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SOCIAL CAPITAL IN MACEDONIA AND ITS IMPACT ON THE ECONOMIC GROWTH

SENAJ DAUT

Center for Economic Analyses (CEA)

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General information about CEA

Logo:

Address:

CENTER FOR ECONOMIC ANALYSES (CEA)
Bul. Jane Sandanski 63/3,
1000 Skopje Macedonia

Tel: + 389 (0)2 24 44 766
Mob: + 389 70 834 636

TIN: 4030003479278
Reg. 5763061

Account number:

Stopanska Banka AD Skopje
Account number: 200000856268559

Web page and e-mail:

www.cea.org.mk

www.lsg-data.org.mk

info@cea.org.mk

Executive summary

This report was prepared under the contract provisions signed between CEA and USAID for nonexclusive services to USAID as part of a grant agreement. This report is the second in a series of such reports and provides research findings on the social capital in Macedonia and it's impact on the growth. This report should be regarded as an initial study that sets the basis for a more thorough and systematic analysis on the importance of the social capital in Macedonia, and its findings should be regarded in that light.

One of the main task of the transition economies, and Republic of Macedonia's, is to catch up with the advanced levels of highly developed economies. The lack of social capital is a major impediment to this process, as it does not allow taking advantage of the comparatively high level of human capital.

All methodological techniques used in this report are explained in greater detail in the papers listed in the References section and will not be explained in detail in this report.

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The report has been prepared by Shenaj Hadzimustafa, (senay_daut@yahoo.com).
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I. Background on the economic growth in Macedonia

The Republic of Macedonia's economic performance since independence has been marked by notable achievements in macroeconomic management, as well as some disappointments in the area of structural reforms. Overall, macroeconomic management has been good. Inflation was brought down from hyperinflationary levels to the low single digits by the de facto exchange rate peg, which was sustained in spite of sometimes challenging circumstances. At the same time, sound fiscal policy helped to gradually lower the level of government debt to about 40 percent of GDP and recently even lower. But the implementation of structural reforms was mixed. Important progress was made in financial sector reforms and trade liberalization; further progress is needed in reforming labor market institutions and the judiciary and in strengthening governance. Privatization has been largely completed but the method of privatization gave insiders a dominant role, resulting in a smaller boost in efficiency than had been expected. Partly as a result of the unfinished structural agenda, economic growth has been lackluster. The average annual growth rate since the mid-1990s was around 1½ percent, well below other transition economies. Unemployment figures have remained high. In the external sector, the current account deficit has widened in recent years while foreign direct investment has been generally low.

Macedonia ranked poorly in international comparisons of the business environment due to high costs of opening and closing a business, hiring and laying off workers, and enforcing contracts. Property rights are poorly defined with the land cadastre incomplete, the tax wedge on labor remains high, and telecommunications services are expensive. The government has amended the constitution and passed new laws to introduce comprehensive judicial reform, yet implementation has just started.

Since the beginning of 1994, the government has been implementing a bold program to restore macroeconomic stability and support a rapid transition towards a market economy. The reform strategy has been designed around the discipline of a fixed exchange rate coupled with structural reforms to create market institutions, consolidate private ownership, and reduce the cost of doing business. Financial support from the International Monetary Fund, the World Bank, the European Union, and other bilateral donors has been key to the successful implementation of the program. An adverse regional environment notwithstanding, the post-independence decline in output has been arrested, price stability has been restored, relations with all external creditors have been normalized, and an extensive structural reform agenda has been implemented.

Here should be noted that in the growth path Macedonia had to face with two crises: Kosovo (1999) and Macedonia crises (2001). The impact of the Kosovo crisis, however, was less severe than initially feared. With the ending of the conflict in early June, economic activity picked up markedly and the balance of payments improved beyond expectations. The negative effects of the Macedonia 2001 security crisis on growth persisted in the early months of 2002, but a turnaround in performance took place in the second half of the year. Real GDP declined by 2 percent, year-on-year, in the first six months of 2002, but a recovery in key sectors is estimated to have increased growth for the year as a whole to 0.5 percent. Industrial output picked up, particularly in the textile and steel industries. Peaceful elections and a decline in ethnically-based violence raise hopes that investor confidence is returning.

Economic performance has started to improve. After a decade of sluggish growth, in part the result of external shocks, growth has reached 4 percent for two years in a row. In 2005, growth was driven by strong exports. A broadly balanced fiscal position and the fixed exchange rate have kept inflation under control. The external position has strengthened, with gross reserves rising from €700 million at end-2004 to around €1,200 (more than 4 months of imports or 25 percent of GDP) by May 2006. The recorded current account deficit fell sharply to 1.3 percent of GDP in 2005 driven by increased private transfers, though these may also capture capital account transactions.

In 2006, growth is projected to remain at 4 percent, with higher domestic demand offsetting some decline in net exports. Some of the data on the economic growth in Macedonia are shown in Table1.

