Journal of International Economics xxx (2015) xxx–xxx

Contents lists available at ScienceDirect

Journal of International Economics

journal homepage: www.elsevier.com/locate/jie

Cultural Differences and Institutional Integration☆

Luigi Guiso [a], Helios Herrera [b], Massimo Morelli [c]

[a] EIEF & CEPR, Rome
[b] HEC Montréal, Canada
[c] Università Bocconi, IGIER & NBER, Italy

ARTICLE INFO

Article history:
Received 3 August 2015
Received in revised form 6 November 2015
Accepted 10 November 2015
Available online xxxx

JEL classification:
D72

Keywords:
Cultural norms
Institutions
Euro area
Crisis mismanagement

ABSTRACT

If citizens of different countries belonging to an economic union adhere to different and deeply rooted cultural norms, when these countries interact they may find it impossible to agree on efficient policies, especially in hard times. Political leaders are bound to follow policies that do not violate their country's cultural norms. This paper provides a simple positive theory and a compelling case study of the Euro area crisis to highlight the importance of cultural clashes when economies integrate. We also provide a normative argument about the desirability of institutional integration: a political union, with a common enforcement agency, is the more beneficial the greater is cultural diversity in an economic union.

'Europe will be forged in crises and will be the sum of the solutions adopted for those crises' (Jean Monnet).

1. Introduction

Over the past 20 years there has been a remarkable increase in economic unions and trade integration driven by the prospect that integrating countries would benefit from economies of scale and access to a larger market. This process has taken a variety of forms. Some, like the proliferation of bilateral trade agreements, are relatively contained in scope. At the other extreme, economic and currency unions, such as those set up by the Caribbean countries and most notably by the Euro area countries, have far reaching implications for the nature of the interactions in the merged pool of heterogenous populations. These latter agreements can be viewed as part of a process that leads geographically close but still institutionally and culturally different countries to allow their people to interact with each other at many levels while each country maintains political control and sovereignty. This implies that national governments are in charge of and are responsible for macroeconomic decisions and outcomes. A step further in the integration process is to delegate some of the power of the national governments to federal institutions designed to manage the decision process of area-wide relevant issues.[1]

In this paper we study the problem faced by two countries that are culturally distant from each other and face the opportunity to join a union. We will call *economic* union any economic integration where constraints to international exchanges and relationships are lifted, but no power is given to any central institution in terms of fiscal policy, political decisions, regulations, etc.; we will call *political* union, a union where every citizen of the various countries in the union comes to consider the central institutions as the only relevant one vis-a-vis key policies of relevance for the whole union, eliminating continuous negotiations between the leaders of the members of the union.

Following Guiso et al. (2006) we define "culture" broadly as a set of norms and beliefs that guide the behavior of the members of a social group and that are transmitted fairly unchanged from generation to generation. This definition captures a key feature of these values and beliefs: their slow moving nature. We argue that an economic union offers great prosperity opportunities for each side but also entails the risk of exposing their populations to a "clash of cultures" — i.e. a conflict arising from the interaction of people with different cultural values. The contrast we describe happens at the level of private interactions between

☆ This paper previously circulated under the title "A Cultural Clash View of the Euro Crisis." We thank two anonymous referees as well as Sascha Becker, Alberto Bisin, Serra Boranbay, Francesco Giavazzi, Tarek Hassan, Gilat Levy, Assar Lindbeck, Elias Papaioannou, John Patty, Giacomo Ponzetto, Andrei Shleifer, Enrico Spolaore, Francesco Squintani, Livio Stracca, Sebastian Turban, Philippe Weil and participants at various workshops for great suggestions and comments. The usual disclaimer applies.

[1] Switzerland is an example of such a political integration arrangement: a set of culturally distinct countries (the cantons) share a common currency and a common market while federal institutions are designed to manage area relevant decisions, including the re-composition of conflicts that the different cultures may give rise to (Bertola, 2014).

http://dx.doi.org/10.1016/j.jinteco.2015.11.005
0022-1996/

individuals as well as at the level of political leaders that must conform to the cultural norms and beliefs of their electorate: leaders cannot pursue strategies that go against deeply rooted norms and beliefs even when doing so could be welfare-improving for their citizens[2]. This *conformity constraint* becomes salient in particular when leaders of two countries with different cultures come to negotiate about policies or rules that do not fit well with some traits of their original cultures. The possibility that the optimal course of action entails policies welcomed by one electorate but opposed by the other on cultural grounds, is a major political impasse which we denote as *cultural clash*. As noted in Huntington (1996), cultural conflict is one of the most important types of conflict to consider going forward, and our goal is to examine how it interacts and evolves with economic integration and institutional development.[3]

We develop a simple evolutionary theory of culture formation in order to evaluate what happens when two countries, on different cultural steady states, merge into an economic union. When the two economies merge, the primary problem is the clash between citizens and conforming leaders of different cultures. We show how the choice itself of the level of economic integration depends on the cultural distance and on the business cycle. In particular, we show a successful economic union may be formed when economic benefits from integration are relatively large and cultures not too distant. Furthermore, while the formation of an economic union (*without* common institutions) may be the optimal outcome initially, if the ex-post realization of the economic benefits is lower than initially anticipated – i.e. a "crisis" realizes – then the cultural clash may surface. In fact, the generalized loss of welfare due to the clash, which is increasing in the degree of cultural heterogeneity, becomes more salient during bad economic times and cannot vanish rapidly given the inertia of cultural norms. In such circumstances countries may reconsider participation in the union, facing the choice of either breaking up and reverting to autarchy or otherwise providing it with a set of federal institutions that grant greater political integration. The latter solution, we show, is more desirable the higher is the cultural distance, or the costs of the clash, and thus the benefit of mitigating it. Thus, for instance, the fact that Europe has countries with more heterogeneous cultures than it was the case for individual states within the US at the time of the US Constitution should push towards an a *fortiori* argument in favor of centralization, rather than the other way round, which is more the common sense.

