Parliament, the judiciary, political parties, public management, and local governments; (2) private institutions – trade unions, private companies and banks; and (3) mass media - newspapers, television, and radio.

Association also plays an important role in social capital. It was possible to identify variables that consider the percentage of associates or members of formal groups. Membership in these groups was separated in two more specific segments, as stated by Knack and Keefer (1997): association to horizontal groups, called Putnam groups or P-groups, traditionally linked to the civic community of Putnam;⁴ and Olson groups or O-groups, clearly related to economic interest that brings together all participants (Olson, 1965).⁵

Finally, it was also identified some variables that represent ‘civic engagement’, when trying to capture the interest and proactivity in solving collective problems.

The synthesis of representative variables of social capital, as well as data sources, is presented in Table 1.

⁴ Sport clubs or recreational and social activities, artistic, musical or educational associations and religious organizations.

⁵ Professional associations, trade unions and political parties.

Table 1. Variables considered as *proxies* of social capital, description and source

Source	Concept	Description
World Values Survey	Interpersonal trust	% replies that answered that “generally speaking, would you say that most people can be trusted”
Latinobarómetro	Interpersonal trust	% replies that answered that “generally speaking, would you say that you can trust most people”
The Americas Barometer	Interpersonal trust	% replies that answered that “and speaking of the people from around here, would you say that people in this community are” very trustworthy
Latinobarómetro	Generalized trust: public institutions	average % of replies that answered that have “a lot” of confidence in public groups or institutions ^a
Latinobarómetro	Generalized trust: private institutions	average % of replies that answered that have “a lot” of confidence in private groups or institutions ^b
Latinobarómetro	Generalized trust: mass media	average % of replies that answered that have “a lot” of confidence in mass media ^c
Latinobarómetro	Association: Putnam groups	average % of replies that answered that participate of Putnam groups ^d
Latinobarómetro	Association: Olson groups	average % of replies that answered that participate of Olson groups ^e
The Americas Barometer	Civic engagement	average % that answered that “in the last 12 months have you tried to help solve a problem in your community or in your neighbourhood” at least once a week, once or twice a month, or once or twice a year in the last 12 months

^a The government; Parliament; judiciary; political parties; public administration; local government; the state.

^b Banks; private companies; trade unions.

^c Newspapers; television; radios.

^d Putnam groups: religious, cultural and/or artistic, and sportive groups.

^e Olson groups: political, labour, student, communal, voluntary, ecological, and other groups.

Institutions, as stated by North (1990), are the “rules of the game”, ie general rules that establish the relations between economic agents. Implicitly literature considers ‘good institutions’ as those able to provide investment incentives, improvements in the distribution of produced wealth, innovation, and efficient allocation of resources. They established a framework of incentives that reduces risk and uncertainty of the decisions, reducing thus transaction costs, whose potential effect would be to increase the efficiency and strengthen economic activity in general.

Governance is considered as a synonym for ‘institutional quality’, ie it comprises mechanisms, processes and institutions through which citizens articulate their interests, exercise their legal rights, meet their obligations and mediate their differences. When considering institutions we mean ‘good governance’: formal rules, laws and contractual procedures; the environment in which laws are made and enforced; restrictions on political and economic power; facility for intra-group mobility; and institutional promotion of ‘political voice’ and participation (Farole et al., 2011). These features have important theoretical and

empirical contributions. Aron (2000) presents a synthesis of studies that show correlation results between growth and / or economic development and institutional variables: property rights and enforcement of contracts (seven studies), civil liberties (10 studies), political rights and democracy (10 studies), institutions that encourage cooperation (clubs and associations, what happens in four cases) and lack of political instability (which occurs 15 times).

Then, proxies that attempt to synthesize these perceptions represent institutional quality (or governance): respect for contracts and property rights, behaviour and quality of bureaucratic structure and political and civil liberties, rather than its characteristics or attributes. This is because the functions performed by the institutions can be more important than its forms (Aron, 2000; Chang, 2011).

