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TRUST AND SOCIAL COLLATERAL*

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This paper builds a theory of trust based on informal contract enforcement in social networks. In our model, network connections between individuals can be used as social collateral to secure informal borrowing. We define network-based trust as the largest amount one agent can borrow from another agent and derive a reduced-form expression for this quantity, which we then use in three applications. (1) We predict that dense networks generate bonding social capital that allows transacting valuable assets, whereas loose networks create bridging social capital that improves access to cheap favors such as information. (2) For job recommendation networks, we show that strong ties between employers and trusted recommenders reduce asymmetric information about the quality of job candidates. (3) Using data from Peru, we show empirically that network-based trust predicts informal borrowing, and we structurally estimate and test our model.

I. INTRODUCTION

A growing body of research demonstrates the importance of trust for economic outcomes.[1] Arrow (1974) calls trust "an important lubricant of a social system." If trust is low, poverty can persist because individuals are unable to acquire capital, even if they have strong investment opportunities. If trust is high, informal transactions can be woven into daily life and help generate efficient allocations of resources. But what determines the level of trust between individuals?

In this paper we propose a model where the social network influences how much agents trust each other. Sociologists such as Granovetter (1985), Coleman (1988), and Putnam (2000) have long argued that social networks play an important role in

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1. Trust has been linked with outcomes including economic growth (Knack and Keefer 1997), judicial efficiency and lack of corruption (La Porta et al. 1997), international trade and financial flows (Guiso, Sapienza, and Zingales 2009), and private investment (Bohnet, Herrman, and Zeckhauser 2008).

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