Our view of the cultural clash and its consequences for the debate about new institutions has a clear application to the Euro crisis context. In Europe, a greater frequency and salience of principal agent relationships between individuals or agencies rooted in different cultures was clearly determined by the lower transaction and mobility costs associated to the introduction of the common currency. Merging into an economic union carries benefits in terms of enlargement of the total available opportunities due to economies of scale and scope (see e.g. Baldwin, 2006) which translate in larger (expected) payoffs to interacting parties. The cost is the potential exposure to a cultural clash which increases with the cultural distance between the merging countries. The discovery in October 2009 that the previous Greek government cooked the books, hiding half of the government fiscal deficit, raised the awareness in Germany about the pervasiveness of moral hazard at all levels in Greece, and the anger led to a clear desire to punish. According to various observers, early action would have contained the crisis both in scope and length, but the culture of responsibility, enforcement and punishment present in Germany made it almost impossible even for the political leaders to go against that sentiment and help the situation right away.

German political leaders are well aware of the dangers of delaying the resolution of a local debt crisis, and can foresee the possible consequences of the "punishment" strategy for their own country, but are bound by a conformity constraint: the need to conform with the widely shared and deeply rooted cultural norms of their fellow citizens that, as we document in detail in the paper, establishes punishment of the group "cheaters", which in this case happen to be the Greeks.[4]

One of the messages of this paper is that if an economic union is complemented by forms of political union, then we should expect much better management of cultural clashes. Indeed, a political union entails the creation of some type of central authority that by definition eliminates the game between sovereign states, freeing them from the conformity constraint and overcoming the materialization of the cultural clash. Put differently, the central authority is not bound to any of the sovereign cultures and would thus avoid reliance on excessive punishment as well as excessive moral hazard, softening the costs of the cultural clash.

The choice to form an economic union in Europe rather than a political union is now being criticized on multiple grounds, but the importance of managing cultural clashes is an important and largely overlooked problem. Culturally heterogeneous countries economically united without joint political and legal institutions are more clash prone and this clash becomes more intense and apparent in times of crisis. The sequential integration choices in Europe as well as other monetary unions such as the African Monetary Union project[5], are far from ideal and can only be explained by a reluctance to lose sovereignty by the individual states.[6]

In our model we treat agent interactions not as symmetric bilateral *exchanges,* but as principal–agent interactions, thus highlighting the counterparty risk. In fact, these are the type of interactions where the cultural traits we want to highlight matter the most. A culture is represented in our framework as "what strategies people play when they interact." This way we capture the notion developed in North (1991), that culture constrains human interactions when cooperation is hard to achieve. The focus on interactions allows us to trace the evolution of culture using replicator dynamics (as in Boyd and Richerson, 1985, 2005).[7] Given this view of an economy as a collection of principal–agent relationships (state vs. tax payer, bank vs. borrower, firm vs. employee, etc.), we model interactions as sequential move games where the agent can cheat and the principal can punish, and the cheat-punish outcome is always suboptimal. We show that evolution can bring a population to multiple steady states with low or high levels of efficiency, cheat-forgive and no-cheat respectively. Our focus is on what happens when two populations acting in accord to different steady states representing different cultural norms integrate into one economy. In this case the integrated economy faces a cultural clash, which takes the form of a cheat-punish outcome in many interactions, an outcome not observed in the

[2] Microfounded models of political pandering have been formalized extensively in political economy (see e.g. Maskin and Tirole, 2004). We do not microfound the conformity constraint of the politicians in this paper.

[3] For example, it would be very difficult for India's leaders to pass a law that forces Indian food firms to produce beef formula when a famine hits the country. Even if political representatives knew this may be the best policy from a nutritional point of view, it would simply fail to pass or, even if passed, it would fail to succeed because it would not be followed by most of the people. Anticipating this reaction, the leader would just avoid proposing it and pander to the prevailing public opinion.

[4] Some political leaders may try to ease the conformity constraint by steering public opinion, but this usually takes time, which unavoidably delays action.

[5] The 1991 Abuja treaty created the African Economic Community and called for an African Economic Community (AEC) with a single currency, now planned for 2023. The AEC would absorb the two regional currency unions in Africa (the West African CFA franc and the Central African CFS franc), an example of staged integration.

[6] The current political debate in Europe is consistent with the implications of the theoretical model. During the unfolding of the sovereign debt crisis in the euro area the creation of a more integrated fiscal union has gained momentum as a policy option (see, e.g. Marzinotto et al., 2011 and Ferguson and Barbieri, 2012). Most interestingly, in reaction to the crisis, in January 2014 the EU has decided to adopt a single banking supervisory mechanism and a single banking crisis resolution authority - what is called the banking union. Though the scope and reach of this institution is still being hotly debated, its adoption is exactly what our model captures when predicting the adoption of a single enforcement federal authority, in the direction of a political union.

[7] We ignore instead the evolution of individual values that does not relate directly to behavior in strategic situations. For models on the transmission of individual values, see Tabellini (2008b), Bisin and Verdier (2000b, 2001), Guiso et al. (2008), possibly accounting for learning through socialization (Bisin and Verdier, 2000a,b).

Please cite this article as: Guiso, L., et al., Cultural Differences and Institutional Integration, J. Int. Econ. (2015), http://dx.doi.org/10.1016/j.jinteco.2015.11.005