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## Collective values, behavioural norms, and rules: Building institutions for economic growth and poverty reduction

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**WIDER**

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Discussion Paper No. 2001/98

## **Collective Values, Behavioural Norms, and Rules**

Building Institutions for Economic Growth  
and Poverty Reduction

Ke-young Chu\*

September 2001

### **Abstract**

Economic growth and poverty reduction require for a country to establish efficient rules for economic and political transactions. Poor countries suffer from inadequate, inefficient transaction rules. Formal rules (e.g., laws, policies) must be nested in hospitable behavioural norms and values. Cultural collectivism in many of these countries and consequent group-oriented values, factionalism, and discretionary rule implementation have adverse implications for their efforts to establish well-defined property rights and other rules. Over time, these countries must establish rules for government-enforced, widespread impersonal transactions. To this end, efficient economic and political transactions should be promoted as repeated games. Institutional reform efforts should be aimed at expanding transactions, initially among small, voluntary groups, capitalizing on economic agents' group-oriented values for intragroup governance; at entrusting important rule implementing functions to autonomous, nonpoliticized agencies; and at inducing competing political groups to align their goals more with societal than factional interests.

Keywords: growth, poverty, rules, institutions, human behaviour

JEL classification: D70, H10, I30, K00, O10, Z10

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## 1. Introduction

This paper combines the recent contributions of North (and other new institutional economists) and of Hofstede to suggest issues for consideration in building institutions for economic growth and poverty reduction in developing (and transition) countries. North (1990, 1994) has analyzed the role of institutions for economic performances of different societies through time. Hofstede (1997), who pioneered cross-country values studies, has analyzed dimensions of culture in different societies and their human behavioural implications. An integration of these contributions can provide a useful way to look at the economic growth process and the role of public institutions.

It is obvious that human behaviour influences long-term economic growth and poverty reduction. While economists distinguish among technical, institutional, and behavioural relations, behaviour affects both technical and institutional relations and shapes them in the long run.<sup>1</sup> Human behaviour, mainly, is what shapes labour supply, human capital formation, invention, tax payments, and many other processes that drive, or affect, economic growth and poverty reduction.

As Simon (1985) has pointed out, nothing is ‘more fundamental in setting our research agenda ... than our view of the nature of the human beings... it [human nature] also makes a difference for the proper design of political institutions’. However, understanding human nature, which is universal, is not sufficient; it is also important to understand how human behavioural norms differ among countries.

A market economy has its superstructure (relations among economic aggregates and product and factor markets), infrastructure (formal institutions), and foundation (values, which determine economic agents’ behavioural norms and shape formal institutions). Economics, as a system of analytical tools, should have its corresponding superstructure (an integrated macroeconomic and general equilibrium microeconomic framework), infrastructure (an analytical framework for formal institutions), and foundation (a clearly specified set of underlying assumptions regarding economic agents’ values).

New institutional economists have criticized neoclassical economists for not paying attention to what should comprise the infrastructure and proper foundation of economics.<sup>2</sup>

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<sup>1</sup> Institutional relations in this context (e.g., tax, government transfer schedules) are narrower in scope than in North's definition of institutions, discussed later in this paper. A production function—a technical relation—assumes technical efficiency, a result of optimization, which is a consequence of human behavior. A de facto tax function—an institutional relation in a narrow sense—depends on tax compliance, an outcome of human behavior.

<sup>2</sup> For example, their questions include the following: Does neglecting transaction costs yield unrealistic economic models? Is the assumption of human rationality underlying neoclassical economics realistic particularly for developing countries? Rationality in economics often means that ‘individuals know what is in their self-interest and act accordingly’. (North, 1994). Economists have since been incorporating transaction costs into their models and using less stringent assumptions (e.g., bounded rationality and instrumental rationality).

They have now made the point that ‘institutions matter’. Moreover, North has stressed that economists must try to understand how *formal* institutions can be compatible with *informal* norms. In this analytical framework, some empirical studies have related economic growth to indicators of a rule of law and other institutional efficiency. However, a question remains: How do different elements of institutions interact, particularly in developing countries? For example, what are the implications of economic agents’ informal norms and values for formal institutions?

The objectives of this paper are twofold: (1) to analyze the implications of human behavioural norms for how formal institutions function and (2) to identify issues for consideration in building institutions, particularly public institutions, in developing countries. The paper discusses how beliefs, ideas, and values of individuals and groups directly or indirectly affect economic growth. While these have crucial implications for economic growth, economics rarely analyzes them.

The paper's approach is interdisciplinary, drawing on conclusions of the research not only in economics, but also in history and other social science disciplines. The aim is to suggest a way to assess the role of values in the process of economic growth, particularly the implications of collective values of a society for the operation and development of its economy.

The organization of the paper is as follows: Section 2 reviews the findings of new institutional economists regarding the relationship between rules and economic growth. While drawing on North’s extensive research, it also discusses some of the recent empirical research. Sections 3 and 4 provide an overview of the findings of recent research in culture, values, and behaviour and suggest their economic implications. In particular, the sections highlight the economic implications of cultural collectivism. Sections 5, 6, and 7 draw on historical analysis of the economic implications of rules to identify issues for consideration in making and implementing rules for growth and poverty reduction in culturally collectivist societies. Section 8 provides conclusions.

## **2. Institutions as rules and economic growth**

### **2.1 Institutions as rules of the game**

Using a game theory analogy, North (1990, 1994) defines institutions as humanly designed formal and informal rules of the game for individual and organizational interactions. Formal rules include a legal system, government regulation, and policy measures; informal rules include norms of behaviour, conventions, and self-imposed codes of conduct. Efficient rules promote economic growth. They encourage individuals to engage in productive activities by providing proper incentives, by establishing a stable structure of human interactions, and, thus, by reducing uncertainty. They also limit the number of choices available for individuals and, as a result, limit the cost of comparing alternative choices.<sup>3</sup>

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<sup>3</sup> Buchanan and Young (2001).

## 2.2 Process of institutional change

Explaining how institutions evolve is a demanding task that requires an interdisciplinary approach. It is particularly demanding when institutions are defined as encompassing informal norms. Drawing on the findings of the recent research in cognitive science, North has suggested an approach to explaining institutional change. The process of institutional development, based on North (1990, 1994), and drawing also on Hofstede (1997) and others, may be sketched as follows:

Beliefs, values, and institutions: Institutional development is a learning process. Human beings learn by forming mental models upon which they interpret their experiences from the physical and sociocultural environment in a structured manner.

- Human beings use mental models to engaged in ‘representational redescription (RR)’; for example, they extract general conclusions from particular experiences and use analogy. In this manner, they develop beliefs, which help them form their individual attitudes, values, and ideologies.<sup>4</sup>
- Shared individual beliefs form collective attitudes, values, and ideologies, which form a culture. Culture provides members of a group with a means of both reducing the divergence in individual mental models and transferring unifying perceptions to new generations. While attitudes, values, and ideologies can promote a rational approach to problem solving, they also can create myths, dogmas, and prejudices.<sup>5</sup>
- A culture manifests itself in values (a broad tendency to prefer certain states of affairs over others), rituals (collective activities), and symbols (languages and other means of expression). If a culture were compared to a multilayered sphere, values would form its innermost core; rituals and symbols its outer layers. Values change only slowly; symbols, less slowly.<sup>6</sup>

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<sup>4</sup> This model of human cognitive development hypothesizes that the RR process separates human learning process from those of other processors of information and identifies three sources of human knowledge: innate predispositions, interaction with the environment, and, most importantly, an *internal mind-enriching process* of representing and re-representing knowledge; see Clark and Karmiloff-Smith (1993).

<sup>5</sup> This is where the views of new institutional economists and some other social scientists diverge from neoclassical economists. For example, North states: ‘The rational-choice framework ... is patently false in making choices under ... the conditions that have characterized the political and economic choices that shaped (and continue to shape) historical change’; see North (1994). Huntington expresses a similar, but perhaps less definite, view of the rationality assumption: ‘People do not live by reason alone. They cannot calculate and act rationally in pursuit of their self-interest until they define their self’; see Huntington (1996). These views are also in line with those of anthropologists. For example, Wilk (1996: 104) notes: ‘Many economists ... believe that once people acquire moral values, they all use them in the same ... predictable way. Although values may be culturally relative, they say, logic and rationality are not... Anthropologists often disagree with economists on this point’.

<sup>6</sup> Psychologists distinguish between terminal values (concerning, e.g., equality, freedom, and happiness) and instrumental values (concerning, e.g., courage, honesty, politeness, and responsibility); see Berry, et al. (1992: 53).

- Given their beliefs, human beings develop institutions to structure and order their interactions.
- Beliefs and institutions thus created are not, in and of themselves, efficient and growth promoting. The process of institutional development is not necessarily a rational process of agents' building efficient institutions through the survival of the fittest. A deterioration in institutional strength in a society does not necessarily trigger its automatic recovery.<sup>7</sup>
- Mantazavinos, North, and Shariq (2001) distinguish between individual learning and shared learning and between two types of shared learning: the static and the evolutionary. While evolutionary shared learning is central to the development of rules for a society, the distinction between static and evolutionary shared learning is central to recognizing what can and cannot change in the short run in designing rules.

