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Public sector

Culture, institutions and economic growth

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Since 1990, a regular survey has been carried out on values at a global level (the World Values Survey) that helps to identify significant differences between countries and even between regions. One of the questions looks at the five qualities parents would like their children to learn. The answers in Spain and in Germany are very different: in one of the two countries, parents want their children to be more independent and imaginative while, in the other, they preferred them to be obedient and altruistic. Does the reader dare guess which is which? And to predict which characteristics are more favourable for a country's economic growth?

One important line of economic research has revealed a close connection between culture and economic performance. At a microeconomic level, for example, a correlation has been observed between cultural differences and female employment or investment in education. At a macroeconomic level, it has been shown that certain cultural traits help to explain differences in income level between different countries or regions. Guido Tabellini, for example, estimates that the cultural differences between Lombardy and the south of Italy can explain half the difference in their respective standards of living.[(1)]

Economists, sociologists and psychologists have highlighted four broad cultural traits that are relevant for the economy: mutual trust, respect for others, individualism and the belief that it is worth making an effort (which we often call the culture of hard work).

Trust facilitates exchange or trade between strangers as well as agreements in a context of incomplete information. Someone who is distrustful will be more reticent about signing an agreement if they cannot predict all possible contingencies that might occur in the future. Similarly, someone who tends to distrust will be more cautious when shopping online. Fluid economic relations require a certain amount of trust. In economic jargon, a lack of trust and the fear of being deceived increase transaction costs outside the closest and most familiar sphere, reducing potential gains from the division of labour and trade.

Respect for other members of a community, related to tolerance, also encourages exchange with strangers and tends to reduce the incidence of opportunistic behaviour. Respect and trust are therefore values that reinforce on each other positively. Moreover, respect is associated with appreciation for what is public and shared, facilitating the provision of public goods, and tends to reduce the incidence of nepotism and corruption among public administrators.

Individualism, understood as daring to take decisions for yourself, is associated with entrepreneurship and innovation. On the other hand, cultures that emphasize obedience and mistrust the ability of individuals to take decisions tend to repress individual initiative. Successful companies and, by extension, successful countries encourage the creativity of individuals, improve their ability to take decisions independently and realize, as Thomas J. Watson, President of IBM for more than 40 years, that «the way to succeed is to double your error rate».

Lastly, the culture of hard work is related to the personal belief that you are the master of your own future, that personal effort is essential to achieve goals. In a culture where hard work is valued, people will tend to invest more, work more and better, innovate and undertake ventures. If a person believes, on the other hand, that what they achieve will be more the result of luck or randomness, they will become passive.

One line of research, complementary rather than alternative to the first, stresses the importance of institutions more than culture as decisive factors in economic success or failure. Numerous studies have confirmed that those institutions that protect private property, offer legal security, guarantee macroeconomic stability, encourage competition and foreign trade and boost flexibility in resource allocation are good for economic growth. What are these institutions? Particularly, a stable regulatory environment favourable towards competition, a good legal system, an independent central bank, public administrations that keep the deficit under control and a flexible labour market.

So does it come down to culture or institution? The evidence is not conclusive although it points towards institutions being more important. It is likely that, in the absence of solid institutions, culture has more influence on economic growth, operating as a network of informal institutions but that, as formal institutions develop, these take over part of the role fulfilled by culture. In practice, countries with cultural traits that favour growth also tend to have good formal institutions (see the tables above), making it difficult to identify the separate effects on growth of both variables.

In any case, culture and institutions interact at various levels. Culture influences how institutions are designed and operate (the Italian legal system is the same throughout the country but a court case takes much longer in the south than in the north). Similarly, institutions affect a society's culture or values. For example, a central bank that attempts to keep inflation low and stable helps to create a culture of saving. This culture is unlikely to take root in an environment with high, volatile inflation.

Both institutions and culture have a lot of inertia. There is no doubt, however, that this is much more the case with culture. Implementing a cultural change is surely impossible in the short term (or clearly undesirable, if we think of attempts such as the Cultural Revolution in China). On the other hand, importing institutions we know to work reasonably well in many other countries is plausible, perhaps by adapting their design to our culture. Although it would be naive to expect them to work just as well elsewhere, improving a country's institutions would undoubtedly help its growth potential. Lastly, returning to the question at the beginning: can the reader now deduce which country is which?

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(1) Guido Tabellini, 2010. «Culture and Institutions: Economic Development in the Regions of Europe», Journal of the European Economic Association, MIT Press. Vol. 8 (4), pp. 677-71.

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