At first, a general recommendation in all writings about governance is maintaining property rights (Chang, 2011). In this regard, Adam Smith states (as quoted by O'Driscoll Jr. and Hoskins, 2003:3-4): “the first and chief design of every system of government is to maintain justice: to prevent the members of society from inroaching on one another’s property, or seizing what is not their own. The design here is to give each one the secure and peaceable possession of his own property”. Another commonly discussed aspect when talking about institutional quality is the rule of law, a characteristic of legal organization that asserts itself through standards or impersonal rules, that are effective and enforceable in fact; it considers the autonomy and independence of the legislative and judicial branches. It should be noted that these two indicators have commonly been used as proxies of institutional quality in literature concerning aspects of economic growth (eg Acemoglu and Robinson, 2010; Rodrik et al, 2002).

Contract enforcement can be defined as institutional conditions that make it possible for agents to establish exchanges and contracts with economic purpose with each other. It considers the effectiveness of legal norms and the existing guarantees and grants that contracts will be respected. The important thing to be pointed is not the simple existence of ‘laws’ but their effects, perceptions and applications in daily life. Literature also refers to formal or structural constraints to the discretion of political power and its consequent interference in economic activity. It can be justified as a feature of institutional quality, respect for political and civil rights, ie the state's ability to serve and respect the agents (Baliamoune-Lutz, 2005; Voigt, 2006).

Finally, it is considered as an institutional quality aspect the existence of conditions to facilitate intra-group mobility. It considers the potential conflict in populations, assessed by the existence of ‘religious and ‘ethnic’ tensions.

A synthesis of these representative variables of institutional quality, as well as data collection sources, is presented in Table 2.

Table 2. Variables considered as *proxies* of institutional quality, description and source

Concept	Description	Source
Property rights	Score to indicator concerning Property Rights	Index of Economic Freedom
Rule of law	Score to indicator 'Rule of law' ^a	World Governance Indicators
Law and order	Index of subcomponent 'Law and Order' of Political Risk Index	International Country Risk Guide
Contract enforcement	Subcomponent 'Legal enforcement of contracts' of Economic Freedom of the World Index	Economic Freedom of the World
'Public Voice'	Score to indicator 'Voice and Accountability' ^b	World Governance Indicators
Executive constraints	Index of Executive Constraints	Polity IV
Political stability	Index of subcomponent 'Government Stability' of Political Risk Index	International Country Risk Guide
Political stability	Score to indicator 'Political Stability/Absence of Terrorism' ^c	World Governance Indicators
Respect to political rights	Rating to political rights	Freedom in the World
Respect to civil liberties	Rating to civil liberties	Freedom in the World
Intra-group mobility (religious fragmentation)	Index of subcomponent 'Religious Tensions' of Political Risk Index	International Country Risk Guide
Intra-group mobility (ethnic fragmentation)	Index of subcomponent 'Ethnic Tensions' of Political Risk Index	International Country Risk Guide

^a Reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

^b Reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.

^c Reflects perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.

Final comments

A big challenge of this research is the future steps that need to be taken in order to analyse the contribution of social capital and institutional quality to economic development. One possible solution is trying to analyse the degree of relationship established between variables, through correlation analysis.

In correlation analysis, there is no dissociation between dependent and independent variables, because both are treated in a 'symmetrical' way and there is no relationship of dependency. There is therefore no potential 'explanation' of one variable by another. It should also be noted that the correlation does not indicate 'cause and effect', only that there is something in the behaviour of a variable related to the other's behaviour. The purpose of a correlation

analysis is to try to capture the ‘strength’ or the degree of linear association between the variables considered. Alternatively, measures the degree of influence or a variable relationship in the other's behaviour.

Finally, it is needed to note a critic with respect to the databases and variables used. When considering formal or informal institutional variables in the analysis of growth and economic development, caution is needed in understanding the results arising; this is because it must be considered that “there is a strong correlation between these indicators [of institutional quality] and the income level of the countries, leaving doubt whether it is wealth that enables better governance conditions or, conversely, whether it is governance that creates the conditions for social equity and wealth” (Schwartzman 2009:84).

Despite the caution, the empirical variables consist in an important opportunity of trying to understand the relationship between social capital, institutional quality and economic performance in Latin America countries.

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Data sources and databases

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- World Values Survey Association. *World Values Survey*