Institutional change and institutional entrepreneurs. Institutions evolve as a result of interactions among rules, organizational or individual agents, and institutional entrepreneurs.

- Institutional entrepreneurs respond to various exogenous and endogenous signals to bring about institutional innovations. The signals are not necessarily economic (e.g., a change in relative prices); individuals' and groups' good or bad *ideas*, as well as *vested interests*, matter. Interactions among individuals—institutional entrepreneurs and political, business, religious, and intellectual leaders<sup>8</sup> of small and large groups—are important.<sup>9</sup>
- Just as Schumpeter's entrepreneurs provide leadership in combining capital and new technology to introduce new products or to operationalize new, more efficient ways to produce old products, institutional entrepreneurs provide leadership in combining ideas and political visions to introduce sustainable, more efficient, and practical new rules (e.g., a new constitution, tax law, and anti-trust legislation). In many cases, they are not public figures.<sup>10</sup> Some are well known (e.g., as discussed later in this paper, Cleisthenes, James Madison, Lee Kuan Yew).<sup>11</sup>

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<sup>7</sup> Arrow (1974: 29), suggesting a similar possibility, points out how inability to break commitments often gives rise to 'the greatest tragedies of history, this sense of commitment to a past purpose which reinforces the original agreement precisely at a time when experience has shown that it must be reversed... The True Believer is much more effective in social action, but whether it is in the right direction may be another question'.

<sup>8</sup> These are not necessarily mutually exclusive groups.

<sup>9</sup> See Lindsay (2000).

<sup>10</sup> 'Institutional entrepreneur' is the term used by North (1994). An institutional entrepreneur could be a minister of finance who seeks foreign advice on the design of a tax system, mobilizes political support for the new system, and institutes a new, efficient, enduring tax regime. An institutional entrepreneur could also be a treasury department director who starts a new, more efficient, and transparent budget execution system; see Section VI of this paper for a further discussion. The technology analogy of institutions has useful

### 2.3. Stages of development of institutions for economic and political transactions

Through history, a country's transition to a mature market economy has passed through two stages for both economic and political transactions.<sup>12</sup> Transactions without adequate third-party enforcement. The development of institutions for economic transactions in this stage takes two phases. In the first phase, intracommunity transactions rely on personal ties.<sup>13</sup> Specialization is minimal, and living standards are low. While primitive societies engaged in this form of transactions, a breakdown of formal rules has pushed economic agents in some advanced societies (e.g., Russia) to resort increasingly to personal ties or similar devices (e.g., business networks). In the second phase, intercommunity transactions take place with inadequate intercommunity institutions. There can be some formal institutions governing intracommunity transactions, but no effective institutions for intercommunity transactions, which are governed by informal ties (e.g., merchant codes of conduct, exchange of hostages, or rituals). As explained later, the Community Responsibility System in the medieval Europe, the Grameen Bank in Bangladesh, and chaebol-bank relations in Korea share some of the features of institutions in this phase of development.<sup>14</sup>

Political transactions also can take place without third-party enforcement. Political groups often engage in competition without a well-defined, tightly enforced legal framework (e.g., an effective election law). Politicians often compete within political groups without a similar formal framework (e.g., an effective charter governing competition for members of a political party).

Whether economic or political, transactions in this stage take place as essentially a noncooperative game. Without an adequate legal framework with third-party enforcement, organizational and individual agents engage in transactions only if they expect their self-enforced transactions to bring about more positive payoffs than in conceivable counterfactual situations.

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implications. As Rodrik (1998) notes, market institutions may be compared to a technology that combines a society's all available *resources*, only a part of which is production technology (or transformation, compared with transaction, technology), to produce goods and services.

<sup>11</sup> This characterization of the role of an institutional entrepreneur in no way reduces the importance of the will of the people in a democratic society. Historians, however, do not hesitate to recognize the special role of, for example, James Madison by calling him the Father of the US Constitution.

<sup>12</sup> The discussion of institutions for economic transaction is based on North (1990). Economic transactions comprise exchanges between buyers and sellers, between creditors and debtors, and more broadly among competitors, for example, among competing producers. Political transactions comprise exchanges between rulers and constituents, between representatives and voters, and among competing political groups, etc. The discussion here is limited to transactions between sellers/creditors and buyers/debtors and among competing political groups and individuals. Economic and political games of various kinds proceed simultaneously.

<sup>13</sup> A 'community' is a group of individuals with personal ties (e.g., kinship, friendship, or acquaintanceship, etc.).

<sup>14</sup> See Greif (1994) for a game theoretic analysis of how individualist values gave rise to formal transaction institutions among the Genoese.



Widespread impersonal transactions with third-party enforcement. In this stage, a coercive government provides efficient institutions for impersonal intracommunity and intercommunity economic transactions throughout a nation state. A low-cost transaction system provides opportunities for specialization and efficient production. Institutions in developed economies have these features. Legal and other rules with third-party enforcement also govern intergroup and intragroup political transactions. Transactions in this stage may be compared to playing co-operative games.<sup>15</sup>

## 2.4 Game theoretic characterization

Institutional development is a process of agents' learning how to engage in exchanges, or transactions, with one another.

Nonco-operative games: Nonco-operative game theory characterizes the conditions underlying institutional development in its initial phase, when there is no adequate third-party enforcement. Economic agents (i.e., players) engage in exchanges without formal rules (i.e., play nonco-operative games—games that players play only because playing their self-enforced games promotes their interests). In the absence of third-party enforcement, however, conditions for voluntary, impersonal exchanges among a large number of agents are difficult to achieve.<sup>16</sup> Game theory offers two types of models of these transactions. The first model explains how intracommunity transactions take place without third-party enforcement. Players engage in exchanges when

- their play is repeated (i.e., they are engaged in a repeated, rather than one-off, game),
- they possess information about other players (i.e., the players' past performances are known to all players), and
- the number of players is small.<sup>17</sup>

A special case is a two-person repeated game with personal enforcement. As far as all agents' past actions are publicly observable, however, Kandori (1992) has shown that a limited number of players can engage in exchange repeatedly with changing partners.

The second model explains how intercommunity transactions take place without third-party enforcement. Kandori (1992) has shown that, such transactions are feasible through contagious punishments, in which a single member's misbehaviour (e.g., default or other violation of codes of conduct), triggers a retaliation by opponent players against all

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<sup>15</sup> Note that a degree of *co-operation* can play a role in nonco-operative games. For example, members of a community observe social norms, not because they are forced to observe the norms, but because they expect to benefit from observing them.

<sup>16</sup> North (1990: 14); see Romp (1997), Aumann (1987), and Nasser (1998) for a distinction between a co-operative game and a nonco-operative game.

<sup>17</sup> North (1990: 12). In the context of banking, Greif (1997) has stated these conditions more formally: The game of exchange is possible if (1) it is repeated infinite number of periods, (2) borrowers have an identity, a 'label' that is known to all the lenders, and (3) the history of the game is common knowledge, namely, each player's past actions are known to all.

members of the community to which the misbehaving agent belongs. In this case, trust is attached to the community as a whole, not to its individual members. Information requirements for repeated transactions are relatively small. As indicated, the Community Responsibility System, Grameen Bank, and chaebol system are examples (see Section 5.2 for a discussion).

Co-operative games: The conditions shown by the models of nonco-operative game for intercommunity transactions without third-party enforcement are demanding ones. Widespread intercommunity transactions that allow efficient specialization are not feasible without transactions with third party enforcement. The models of co-operative game show that an enforceable contract can bring about Pareto-optimal improvement for the players engaged in a prisoners' dilemma.<sup>18</sup>

## 2.5 Efficient rules and economic growth

Only efficient institutions promote growth.<sup>19</sup> Affluence in developed countries is a cumulative result of efficient institutions; poverty in poor countries, of inefficient institutions. For institutions to function well, formal rules should be securely nested in hospitable informal norms, which provide legitimacy to them. North (1994) stresses the role of culture in characterizing informal norms and in reinforcing, or interfering with, the functioning of formal rules. The slowness with which culture changes, and other linkages of the present to the past, gives rise to 'path dependence'. In addition, economic institutions must be supported by appropriate political institutions.

Rules vs. discretion: To promote productive investments and other activities, rules (e.g., laws, regulatory measures, policies, and decrees) should be stable, allowing economic agents to predict how these rules will affect the returns to their investments. To satisfy this requirement, rules should be interpreted and implemented objectively and without discretion, which creates an environment damaging to productive long-term economic investments.<sup>20</sup>

Rules and economic growth—empirical studies. Recent research efforts have postulated and empirically estimated relations between economic growth and measures of institutional efficiency. For example, the World Economic Forum assesses the economic growth prospects for each of the more than 50 countries covered in its database by using its competitiveness index, which reflects the country's institutional efficiency. This relationship, estimated by Sachs and Warner (1996), may be presented by

$$g = f(z, \dots)$$

where

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<sup>18</sup>See, for example, Aumann (1987) or Cooter (2000).