Table 1. Economic growth in Macedonia

Year	Real GDP (%)	Year	Real GDP (%)

1993	-7.5	2000	4.5
1994	-1.8	2001	-4.5
1995	-1.1	2002	0.9
1996	1.2	2003	2.8
1997	1.4	2004	4.1
1998	3.4	2005	4.0
1999	4.3	2006	4.0

*Source: SSO, Ministry of Finance and National Bank of Macedonia

II. Social capital and economic growth

a) Economic growth factors

In it's analysis of production, economics has always included land, labour and (man-made) capital. With the industrialization man-made capital takes the central role in analyses of production and economic growth and development. The endogenous growth theory has in as sense rehabilitated the state's role as an investor in education and a force influencing technological development. The state's role is considered in a new and multifaceted way, "good governance does matter". The conscientious state supports growth and development (Hjerppe, 1998).

In the debate on economic growth and development there has been a need for concepts to link the immaterial preconditions of the economy (such as skills, the functioning of institutions, the atmosphere in society) to economic theories so as to complement the material preconditions for production and incorporate them into the scope of the analyses. The concept od human and social capital is very familiar and an established factor in any debate on economic growth and development.

b) Social capital concept

The concept of social capital is attracting increasing interest within research on economic growth and development. However, the concept has not yet quite established itself in economics. Views are also divided on it's siginificance.

According to Putnam "social capital...refers to features of social organization, such as trust, norms, and networks, that can improve the efficiency of society by facilitating coordinated actions"(Temple, 2000). He appears to be the narrowest with a focus on horizontal social networks empirically associated with norms that affect economic performance. Boix and Posner argue that social capital may reduce the probability of individuals to engage in opportunistic behavior. This saves on resources devoted to monitoring agent's performance and makes more resources available for more productive investments (Beugelsdijk and Smulders, 2004).

Coleman offers a wider definition that expands the concept, including vertical, hierarchical institutions and firms and the possibility of negative as well as positive impacts on performance. Finally, North and Olson present the most encompassing perspective, which emphasizes the role of formalized institutions, such as court systems, rule of law, and political liberties in shaping the social and political environment and patterns of development (Parts, 2003).

The World Bank defines social capital as the institutions, social relationships, networks, and norms shaping the quality and quantity of a society's social interactions (World Bank, 2003).

c) Social capital and the institutions

The history of the institutional economy is a long one. The social capital theory falls within the new institutional theory. North in particular has stressed that economic growth and development are very much dependent on the institutions of society. Institutions are understood as principles that guide human actions either formally (consisting of legislation or other written percepts) or informally (consisting of culture or customs).

Modern institutional economics stresses the importance of reliable rules of conduct as an important element in a well functioning society. Trust in formal and informal rules forms an essential precondition for an efficiently functioning society. The role of networks is emphasized because broad-based networks form channels of communication in society and enable an efficient dissemination of information to the different members of society. The level of transaction costs is a key factor affecting the efficiency of the economy. The new institutional economics stresses the importance of unequivocal ownership rights and binding agreements. These are important element in the definition of social capital.

In countries with more secure property rights, firms might allocate resources better and consequentially grow faster as the returns on different types of assets are more protected against competitors' actions. Using data on sectoral value added for a large number of countries, it was find evidence consistent with better property rights leading to higher growth through improved asset allocation. Quantitatively, the growth effect is as large as that of improved access to financing due to greater financial development. The results are robust using various samples and specifications, including controlling for growth opportunities (Nikolov, 2006).

Moreover, in certain crucial areas in Macedonia the situation is not improving example in Table 1.

Table 1: Governance Performance 1998/2004

accountability		government effectiveness		regulatory quality		rule of law		control of corruption	
1998	2004	1998	2004	1998	2004	1998	2004	1998	2004
53,4	46,1	36,1	51,4	38,6	45,3	42,7	41,5	47	38,4

Source: Kaufmann D. (2005).

The Public Institutions Index of the World Economic Forum for 2005 has also recorded a marked deterioration in the country's position from 92nd in 2004 to 96th in 2005, with only Albania lagging behind in the 102nd place[1].

d) Social capital and economic growth

What the concept of social capital adds to analyses of economic growth and development.Why is the concept of social capital important in this connection?

Although human capital and especially social capital may seem to be merely fashionalble phrases, there exists a long history in using these concepts as a factors of economic development in economic theory. Endogenous growth models added human capital to the list of production factors. The theory of social capital helps to show that participation in informal networks and the trust based on it are also values that are part of the society's capital. Almost all economic activities are connected to a network of social relations and social capital affects productivity at both micro and macro level. Informal relations do not directly increase material welfare, but without these relations the growth in melfare is harder to achieve. Social capital complements the market in its allocation and distribution functions. Most significantly, civil social capital can raise total factor productivity, because the quantity and quality of social capital affect managerial capability in both the private sector and the public sector. Managerial capability improves when social capital reduces information costs, transaction costs and risk, and helps to avoid moral hazard and adverse selection problems. Social capital also influences the quality and the rate of accumulation of other types of capital.

