



Ethics, welfare, and capital markets [☆]



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ARTICLE INFO

Article history:

Received 10 February 2013

Available online 13 April 2014

JEL classification:

D72

G30

C70

Keywords:

Culture

Guilt

Pride

Finance

Contract

Welfare

ABSTRACT

We examine implications of a society's cultural emphasis on moral sentiments. Entrepreneurs and investors interact in a game that entails both adverse selection and moral hazard; entrepreneurs may attempt to breach their contracts and expropriate investors. An agent is born into a particular culture but chooses whether to develop a moral conscience and thereby subject himself to moral sentiments. In equilibrium, societies that place less emphasis on guilt exhibit a lower risk of expropriation in contracts, a greater net price of capital, a larger size of firms, increased capital inflows and greater social welfare. The results of a greater emphasis on pride are in the same direction.

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1. Introduction

It is often argued that a society's culture is a significant factor in its economic performance and welfare (Weber, 1930; Banfield, 1958; Guiso et al., 2006). Support for this view also comes from recent empirical research that identifies important effects of culture on rent seeking, expropriation and contract breach (Guiso et al., 2003, 2004, 2006; Stulz and Williamson, 2003). Of particular interest is the empirical finding that culture impacts financial transactions (Stulz and Williamson, 2003; Guiso et al., 2004); since capital markets are often afflicted with asymmetric information and limited contractual enforcement (Hubbard, 1990; Rasmusen, 2007), they may be especially sensitive to informal instruments – such as cultural characteristics – that may mitigate such imperfections. However, despite the anecdotal and empirical evidence, the link between culture, finance and social welfare has received relatively little attention in formal economic theory.

In this paper, we construct a model of culture and capital markets to highlight a potential mechanism through which society's ethical system may impact economic outcomes. Our analysis has two basic ingredients. First, it assumes that agents may experience intrinsic motivation in actions that have ethical implications (Smith, 1759); such intrinsic motivation may be both positive, in the form of pride, and negative, in the form of guilt (Benabou and Tirole, 2006). The strength of these moral sentiments may vary significantly across cultures (Murphy, 1974; Eid and Diener, 2001; Kitayama and Cohen, 2007;

[☆] We thank Kerry Back, Douglas Gale, Peter Hartley, John Leahy, Barbara Ost diek, Paola Sapienza, an anonymous referee and an anonymous associate editor for helpful suggestions. We are also grateful to participants in the 2010 European Economic Association Meetings, the 2012 World Finance Conference and the Second NYU Economics Alumni Conference.

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Tracy et al., 2007). And second, in the spirit of the Chicago School (e.g., Becker and Murphy, 1988, 2001; Becker and Mulligan, 1997), our analysis incorporates rational agents who choose whether to become moral or amoral – i.e., whether to develop a conscience that allows them to subsequently experience intrinsic motivation.¹

We adopt the view of culture of Weber (1930) and Guiso et al. (2006); the latter (p. 23) define it as “those customary beliefs and values that ethnic, religious, and social groups transmit fairly unchanged from generation to generation.” Thus in our model culture is exogenous and durable, possibly the outcome of a historical accident (Banfield, 1958; Tabellini, 2008a). Agents are born into a specific culture, but can choose whether to accept their society’s cultural moral code and become moral, or to reject it and become amoral.² Moral agents develop a conscience; when presented with an opportunity to engage in unethical behavior – i.e., in appropriation, – they have feelings of pride if they abstain from and feelings of guilt if they engage in it. Amoral agents are assumed to have no conscience and their overall payoff is solely pecuniary. We show that cultural moral codes having a weaker emphasis on guilt lead to a lower risk of expropriation in contracts, a higher net price of capital, larger firms, increased capital inflows and greater social welfare.

In our analysis, agents of unobservable and possibly different ethical types – moral and amoral – transact with each other as investors and entrepreneurs, where investors finance the projects of entrepreneurs. Entrepreneurs may attempt to expropriate some of the returns of their investors. To protect themselves from appropriation, investors safeguard (imperfectly) their contracts with entrepreneurs. The chosen level of attempted expropriation by an entrepreneur and of contract safeguarding by an investor is unobservable to other agents. We thus have a game that entails both adverse selection – when investors choose the entrepreneurs with whom they team up – and moral hazard – when entrepreneurs choose the extent of their expropriation activities.