<sup>19</sup>This definition of efficiency is in line with Posner's two types of efficiency: a rule is substantively efficient if it ... promotes allocative efficiency; a rule is procedurally efficient if it is designed to reduce the cost ... of using the system of rules; see Posner (1998).

<sup>20</sup>In an example used by Arrow (1974), a traffic light, which does not use discretion, is more predictable than a traffic policeman is; the latter is bound to use personal judgment and, possibly, a degree of discretion.

$g$  = projected growth rate of a country, and  
 $z$  = country's institutional efficiency, which is a weighted average of a large number of measures of how its institutions function.<sup>21</sup>

In a similar effort, Brunetti, Kisunko, and Weder (1998) have postulated that *economic growth* is determined by the *predictability of rules* and a number of other more traditional factors, including educational attainment, inflation, and trade.<sup>22</sup> The predictability of rules is a composite index of the predictability of rule making, perceived political stability, security of persons and property, and predictability of judicial enforcement. The estimation results support the argument that institutional effectiveness promotes growth.

Their equations may be represented by

$$g = f(r, \dots)$$

where

$g$  = economic growth, and  
 $r$  = predictability of rules.

## 2.6. Unresolved questions

While highlighting critical aspects of the role of institutions, these formulations do not reveal how different elements of institutions, or rules of the game, interact. For example, they do not reveal how *formal* and *informal* rules are related.<sup>23</sup> The strength of rules is simply a composite index of measures of the strength of individual rules. While stressing the importance of an efficient rule of law for economic growth, they do not suggest *why* some countries have been able to establish an effective rule of law, but others have not.<sup>24</sup>

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<sup>21</sup> On the basis of cross-country data, Sachs and Warner have estimated an equation that relates economic growth to competitiveness (reflecting, among other factors, institutional strength), initial income, and other variables:

$$g_i = f(z_i, y_{0i}, \dots)$$

where

$g$  = growth rate,  
 $z$  = institutional strength,  
 $y_0$  = initial income, and  
 $i$  = country subscript.

<sup>22</sup> Others (e.g., Barro, 1998) have estimated similar cross-country equations.

<sup>23</sup> See Mantzavinos, North, and Shariq (2001) for a discussion of the research agenda in this area.

<sup>24</sup> A 'rule of law' here refers to 'governing by law'; the term 'rules' in 'formal rules' is used as a contrast to 'discretion'. As discussed later in this paper, a 'rule of law', meaning a 'rule of rules formulated and enforced through democratic political processes', is often compared with a 'rule of man', meaning a 'rule of discretionary decisions of leaders'.

### 3. Collective values and behavioural norms

#### 3.1 Determinants of human behavioural norms

Three levels of uniqueness of human mental programming. Hofstede's (1997) extensive analysis of the world's cultures offers a useful explanation of why a rule of law prevails in some countries, but not in others.<sup>25</sup> Hofstede notes that there are three levels of uniqueness in human mental programming: human nature, culture, and personality.

- Human nature is *universal* and is *inherited*.<sup>26</sup>
- Culture is *group-specific* and is *learned*. A group can be an extended family, a political party, or a labour union. It can be the alumni of a university or the residents of a town, a region, a country, or a group of countries.
- Personality is individual-specific and is both inherited and learned.

Dimensions of culture. Hofstede's approach reduces the study of culture to manageable proportion by focusing on four quantifiable dimensions of culture. The analysis of these dimensions suggests channels through which culture affects human behaviour, with regard to the relations among individuals, between individuals and groups, and among groups and with regard to their use of rules. The four dimensions of culture are collectivism-individualism, power distance, uncertainty avoidance, and masculinity-femininity. The analysis in this paper focuses only on the first three as the most relevant to economic growth:

- Individualism-collectivism (IC) indicates the degree to which individual interests prevail over collective interests.
- Power distance (PD) indicates the degree to which members of a society expect and accept that power is distributed unequally.
- Uncertainty avoidance (UA) indicates the degree to which the members of a society tolerate uncertainty.

#### 3.2 Collective values and general behavioural norms

On the basis of surveys consisting of a series of questions, Hofstede estimates individualism-collectivism (IC), power distance (PD), and uncertainty avoidance (UA) indices for 53 countries.<sup>27</sup> One of his key findings is that the IC index is closely correlated

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<sup>25</sup> Hofstede's pioneering work in the 1980s has inspired a series of extensive research in this area in cross-cultural psychology; see, for example, Berry, et al. (1992).

<sup>26</sup> Note that the term 'collective values' refers to *shared values* of members of a group and is compared with *individual values*. The term 'collectivism' refers to a group-oriented value system and is used in this paper to refer to a cultural phenomenon, not a political-economic system (e.g., a system of collectivized production). Rand (1946) has used the terms, 'collectivism' and 'individualism', similarly; see Rand (1960), 'The Soul of an Individualist', from Rand (1946).

<sup>27</sup> Hofstede (1997). Sociologists and anthropologists have long studied collective values, while psychologists have studied individual values. Recently, collective values have been identified by aggregating individual

(negatively) with the PD index, while the UA index is largely independent of both the IC and PD indices. The countries with an individualist culture tend to have a small PD, while those with a collectivist culture tend to have a large PD. Hofstede's IC index measures the degree of individualism in a society—a high index implies a high degree of individualism.

Individualism-collectivism (IC) and power distance (PD). Table 1 contrasts general human behavioural norms in a collectivist culture (and with a large PD) with those in an individualist culture (and with a small PD). The table also contrasts general human behavioural norms associated with strong UA with those associated with weak UA.<sup>28</sup> The IC index suggests general behavioural norms of individuals in relation to their groups. The behavioural norms indicate that in a collectivist culture (with a large PD),

- members of society tend to value group interests over individual interests and to accept authoritarian and paternalistic leaders;
- personal ties among members of a group play important roles;
- rule of man, more than rule of law, tends to prevail; discretionary actions, particularly of those in authority, tends to play an important role; and
- group rivalry and factionalism within a society are pronounced.

By comparison, in an individualist culture (with a small PD), members of a group tend to value their own interests over group interests and prefer resourceful, democratic leaders. Those in authority are expected to lead by rules rather than by discretionary, paternalistic actions.<sup>29</sup> The contrast between values in an individualist culture (with a small PD) and a collectivist culture (with a large PD) is clearly reflected in the following four passages:

Each member of society is thought to have an inviolability founded on justice ... which even the welfare of every one else cannot override. Justice denies that the loss of freedom for some is made right by a greater good shared by others. The reasoning

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responses to survey questions. Examples of questions to measure individualism-collectivism (IC) indicators for individuals include the following: (1) If the group is slowing me down, it is better to leave it and work alone (individualism). (2) To be superior, a man must stand alone (individualism). (3) I enjoy meeting and talking to my neighbors every day (collectivism). (4) It is reasonable for a son to continue his father's business (collectivism), etc. (Berry et al, 1992).

<sup>28</sup> Note that the indices are national averages; individual indices are distributed around the averages. While Hofstede (1997) does not provide measures of dispersions that can be used to conduct a test of the statistical significance of the differences between national averages, the differences between some national averages are large enough to belong to a same population. The examination of measurement errors and statistical tests of these estimates, however, will enhance the understanding of the relationship between dimensions of culture and behavioral norms. Note also that the discussion is on behavioral norms. Actual behavioral patterns may deviate from these norms. A large difference in behavioral norms between two societies with different cultural orientation, however, will result in a large difference in actual behavioral patterns.

<sup>29</sup> See Barzun (2000: 596-7) for a discussion of how, in the United States, individualist values, competition, and wealth accumulation were compatible with the growth of nonprofit, nonmarket organizations that redistributed wealth.

that balances the gains and losses of different persons as if they were one person is excluded.<sup>30</sup>

No creator was prompted by a desire to serve his brothers ... His truth was his only motive. His own truth, and his own work to achieve it in his own way...<sup>31</sup>

Nation before [ethnic] community and society above self ...Regard and community support for the individual;...Consensus instead of contention ...<sup>32</sup>

If we had to cite a single characteristic of the African culture, the subordination of the individual by the community would surely be the reference point to remember. African thought rejects any view of the individual as an autonomous and responsible being. The African is vertically rooted in his family...; horizontally, he is linked to his group, to society, to the cosmos...<sup>33</sup>

The first two statements capture the essence of individualism: primacy of the individual. The last two statements highlight collectivism and a large PD: group orientation, paternalistic role of groups for individuals, and emphasis on social cohesion. As discussed later, however, the emphasis on the interests of the nation as a whole in the official Singaporean version of collectivist values is not in line with the general reality of a collectivist culture, where factionalism and group rivalry within a country are a predominant feature.

Uncertainty avoidance (UA): The UA index indicates the extent to which individuals fear, and try to avoid, uncertainty. In a culture with strong UA, people have emotional needs for rules and, therefore, tend to rely on formal rules, even if the rules do not work; their rules tend to be numerous and precise. By contrast, in a culture with weak UA, individuals tend to accept uncertainty and have small needs for formal rules.