Lack of social capital has been claimed to be the main reason for slow GDP growth in post-socialist countries, given the amount of physical and human capital available at the start of the transition. Also, social capital is important for poverty alleviation, as one of the defining features of being poor is that one lacks connections with the formal economy, including material and informational resourses.

What impact does social capital have on economic performance? Social trust tends to increase public pressures for efficient governance, which in turn positively influences economic growth. Government officials under public scrutiny are more effectively discouraged from corrupt behavior as the penalties for being detected increase (Raiser, 1997).

III. Social capital and transition

The transition from central planning to a market economy and the transition from an authoritarian to a democratic regime is fundamentally a process of accelerated institutional change. Both formal and informal institutions need to adapt to the requirements of democracy and of market transactions. The resulting uncertainty places a

[1] World Economic Forum (2005)

heavy load on social arrangements. Mechanisms are thus needed to stabilize mutual expectations and to make behavior of actual or potential counterparts more predictable.

The transition process is eminently a process of institutional change. As such, it is conditioned to a substantial extent by the inheritance of a given set of informal institutions that shape people's expectations and constrain the enforcement of new market-based incentive structures. History matters for transition outcomes and the assets on which reformers can build in this respect differ between the various transition economies. This implies that there cannot be one optimal strategy for institutional reform, but that the given strength and legitimacy of the state has to be taken into account in designing policies for institutional reform.

Theoretical, historical and cross-country evidence suggests that a crucial role of informal institutions in all societies is to facilitate economic exchange both by supporting self-enforcing "rules of the game" and by fostering trust in third-party enforcement through the state. Such trust will grow out of an articulated civil society in which individuals communicate and seek cooperative solutions to dilemmas of collective choice. In other words, trust positively depends on the level of social capital in a given society. This in turn relies to some extent on the existence of a universal morality at least at the level of the nation state.

Trust in government institutions is promoted by good political and economic performance. While governments cannot directly influence trust in public institutions, they can do so indirectly through formal institutional reforms that limit the scope for predatory behavior by public officials and improve political and economic performance. Advance signaling of reform commitment through packaging of individual measures may increase trust by enhancing public perceptions of future economic prospects.

The weakness of institutional social capital in the transition countries can be best illustrated by the weakness of governance and public administration, and by the widespread corruption which breeds distrust of public institutions. The lower trust is positively correlated with lower foreign direct investments inflow and the level of corruption, thus hindering future development perspectives in many transition countries (Parts, 20003).

IV. Social capital and Macedonia

Institutional performance does affect trust, and local institutions are better regarded than more institutions which are socially more distant from the respondents.

The respondents, who have had actual experience with the institutions in Macedonia report relatively great satisfaction with the performance of these institutions: the Education (66 %), the Health System (62 %), the Police (54 %), the Municipality (52 %), the Tax Office (49 %), and the Court (39 %). These respondents report even higher levels of fair treatment on behalf of the institutions. The correlations between personal experiences (and satisfaction) and general evaluation and trust in the institutions are not high – ranging from 0.07 for the courts, and 0.23 for the tax office. Again, the inference is that this channel for enhancing social capital, while existing is weak and possibly slow (Ganev, Papazova, Dorosiev).

The data indicate that people in Macedonia feel more empowered to influence government institutions which are closer to them socially and geographically, such as municipal authorities. This provides tentative support for the hypothesis that strengthening and empowering local institutions may help increase social capital in Macedonia.

Also should be stressed greater horizontal relatedness between the institutions in order more efficient work performance which will influence the social capital and by that the economic growth towards positive values. Also the latter can be managed through horizontal social networks and information spread via them.

Given the importance of social capital as a factor of economic growth and development, the fundamental question is how to encourage it's accumulation in Macedonia? The logic of social capital warns against active interference; the best that governments can do is creating proper enabling environments for social capital generation and fighting against negative social capital, especially corruption.

We should stress here the importance of the regulatory framework for the business environment, in particular for small and medium sized enterprises as well. A healthy regulatory environment produces the framework conditions conducive to growth. It stimulates investment, provides legal certainty, reduces red tape and increases confidence in the business environment. This in turn, has positive effects on other economic variables.

There are also a lot of improvements that should be done in the sphere of creating enhancing business environment. Macedonia have made some improvements, but still a lot has to be done, especially when starting a business, dealing with licenses, getting credit and enforcing contracts (World Bank, 2006). An efficient enforcement system is what is required, overall assessment of the impact of regulations on businesses, cost of compliance to businesses, impact of regulators on tariffs, market entry, accessibility, public service obligations and competition.

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