The analysis shows that in equilibrium, moral entrepreneurs are always unable to separate themselves through signaling from amoral entrepreneurs. The benefits of being considered moral are greater for amoral, rather than for moral, entrepreneurs, which precludes the occurrence of a separating equilibrium. However, there exist perfect Bayesian pooling equilibria, among which there is a unique equilibrium that meets the Grossman–Perry criterion in the pricing subgame. Then, a greater emphasis on guilt in society’s cultural moral code generates opposing effects on the equilibrium risk of expropriation in contracts. The recognition of possibly experiencing stronger feelings of guilt in the future discourages agents from choosing to become moral in the first place *ceteris paribus*; this tends to increase the risk of expropriation. Guilt, on the other hand, discourages individual agents that have chosen to be moral from engaging in expropriation *ceteris paribus*; this tends to decrease the risk of expropriation.

Our analysis shows that the former effect always outweighs the latter. In particular, a greater cultural emphasis on the negative feeling of guilt makes moral entrepreneurs worse off *ceteris paribus*. However, since in equilibrium the payoffs of moral and amoral entrepreneurs must be equal (otherwise agents would deviate), a stronger emphasis on guilt leads to a greater equilibrium risk of expropriation in contracts and thus greater safeguarding by investors. Greater safeguarding by investors equalizes the payoff of the two types of entrepreneurs by reducing the payoff of amoral entrepreneurs by more than that of moral ones; the payoff of moral entrepreneurs also contains non-pecuniary elements that are insensitive to safeguarding.

Since a greater cultural emphasis on guilt increases the equilibrium risk of expropriation in contracts, it results in a decrease in the net price (after the risk of expropriation and the cost of safeguarding) that investors obtain when they sell their capital. Furthermore, it leads to a Pareto-deterioration of the economy. In addition, the proportion of entrepreneurs is greater and the size of firms, – as measured by the amount of capital that each firm utilizes, – is smaller in an economy with a more guilt-based ethical system, in that the lower net price of capital encourages more agents to become entrepreneurs, rather than investors. As society’s capital is allocated among a larger number of entrepreneurs, the size of firms decreases. Furthermore, in the presence of international capital mobility a stronger cultural emphasis on guilt encourages capital outflows, reducing the amount of available capital in the economy. Finally, we also examine the sentiment of pride and show that the results of an increased cultural emphasis on pride are in the opposite direction of those of an increased emphasis on guilt.

There is some empirical evidence that relates to our analysis. For example, cultural psychology suggests that there may be substantial cross-cultural variation in the strength of the emotion of guilt (Kitayama and Cohen, 2007; Tracy et al., 2007). The emphasis on guilt in a few specific countries (Australia, China, U.S., Taiwan) has been recorded.³ Then, our analysis is consistent with the casual observation that Australia and the U.S., which deemphasize guilt, appear to have a lower risk of expropriation or a stronger rule of law and a larger amount of physical capital per capita than China and Taiwan, which

¹ For example, Becker and Murphy (1988) and Becker and Mulligan (1997) present models of endogenous preferences where individuals may shape their utility functions. In a different vein, Akerlof and Kranton (2000, 2005) note that agents may often choose their identity. In Tabellini (2008b), an agent’s ethical type, trustworthy or untrustworthy, and preferences are also shaped by conscious (albeit imperfect) choices.

² An agent’s ability to choose (perfectly or imperfectly) an identity or a particular type from a culturally predefined – exogenously predetermined – set is a standard assumption in the literature (e.g., Akerlof and Kranton, 2000, 2005; Bisin and Verdier, 2000, 2001; Tabellini, 2008b).

³ For example, the U.S. and Australian societies may place a weaker cultural emphasis on guilt than the Chinese and the Taiwanese ones (Eid and Diener, 2001), while British Canadians may place a weaker cultural emphasis on guilt than French Canadians (Murphy, 1974). As far as we know, there are no other major studies that compare the emphasis on guilt in specific countries. We thank Richard Robins and Jessica Tracy for providing us with information on related research in cultural psychology.

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