IC, PD, and UA across countries: Table 2 classifies the sample countries into six groups by their IC and PD indices. For each country, the table reports the pair of IC and PD indices in parentheses. A high IC index indicates a high degree of individualism; a high PD index, a large PD. Hofstede has found a strong statistical correlation between collectivism and a large PD. In the table, it is clear that, generally, the countries in the western Civilization tend to have an individualist culture and a small PD. Countries in the rest of the world tend to have a collectivist culture and a large PD.<sup>34</sup>

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<sup>30</sup> Rawls (1990; 24-5). Rawls makes it no secret that his objective is to offer an alternative to utilitarianism, which he believes is not individualistic (p. 26).

<sup>31</sup> Rand (1943).

<sup>32</sup> This is the definition of 'shared values', in a Government of Singapore white paper, quoted in Huntington (1996). Huntington notes that the Singaporean government added the phrase 'regard ... for the individual' in a last stage of drafting the paper.

<sup>33</sup> Etounga-Manguelle (2000).

<sup>34</sup> In Tables 2 and 3 and later in this paper, Hong Kong, SAR refers to Hong Kong, Special Administrative Region and Taiwan PC refers to Taiwan Province of China.

Table 1  
Dimensions of Culture and General Human Behavioural Norms

Individualism-Collectivism (IC) and Power Distance (PD) Dimensions		
	Collectivist/Large PD	Individualist/Small PD
Interpersonal relationship		
Individual identity	Based in the social network	Based in the individual
Virtues in interpersonal relations	Harmony	Speaking one's mind
Relationship and task	Relationship over task	Task over relationship
Inequalities among people 1/	To be expected and desired	To be minimized
Prevailing ideology 1/	Equality over individual freedom	Individual freedom over equality
Consequence of trespassing	Shame	Guilt
Privileges	Justified for the powerful	Not justified for the powerful
Communication	High context	Low context
Relationship between individuals and group		
Prevailing interest	Collective	Individual
Societal goals	Harmony and consensus	Self-actualization
Loyalty to group	Strong	Weak
Preferred organization	Centralization	Decentralization
Intergroup relationship		
Laws and rights	To differ across groups	To be the same across groups
Leadership		
Ideal boss	Benevolent autocrat	Resourceful democrat
Guiding value	Authoritarian	Democratic
State		
Role of state	Dominant	Small
Political power	Exercised by interest groups	Exercised by voters
Governance	Rule of man	Rule of law
	Discretion	Rules
Sources of power	Ability to use force	Ability to give rewards
	Family and friends	Formal position
Means of reform	Changing top people	Changing rules
Prevailing philosophy	Hierarchy and stratification	Equality
Uncertainty Avoidance (UA) Dimension		
	Strong UA	Weak UA
Dealing with uncertainty		
Uncertainty	Feared	Tolerated
Rules (and laws)	Emotional need for rules, even if they do not work	Minimal need for rules
	Many and precise	Few and general
Innovation	Resisted	Tolerated
Truth and ideology		
Truth	Absolute	Relative
Ideology	Nationalism	Internationalism

Source: Compiled from Annex Table 1.

Note: Expecting inequalities among individuals prevails in a culture with a large PD, while the ideology to prefer equality to individual freedom prevails in an individualist culture. While most individualist values are compatible with those in a culture with a large PD, these two values are contradictory to some extent. Note, however, that the prevailing ideology compares equality with individual freedom, not a higher degree of inequality with a lower degree of inequality.

Table 2  
Country Groups By Individualism-Collectivism (IC) + Power Distance (PD) Indices

	Large PD	Moderate PD	Small PD	
Individualist			United States (91,40)	
		Australia (90,51)	United Kingdom (89,35) Canada (80,39) Netherlands (80,38) New Zealand (79,22)	
		Italy (76,50)		
	Belgium (75,65)		Denmark (74,16) Sweden (71,31)	
	France (71,68)		Ireland (70,28) Norway (69,31) Switzerland (68,34) Germany (67,35)	
		South Africa (65,49)	Finland (63,33) Austria (55,11) Israel (54,13)	
		Spain (51,57)		
	Collectivist	India (48,77)	Japan (46,54) Argentina (46,49)	
		Brazil (38,69) Turkey (37,66) Greece (35,60) Philippines (32,94) Mexico (30,81) Portugal (27,104) Malaysia (26,104) Hong Kong (25,68) Chile (23,63) Singapore (20,74) Thailand (20,64) Korea (18,60) Taiwan (17,58) Peru (16,64)		Costa Rica (15,35)
		Indonesia (14,78) Colombia (13,67) Venezuela (12,81)		

Source: Geert Hofstede (1997).

Note: In parentheses, the first figure indicates individualism; the second PD.



Table 3  
Country Groups by Individualism-Collectivism (IC)  
+ Uncertainty Avoidance (UA) Indices

	Strong UA	Moderate UA	Weak UA
Individualist		United States (91,46)	
		Australia (90,51)	
		Canada (80,48)	United Kingdom (89,35)
		Netherlands (80,53)	
		New Zealand (79,49)	
		Italy (76,75)	
		Belgium (75,94)	
			Denmark (74,23)
			Sweden (71,29)
		France (71,86)	
			Ireland (70,35)
			Norway (69,50)
			Switzerland (68,58)
		Germany (67,65)	
		South Africa (65,49)	
		Finland (63,59)	
	Austria (55,70)		
	Israel (54,81)		
	Spain (51,86)		
Collectivist	Japan (46,92)		
	Argentina (46,86)		
	Brazil (38,76)		
	Turkey (37,85)		
	Greece (35,112)		
			Philippines (32,44)
	Mexico (30,82)		
	Portugal (27,104)		
			Malaysia (26,36)
			Hong Kong, SAR (25,29)
	Chile (23,86)		
			Singapore (20,8)
	Thailand (20,64)		
	El Salvador (19,94)		
Korea (18,85)			
Taiwan PC (17,69)			
Peru (16,87)			
Costa Rica (15,86)			
		Indonesia (14,48)	
	Colombia (13,80)		
	Venezuela (12,76)		

Source: Hofstede (1997).

Note: In parentheses, the first figure indicates individualism; the second UA.

Belgium and France are the only western developed countries with large PD indices. Costa Rica is the only country in the rest of the world with both a collectivist culture and a small PD. Australia, Italy, Spain, Japan, and Argentina are the countries in either the

individualist or the collectivist camp with a moderate PD. South Africa, Spain, Japan, and Argentina are moderate with respect to both IC and PD indices.

Table 3 classifies the sample countries by their IC and UA indices. While collectivist countries tend to have strong UA, individualist countries are scattered over a wide range of the UA zone. For example, Italy, Belgium, France, and Germany are individualist countries with strong UA. The United Kingdom, Denmark, Sweden, and Ireland have weak UA.

### **3.3 Economic implications of cultural collectivism and a large power distance**

Cultural collectivism has clear economic implications.

**Ambiguous property rights:** Group-oriented values can be an obstacle to an effective system of property rights. They can also be a source of government's discretionary enforcement of well-defined formal property rights. This can be true between the government and the private sector, among private groups, and within families. Governmental discretion discourages efficient transactions and can promote corruption.<sup>35</sup>

**Group rivalry and conflicts:** Group orientation can mean intragroup cohesion and harmony,<sup>36</sup> but can also mean intergroup rivalry and conflicts. Effective debates on economic reform proposals may be facilitated by emphasis on interests of the whole society over those of different individuals and groups. However, consensus might not be easy to obtain because of the conflicts among different interest groups, whose respective members tend to have fierce group loyalties.<sup>37</sup>

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<sup>35</sup> The Chinese phrase, 'eating from one pot', characterizes economic, social, and political interactions in many countries both in the Sinic and other civilizations with a collectivist culture.

<sup>36</sup> Confucianism formalizes a group-oriented social and political order dominated by wise, paternalistic leaders. Thus, Confucius' ideals stress personal cultivation as the basis of a world order: 'Confucianism traced back the ordering of a national life to the regulation of the family life and the regulation of the family life to the cultivation of the personal life'; see Lin (1938: 21). In this respect, the ideals of Confucius (551-479? BC) resemble those of Plato (ca. 427-347 BC), who stressed the role of philosopher-rulers: well-intentioned aristocrats with trained expertise (Frost, 1962: 182; and Lee, 1987: liii). Unlike in the western system of government, Confucianism deemphasizes the rule of law. Note that these are ideals; as individualist societies have deviated in many respects from the ideals of individualism, Confucian societies have been far from Confucius' idealized world. It appears that Confucian societies, and more broadly culturally collectivist societies, continue to stress unduly the importance of the roles of wise leaders; this is in contrast to the tradition of skepticism about such roles in the western world. For example, Madison has stated: 'It is in vain to say that enlightened statesmen will be able to adjust these clashing interests [of different groups], and render them all subservient to the public goods. Enlightened statesmen will not always be at the helm'; see Madison (1787). This is an effective argument for a rule of law and against a rule of man.

<sup>37</sup> The strength of group loyalty would tend to aggravate the conflicts of different groups' interests.

Possible unfairness: Attachment to personal ties can mean low costs for intracommunity transactions, but implies a limited opportunity for intercommunity transactions.<sup>38</sup> It can also mean discrimination against nonmembers in hiring, promoting, issuing licenses, granting tax exemptions, and allocating public resources. These practices inevitably lead to unfairness and allocative inefficiency.

Governmental paternalism. A large PD in a collectivist culture implies a tendency of governmental paternalism. Paternalistic government under wise leadership can correct some market failures. Misguided paternalism, however, can discourage individual initiatives and promote allocative distortions. Paternalism justifies governmental intrusion into personal activities of individuals; it also gives rise to public expectations of paternalistic government intrusion.<sup>39</sup> Here are a few examples from Korea, a culturally collectivist country with a large PD.<sup>40</sup>

- The government promoted industrialization through directed lending, tax incentives, and other administrative support. ‘The state masterminded the early import-substitution projects in cement, fertilizers, oil refining, and synthetic fibers... The government also kept alive some unprofitable factories inherited from the colonial period...’<sup>41</sup>
- Ju-young Chung, the founder of the Hyundai Group in Korea started building ships at the suggestion of the government. His autobiography vividly describes how President Park cajoled, and almost forced, a hesitant Chung to start shipbuilding.<sup>42</sup>
- At the beginning of the financial crisis, a number of top businessmen advocated a way out of the crisis through a massive export drive to be supported by the government.<sup>43</sup>

A direct governmental push for private entrepreneurs to commit to large investment projects inevitably create expectations of a possible future bailout. Therefore, investors tend to discount investment risks. The discounting of risks then leads them to excessive investments supported by government directed bank loans, excess production capacity in

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<sup>38</sup> Akerlof has noted the role of informational asymmetry in observing similar phenomena (e.g., Hong Kong village shopkeepers’ extension of credits to regular customers (Akerlof, 1984).

<sup>39</sup> Group orientation, while often associated with Asian societies, is a broader phenomenon reflecting cultural collectivism.

<sup>40</sup> Focusing on long-term issues, this paper characterizes the Korean government's policies in the recent 30-40 years. The Korean government has been pursuing a wide range of economic reform. Some of the policies described in this paper have been abandoned or modified. Some others will change as a result of the government's ongoing reform efforts. The slowness with which values change, however, can frustrate the government's reform efforts.

<sup>41</sup> Amsden (1989).

<sup>42</sup> Chung (1998).

<sup>43</sup> The explanation of government controls (e.g., inefficient price controls, regulations, and tax incentives), if based on a standard framework assuming individualism, would stress the role of rent seeking by government officials as an underlying factor. The analysis in this paper would point to government paternalism and group-orientation that may play a leading or reinforcing role.

certain sectors, low business profitability, and an accumulation of bad loans for the banks that have loaned to them.<sup>44</sup>

Other implications: Members of a culturally collectivist society tend to be less keen to search for truths that might damage personal ties. Avoiding truths that may damage personal ties can mean social harmony, but can also mean a suppression of painful truths. Innovations, scientific discoveries, and rational solutions to social problems may be elusive. Their behaviour tends to be driven more by shame than by guilt, which tends to be a prevailing emotion in individualist societies. Shame is a social, while guilt individual, emotion. In comparison with guilt-driven societies, shame-driven societies will have higher law enforcement costs, including for detecting tax evasion.

Collectivism can damage competitive processes by creating a sense of community among competing firms. This sense of community can give rise to collusion among competing firms. In his autobiography, Chung (1998: 371-2) mentions an episode of an apparent collusion that took place during an early stage of industrialization in Korea. The owners of several construction companies in Korea were negotiating among themselves over who should *win* a major construction project. Chung uses this episode to stress that Korean business firms were collegial, not viciously competitive.

## **4. Values and rules**

### **4.1 Cultural collectivism, a rule of man, and discretionary rule implementation**

Scholars have studied the rises and declines of world civilizations through history. They group contemporary nations into several civilizations. Relying on this grouping, Huntington (1996) has analyzed the political interactions among seven civilizations: African, Hindu, Islamic, Latin American, Orthodox, Sinic, and western. On this basis, Huntington argues that the western Civilization is unique, with several characteristics: Christianity, a well-established system of property rights, a rule of law, individualism, rationalism, and the Greek and Roman legacy.

Hofstede's research highlights that cultural collectivism and a large power distance provide an environment for a rule of man, which justifies discretion in interpreting and implementing rules. By contrast, countries with an individualist culture tend to have a rule of law. In the former, personal authority plays a critical role; in the latter, laws play a critical role. To pursue reform, the former have to change people in authority; the latter have to change laws. For the purpose of this paper, it is sufficient to contrast the two broad country groups:

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<sup>44</sup> Perkins notes a blurring of the line between the spheres of government and business, arising not from government paternalism, but from personal ties: 'Where personal ties between government officials and businessmen were based on family and family-like relationships (e.g., school ties, origin in the same town or province), the line between the sphere of government and the sphere of business was gotten blurred...' (Perkins, 2000: 129)

- The prosperous economies are those with efficient institutions, in particular, sound rules, including a rule of law. These are mostly the economies in the western Civilization, with a high degree of individualism and a small PD. Only a few economies outside the western Civilization have achieved comparable wealth and soundness in their institutions.
- Most developing and poor economies belong to a world of cultural collectivism.

While poor countries suffer from low human and physical capital, they also suffer from weak, inefficient institutions. Human capital formation can expand economic opportunities for the poor, but institutional change often is crucial for human capital formation. Even in the presence of high-quality human capital, weak institutions can damage growth prospects.

If culture influences the effectiveness of rules that govern a society, how strong is the statistical evidence? The following section offers the results of statistical tests on rules and dimensions of culture.

Table 4  
Dimensions of Culture and Effectiveness of Rules

	Dimensions of culture			Effectiveness of rules			
	Sample countries	Individualism-collectivism	Power distance	Uncertainty avoidance	Rule of law	Burden of regulation	Tax evasion
Mean		48.0		64.5	5.3	3.6	3.7
SD		25.6		24.3	1.1	0.7	1.1
Range		12-91		8-112	2.8-6.7	2.2-5.2	2.4-6.1
High index =		individualism	large	strong	effective	small	small
			PD	UA	rules	burden	evasion
Western	20-22	70	37	60	6.2	3.7	4.0
Rest of the world	21-25	25	72	71	4.0	3.1	2.8

Sources: Hofstede (1997) and World Economic Forum (2000).

Note: The number of countries used for the averages vary across country groups and indicators. See Annex Table 2 for details.

#### 4.2. Aspects of rules and dimensions of culture: an illustrative cross-country analysis

Tables 4, 5, and 6 present the results of a statistical analysis that combines databases from two separate sources: Hofstede's measures of national individualism-collectivism (IC), power distance (PD), and uncertainty avoidance (UA) indices and the World Economic Forum's measures of three national indices of the effectiveness of rules: the effectiveness of the rule of law (represented by a composite index of the indices for judiciary independence, soundness of property rights, and independence of the legal framework),

efficiency of government regulation, and tax evasion.<sup>45</sup> The estimation is based on a sample of 42 countries for which data are available from both sources.

Overview—the west and the rest of the world: Table 4 provides an overview of the averages for two country groups: the countries that belong to the western Civilization and the rest of the world. The first three columns report the average IC, PD, and UA indices for the two country groups; the second three columns report the average indicators of the rule of law, burden of regulation, and tax evasion. On average, the west, by comparison with the rest of the world, has an individualist culture with a high IC index (a higher index indicating a higher degree of individualism) (70 vs. 25) and a small PD index (37 vs. 72). The west tends to have a smaller UA index than the rest (60 vs. 71).

The west, clearly, has a higher rule of law index than the rest (6.2 vs. 4.0). These results are consistent with a smaller burden of regulation (3.7 vs. 3.1, a smaller index meaning a higher burden) and less tax evasion (4.0 vs. 2.8, a higher index meaning less tax evasion). By comparison with the large difference between the rule of law and tax evasion indices for the two country groups, the difference between the burden of regulation indices is not large. To understand this phenomenon, it is not enough to compare the average indices for the two groups. Rather, it is necessary to take into account other possible factors that affect the burden of regulation.

For example, it is necessary to note that the western countries tend to have an elaborate regulatory regime aimed at product safety, antitrust, environmental protection, and other objectives. Similarly, the observed difference between the tax evasion indices mask an even larger problem implied for widespread tax evasion in the rest of the world. The western countries, compared with the rest, have a high *statutory* tax burden, which tends to encourage tax evasion. Considering these circumstances, the difference in the tax evasion indices between the two country groups is considerable. The western countries suffer from less tax evasion than the rest of the world, although they have higher statutory tax rates. The regressions reported below further support this conclusion.

Rule of law: Equation (A) postulates that the rule of law ( $r$ ) is a function of individualism ( $i$ ).

$$(A) \quad r = f(i)$$

On the basis of Hofstede's analysis, countries with a high individualism index should tend to have a high rule of law index. Table 5 reports the results of regressions that postulate that the three indicators of the effectiveness of rules are explained by some of the dimensions of culture. Alternative functional forms yield statistically significant coefficient estimates with a right sign. Individualism 'explains' the rule of law with a large t-ratio for the coefficient and an adjusted R-square exceeding 0.500.<sup>46</sup> Regulatory burden and tax

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<sup>45</sup>Note that the IC, PD, and UA indices change only slowly, and it is unnecessary to update these indices annually for statistical analysis.

<sup>46</sup>The estimation results are robust: Using each of the three components (i.e., for judiciary independence, soundness of property rights, and independence of the legal framework), rather than the composite rule-of-law index, as the dependent variable still gives strong statistical results.

compliance: Equations (B) and (C), respectively, relate the regulatory burden and tax compliance to cultural factors.

$$\begin{aligned} \text{(B)} \quad b &= g(u, r) \\ &= g(u, f(i)) \end{aligned}$$

$$\begin{aligned} \text{(C)} \quad e &= h(r, t) \\ &= h(f(i), t) \end{aligned}$$

Equation (B) postulates that the burden of regulation ( $b$ ) is a function of UA ( $u$ ) and the rule of law ( $r$ ). Countries with a high degree of UA would tend to have a complicated regulatory regime; however, if they have an effective rule of law, they would tend to limit the burden of regulation.

The countries with no effective rule of law would tend to use governmental discretion, which would increase the regulatory burden. If the rule of law is a function of individualism, Equation (B) will have a reduced form, in which the burden of regulation would be a function of UA and individualism.

Equation (C) postulates that tax evasion is a function of the rule of law ( $r$ ) and statutory tax rates, represented by an average statutory tax rate ( $t$ ). An effective rule of law would help a country reduce tax evasion. However, other things being equal, high statutory tax rates would encourage tax evasion. Equation (C) also has a reduced form, in which tax evasion is a function of individualism and statutory tax rates. The results for the functional forms (3) of Equations (B) and (C) are not as strong as for Equation (A). However, there is a considerable evidence that certain dimensions of culture influence the effectiveness of rules.

Test for a sample of collectivist countries: One might ask: Do these results simply reflect the difference between the west and the rest? The countries in the west have a high degree of individualism and an effective rule of law. Therefore, the results merely confirm these obvious facts. Are the relationships postulated in Equations (A), (B), and (C) statistically valid for a sample of collectivist countries?<sup>47</sup>

Table 6 reports the results of regressions conducted only for 21 culturally collectivist countries (i.e., countries with an IC index less than 50). The results are not qualitatively different from those based on the whole sample.<sup>48</sup> A conclusion is that, among collectivist countries, those with a less collectivist tendency, or a more individualist tendency, have a

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<sup>47</sup> Like western countries, non-western countries have a varying degree of individualism. For example, Japan is more individualistic, or less collectivist, than many other collectivist countries. While it is unclear how quickly a society can become more individualistic, Japan began to adopt some elements of the western culture following the Meiji Restoration in the nineteenth century; see Hane (1986).

<sup>48</sup> Equation (A) has been estimated with and without a dummy for Hong Kong, SAR and Singapore. Hofstede's indices were estimated when Hong Kong, SAR was still under the British rule. Singapore, which will be analyzed later in this paper, is one of the few exceptional countries with a collectivist culture and an effective rule of law.

better performance in maintaining a rule of law than those with a more collectivist tendency.

Table 5  
Dimensions of Culture and Behaviour of Economic Agents  
(42 Individualist and Collectivist Countries)

		Explanatory Variables								
		Central tendencies of independent variables			Constant	Individualism	Uncertainty avoidance	Rule of law	Average statutory tax rate	Adjusted R-square
Central tendencies of explanatory variables	Mean					48.0	64.5	5.3	21.7	
	SD					25.6	24.3	1.1	7.0	
	Range					12-91	8-112	2.8-6.7	6.9-36	
Dependent variable		Mean	SD	Range						
Rule of law high index= effective rules		5.3	1.1	2.8-6.7	3.659 (15.22)	0.034 (7.60)				0.581
Burden of regulation high index = small burden	(1)	3.6	0.7	2.2-5.2	2.200 (4.76)		0.259 (3.02)			0.165
	(2)				4.301 (15.57)		-0.011 (-2.84)			0.147
	(3)				3.069 (4.64)		-0.008 (-1.79)	0.188 (2.04)		0.209
Tax evasion high index=small evasion	(1)	3.7	1.1	2.4-6.1	4.608 (8.38)				-0.043 (-1.78)	0.050
	(2)				0.328 (0.51)		0.635 (5.31)			0.399
	(3)				1.328 (2.15)		0.710 (6.74)	-0.064 (-3.80)		0.429

Sources: Regressions based on data from World Economic Forum (2000) and Hofstede (1997).

Note: The two numbers reported for each explanatory variable and each equation are the estimated coefficient and associated t-ratio (in parentheses).

Reverse causation? One might also ask: Does causation run in the reverse direction? Rather than individualism's leading to a rule of law and economic growth, does economic prosperity provide a society with resources to build a rule of law? Do economic growth and urbanization reduce group cohesion and lead to individualism? This possibility seems remote. There are prosperous countries that are culturally collectivist. Saudi Arabia, Kuwait, and some other oil-rich countries are prosperous *and* culturally collectivist. Korea; Hong Kong, SAR; Singapore; and Taiwan PC are all prosperous countries or regions that are culturally collectivist.



Table 6  
Dimensions of Culture and Behaviour of Economic Agents (21 Collectivist Countries)

		Central tendencies of dependent variables			Constant	Individualism	Uncertainty avoidance	Rule of law	Average statutory tax rate	Hong Kong and Singapore dummy	Adjusted R-square
Central tendencies of explanatory variables	Mean				26.2	71.3	4.5	18.7			
	SD				11.3	26.3	0.9	5.9			
	Range				12-48	8-112	2.8-6.1	6.9-28.7			
		Mean	SD	Range							
Dependent variable											
Rule of law	(1)	4.5	0.9	2.8-6.1	3.707	0.029					0.096
high index = effective rules	(2)				(8.13)	(1.80)					
					3.413	0.034			1.793		0.447
					(9.35)	(2.68)			(3.70)		
Burden of regulation	(1)	3.5	0.8	2.2-5.2	1.440		0.461				0.243
high index = small burden	(2)				(1.91)		(2.78)				
					4.372	-0.012					0.139
	(3)				(9.84)	(-2.10)					
					2.386	-0.009	0.385				0.291
					(2.50)	(-1.54)	(2.30)				
Tax evasion	(1)	3.3	1.1	1.9-6.1	5.152			-0.100			0.241
high index = small evasion	(2)				(7.33)			(-2.77)			
					-0.134		0.767				0.325
	(3)				(-0.13)		(3.33)				
					1.866		0.638	-0.076			0.457
					(1.49)		(2.99)	(-2.42)			

Sources: Regressions based on data from World Economic Forum (2000) and Hofstede (1997).

Note: The two numbers reported for each explanatory variable and each equation are the estimated coefficient and associated t-ratio (in parentheses).

More fundamentally, there is evidence that the emergence of individualism in the west preceded economic growth. Symptoms of individualism in the west emerged as early as in ancient Greece and biblical times:

Men began to question the older blind loyalty to the powers of the state, and many began to assert their own independence and their right to a life more or less free from the dominance of the established government. Individualism was in the air. Some suggested that man

should divorce himself from the authority of the group ... The Sophists ... led this advance into individualism...<sup>49</sup>

... a recent general survey of historical and philosophical writing of individualism concedes that some of the roots lie deep in classical and biblical times and also in medieval mysticism ...<sup>50</sup>

This intellectual development, however, did not become a widespread belief. While scholars are not precise on when individualism emerged, the general acceptance of individualist values in countries in the western Civilization had to wait for centuries, but not until industrialization. Anthropologist Macfarlane's (1987) research has indicated that English society had manifestations of individualism even in the thirteenth century.

... in general it [a recent general survey of historical and philosophical writing of individualism] stresses the Renaissance, Reformation and the Enlightenment as the period of great transition. Many of the strands of political, religious, ethical, economic, and other types of individualism are traced to Hobbes, Luther, Calvin and other post-1500 writers. Yet, if the present thesis is correct, individualism in economic and social life is much older than this in England... Individualism, however defined, predates sixteenth century changes and can be said to shape them all.<sup>51</sup>

### 4.3. Questions

This paper has argued that individualist and collectivist values have different behavioural implications. Group-oriented behaviour has its roots in collectivist values. These values allow members of a culturally collectivist community to engage in transactions without formal transaction institutions. Collective sanctions are effective for members of a culturally collectivist community. Research in game theory, however, raises important questions. Some game theorists (e.g., Kandori) have advanced models based on mutual and contagious sanctions to explain these behavioural patterns for agents with *individualist* values. Some others (e.g., Greif) have noted that, through history, collectivist and individualist societies have developed different institutions. For example, through history, it is individualist societies that have developed formal institutions.

Do people in collectivist societies not care about them as individuals? Isn't it human nature, as assumed in many economic models, that human beings seek self-interests? While they do, it is clear that individualism and collectivism have different behavioural implications. This paper argues that, even if human beings *by nature* tend to seek self-interests, cultural values, which human beings acquire through learning, can dictate human

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<sup>49</sup> Frost (1962: 179).

<sup>50</sup> Mcfarlane (1987: 196).

<sup>51</sup> Mcfarlane (1987: 196). Greif (1994) also indicates that individualism characterized social norms of the medieval Genoa.

beings in different societies to behave differently.<sup>52</sup> Group-oriented values shape human behaviour in all human societies, but particularly in collectivist societies. Individuals in culturally collectivist societies, while being guided by group-oriented values, clearly have varying degrees of tendencies to seek self-interests. Their behaviour may also be constrained by societal values that stress the importance of group interests.

There are other questions. How have some of the culturally collectivist countries, without effective rules, achieved growth? Hong Kong, SAR; Japan, and Singapore are among the world's wealthiest countries and regions. Korea and Taiwan PC are less prosperous, but have achieved impressive growth records. China, Thailand, Malaysia, and other countries, all with culturally collectivist values, also have achieved sustained growth. These countries are all culturally collectivist. These are not simple questions to answer, but one should point out that growth is a multidimensional phenomenon. What this paper is highlighting is the implications of (1) rules for growth and (2) values for rules. There are factors other than rules that affect growth, and there are factors other than values that affect rules. Rules matter for growth, but they are not all the factors that matter for growth. Values matter for rules, but they are not all the factors that matter for rules. While a rule of law and rule-based transactions are critical for growth, so are human capital, high savings, and work efforts. These countries' rules—at least some of them—must have been more efficient, transparent, and stable than those in less prosperous countries.

It is also obvious that many of these countries face challenging institutional reform tasks. Without successfully meeting these challenges, they may not continue to enjoy sustained growth. If a rule of law is essential for sustained economic growth, but is not readily achievable in a collectivist culture, and if culture changes only gradually, is it hopeless for poor countries to achieve long-term economic growth and poverty reduction? Indeed, there are some reasons why the prospects are not good. North is among those who share this pessimism:

There is no guarantee that the beliefs and institutions that evolve through time will produce economic growth... Throughout most of history and for most societies in the past and present, economic performance has been anything but satisfactory... Moreover, the radical improvement in economic performance, even when narrowly defined ... is a modern phenomenon of the last few centuries and confined until the last few decades to a small part of the world.<sup>53</sup>

Some have argued that culture should be changed. For example, Etounga-Manguelle (2000) advocates a 'cultural revolution' in education, politics, economics, and social life. In Japan, a Prime Minister's Commission (2000: 1-2) notes: '... we [Japanese] cultivated ethical norms extolling social and organizational harmony. Socioeconomic affluence and internationalization, however, made it difficult to sustain such ethical norms unchanged... How can the power of individuals be better utilized? ... Here we outline two essential changes. One is to change the methods and systems whereby citizens interact with

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<sup>52</sup> Experiments with games have shown that human actions even in the west often are backward looking and adaptive, not strictly rational egoists (see Mueller, 2000).

<sup>53</sup> North (1994).

society... The other essential change is ... promoting individuality and individual initiatives... ‘

One might argue that, with the process of globalization, cross-country cultural diffusion might lead to increasingly individualist tendencies in the developing world. However, it is not revolution, but evolution, that transforms culture, particularly the values that comprise its innermost core.<sup>54</sup> Moreover, it is unclear whether culturally collectivist societies will accept even a gradual transformation to individualist values. Therefore, it becomes essential to explore the following questions:

- How do developing countries with a collectivist culture cope with inadequate institutions to promote growth and poverty reduction?
- How do they build a rule of law, and a system of rules, rather than of discretion, while still remaining collectivist in their cultural orientation?
- In particular, how do they build public institutions that can overcome group rivalry and factionalism in their culture?

## **5. Coping with inadequate transaction institutions for growth and poverty reduction**

### **5.1 Developing countries—institutional reality**

Developing countries must go through a long process of institutional development. Establishing sound formal institutions takes time. It requires technical expertise, as well as political will and social consensus; some institutions (e.g., a lower rate tax system, an expanded social protection programme) may require financial resources.

While developing countries can import *formal* institutions from developed countries relatively quickly, intercultural transplantations of informal norms take much longer, even when developing countries are willing to receive such transplantations.<sup>55</sup> Perhaps, in the long run, this is the most difficult problem facing developing countries in establishing an economy based on rules and promoting economic growth and poverty reduction. The

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<sup>54</sup> Psychologists' and historians' research indicates that cultural diffusion is very slow. Psychologists often distinguish between two types of cultural diffusion: enculturation (cultural diffusion between generations within a culture) and acculturation (cultural diffusion between cultures). Whether individual or social, acculturation is a slow process; see Berry, et al. (1992). In the framework of psychologists' model of enforced changes in behavior, new formal or informal rules would change human behavior through compliance, identification, and internalization. Internalization of alien rules will take longer than identification, which takes longer than compliance. Cultural diffusion would not be complete, however, without internalization; see Lieberman (1956).

<sup>55</sup> As Rodrik (1998) points out, acquiring or building institutions may be compared to adopting a new technology. Institutional technology is specific to local conditions and contains a high degree of 'tacitness', leaving imported blueprints incomplete.

western industrial countries have developed their formal and informal institutions over several hundred years.<sup>56</sup>

## 5.2 Coping with inadequate transaction institutions—examples

Through history, societies have responded to institutional needs in a variety of ways with various degrees of success:

Endogenous networks. Following the breakdown of the Soviet Union, many former Soviet Union countries, without effective market institutions, saw an emergence of business networks. The transactions among members of a network, however, are essentially intracommunity in nature, even if the partners are located geographically wide apart.<sup>57</sup> Intracommunity enforcement for intercommunity transactions. The following independent episodes have common features:

- During the Commercial Revolution, traders in European communities were engaged in intercommunity trade, without formal intercommunity institutions, by relying on the Community Responsibilities System (CRS). For example, merchants in Genoa or Venice traded with merchants in Constantinople or London without a legal contract enforcement system governing their transactions and without knowing them personally. The system was reasonably effective. Under the system, a failure to honour contracts with a member of a community by a member of another community mobilized latter community's collective sanctions against all members of the former.<sup>58</sup>
- During the nineteenth century in China, Shanxi bankers expanded their lending to borrowers in distant places by holding family members of the borrowers collectively liable. Defaulting borrowers became nonentities within their families. Family members often were held hostage.<sup>59</sup>
- The microcredit programme pioneered by the Grameen Bank in Bangladesh and the chaebol-bank relationship in Korea share similar characteristics (see below).

It is not strictly right to characterize the CRS, Grameen Bank, and chaebol-bank relations equally as responses to a failure in intercommunity transaction institutions. Clearly, the CRS functioned with no intercommunity institutions. The operations of the Grameen Bank and chaebol groups are governed by the respective legal systems of Bangladesh and Korea.

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<sup>56</sup> North (1973) documents in detail how market institutions in Europe gradually emerged centuries before the Industrial Revolution.

<sup>57</sup> For discussion of endogenous business networks, see Kali (1999). Li (2000) distinguishes between 'relation-based governance' and 'rule-based governance'.

<sup>58</sup> Greif (1997); see also Greif (1994), who associates collective punishments more generally with a collectivist culture. Greif's analysis also shows that some medieval communities were more collectivist, while others more individualist, in their cultural orientation and that the collectivist transaction institutions were more efficient in supporting intracommunity transactions, requiring less costly formal institutions, but less efficient for *intercommunity* transactions (Greif, 1994: 942).

<sup>59</sup> See Perkins (2000: 234-5). Clearly, as Perkins points out, the Confucian family values helped the system to function effectively. However, the system has been widespread throughout non-Confucian societies.

The successful loan management record of the Grameen Bank, however, has been attributed more to its policy to require borrowers to be jointly liable than to an effective legal system. The chaebol-bank relations in Korea is subject to a multitude of laws in Korea; however, there is a general agreement that commercial banking requires major reform, which is now a key challenge facing Korea.

### **5.3 Grameen Bank and the chaebol system—institutional dimensions**

In spite of their apparent differences, the Grameen Bank's loan programme and the chaebol-bank relations share remarkable similarities. These institutions allowed intercommunity financial transactions to take place without adequate formal intercommunity institutions governing the transactions. Both institutions have features of a repeated game—between the Grameen Bank and each borrower group and between a chaebol group and a bank.

**Grameen Bank:** In Bangladesh, the Grameen Bank has successfully instituted a micro-financing programme by introducing groups of rural villagers to credits, step by step, through a learning process in a repeated borrowing-and-repaying game, in which members of a group provided one another with 'peer support in the form of mutual assistance and advice' and 'discipline'.<sup>60</sup> The Grameen Bank has relied on an interesting mix of punishments, threats of punishments, and incentives, as well as of traditional and modern institutional approaches. For example, while relying on intracommunity personal ties and discipline of borrowers for loan collection, the bank has rotated loan officers geographically throughout the country to prevent them from developing personal ties with borrowers.<sup>61</sup>

**Chaebol system:** A chaebol group is a collection of large and small, legally separate, vertically and horizontally linked corporations managed by a mix of professional and owner executives controlled by an owner-family, usually headed by a paternalistic chairman. Many chaebol groups have their own marketing channels for some of their products. A chaebol group's influence extends to a large number of small subcontractors and suppliers, which often have exclusive business relations with the group.<sup>62</sup> The emergence of the chaebol system cannot be explained without paying attention to the role of institutions, including informal norms. From institutional perspectives, this system is an outcome of inadequate transaction institutions and cultural collectivism.

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<sup>60</sup> Yunus (1999).

<sup>61</sup> Yunus (1999) stresses the importance of 'the power of peers... If one member fails to repay a loan, all members risk having their line of credits suspended or reduced'. Borrowers are required to join the bank in self-formed, five-member groups. '... a new group submits loan proposals from two members, each requiring between \$25 and \$100. After these two borrowers successfully repay their first five weekly installments, the next two group members become eligible to apply for their own loans. Once they make five repayments, the final member of the group may apply. After 50 installments have been repaid, a borrower pays her interest, which is slightly above the commercial rate. The borrower is now eligible to apply for a larger loan'. Apparently, the Bank used threats of collective punishments, but these threats have rarely been carried out; see Dowla (2000).

<sup>62</sup> See Amsden (1989: 184-8) for a discussion of the close and exclusive ties between the Hyundai Motor Company and some of its legally separate subcontractors.

- To an extent, chaebol groups were the means for Korean entrepreneurs to overcome the weakness of the Korean financial system.<sup>63</sup> Banks loaned to chaebol firms partly because the banks and chaebol groups developed an understanding that the firms belonging to a chaebol group were collectively liable for all individual loans to them. Collective liability was ensured through a number of means, including cross guarantees and chaebol chairmen's de facto authority over intra-chaebol financial transactions.<sup>64</sup> It is possible that these and other advantages in accessing bank loans outweighed the inefficiency arising from excessive diversification and inadequate specialization. A paternalistic government supported the emergence of these relations.
- Chaebol groups benefit from a vertical integration, through ownership and de facto control of marketing channels, suppliers, and subcontractors. In an economy with inadequate transaction institutions, internalizing transactions can reduce transaction costs for chaebol groups.<sup>65</sup>
- The emergence and operation of chaebol groups cannot be fully explained without discussing the role of cultural collectivism and a large power distance (PD). Chaebol chairmen tend to manage their groups in a paternalistic, group-oriented manner. Intra-chaebol transactions tend to be discretionary and not necessarily governed by market principles. When the chairman of a chaebol group decides to transfer financial resources from one corporation to another in the group, the property rights of the small stockholders of the first corporation are violated. Owner-founders tend to hand over not only the ownership, but also the management of their corporations, some of which operate globally, to their sons, not necessarily through a vigorous competition to choose the best managers. Clearly, *dynastic* management transfers for large corporations are an inefficient practice.

#### 5.4 Limitations of intracommunity enforcement mechanisms

The Community Responsibility System could not support a broad expansion of trade. As the size of communities increased, the system began to face a number of difficulties (e.g., the ease of falsification of community affiliation and adverse selection, insufficient incentives for lenders to examine the creditworthiness of individual borrowers).<sup>66</sup> Eventually, the system disintegrated as nation states emerged to provide effective

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<sup>63</sup> Since the financial crisis Korea experienced in 1977-78, the *chaebol* system has been undergoing changes, partly as a result of the Korean government's effort to reform banking and corporate financing and governance.

<sup>64</sup> Amsden (1989).

<sup>65</sup> For a *chaebol* group, vertical integration gives rise to a mix of forces: It increases the costs of internal governance. It might give the benefit of economies of scale. It also reduces the costs of market transactions. The cost of market transactions is higher when product specificity increases. For a given degree of product specificity, weak transaction institutions in Korea elevated the costs of market transactions, relative to the costs of internal governance; see Williamson (1985) for a discussion of the efficiency of hierarchical transactions relative to market transactions in driving vertical integration and of the relationship between the costs of internal governance and market transactions.

<sup>66</sup> Greif (1997).

intercommunity transaction institutions. The Grameen Bank experience would not be effective in urban areas with weak personal ties between residents. In an earlier stage, the chaebol system served useful functions for Korea's drive for growth. The system, however, is now considered an obstacle for Korea's further economic development. Korea's further growth depends on whether Korea will develop sound economy-wide institutions that promote low-cost transactions.

### **5.5 Lessons for promoting poverty reduction in developing countries**

The poor, who are potential entrepreneurs and workers, in developing countries suffer from not only limited education and skills, but also a lack of access to banks, markets for their products, inputs for their production, and employment opportunities. Consider the following hypothetical, but realistic, cases:

- A small farmer needs to buy an equipment, but has to pay for it in cash, which may not be available until his next crop is harvested and sold.
- A skilled village artisan is unable to borrow money from a local bank to open a small shop because she does not have a collateral.
- A shopkeeper in a small town wants to hire a part-time helper. While several qualified candidates are available, she does not know any one of them well enough.

In these examples, critical constraints to growth and poverty reduction are ineffective transaction institutions. More generally, producers can rarely expand production and employment without engaging in exchange separated over time and space between the *quid* and the *quo*. Such an expansion, however, inevitably gives rise to an increase in the needs to extend or access credits.

Building transaction institutions as a repeated game: Grameen Bank experiences suggest for developing countries an approach to helping the poor establish access to credits, markets, and inputs in the absence of efficient transaction institutions, including an effective legal system, that govern borrowing and lending. In line with what game theory suggests, governments' policy should focus on providing a framework for producers to form small voluntary groups, such as co-operatives. This framework should be aimed at (1) building a system of transactions as a repeated game and (2) promoting a system in which players (e.g., co-operatives, their present and potential creditors) have easy access to information on the performances of co-operatives, not necessarily of their individual members. The co-operatives, or co-operative-like groups, would not necessarily have a formal internal governance structure; their internal governance would be based on personal ties for co-operation, competition, and mutual sanctions. The size of a group, therefore, should be small. It would take time for large groups and formal intragroup governance systems to be established:

- The financial institutions should gradually increase the amounts of loans.
- Producers (e.g., smallholders) should be able to increase their access to financial institutions by forming groups (e.g., credit co-operatives) each comprising a small number of producers who are collectively liable for the credits extended to them. These co-operatives also can organize their efforts to sell their products and to buy inputs.



- The members of each co-operative can maintain its credit standings through mutual sanctions based on members' personal ties.
- These schemes would be applicable, to some extent, to small shopkeepers and independent entrepreneurs in urban areas. An important point is that groups should be formed voluntarily among those who have personal ties.<sup>67</sup>
- As an insurance against employee misconduct on jobs dealing with cash or merchandise, some employers may demand a 'collateral' from impoverished job seekers whom they do not know. Virtual impossibility for job seekers to satisfy this requirement may result in failure for an employment contract to materialize. The employer would either have to find a relative or cancel an expansion. Employees' or job seekers' small voluntary co-operatives or co-operative-like organizations, based on personal ties, could help poor workers secure such jobs.<sup>68</sup>

Using business groups for large-scale investments. Without the benefits of efficient institutions for intercommunity transactions, chaebol groups in Korea mobilized financial resources for large-scale investment projects by relying on informal arrangements that have proven useful throughout history. Other developing countries may not have choices other than using a similar system for large-scale investments. Yet the chaebol system is considered to have been, and to continue to be, inefficient. An effort to use a similar system should be complemented by an incentive system to minimize its inefficiency. A collectivist culture justified paternalistic chaebol chairmen to use nonmarket intra-chaebol transactions and also led a paternalistic government to use directed lending to chaebol *groups* to expand investments in the sectors the government wanted to promote. Cross-guarantees provided banks with incentives to lend to chaebol groups rather than to more efficient smaller firms. Chaebol groups' excessive borrowing and high debt-equity ratios made them financially vulnerable. Chaebol groups would not achieve full efficiency unless they became specialized. Without efficient transaction institutions, however, chaebol groups would not be easily broken up. The collectivist culture in Korea will change only gradually. The government's effort to transform chaebol groups into more efficient sets of independent corporations should be supported by efforts to build up rule-based transaction institutions.

## 6 Issues for building public institutions

Formal economic and political institutions in the western developed economies have evolved over centuries. Underlying this evolution has been informal norms, supported by western values. The key features (e.g., individualism, rule of law, rationalism, and well-established property rights) that Huntington has noted as uniquely associated with the western Civilization are not unrelated among themselves. The findings reported in this paper suggest that the western rule of law and a system of property rights depend, among

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<sup>67</sup> In an urban area, where intercommunity mobility is extensive, it would be challenging, but not impossible, for interested individuals to form small, voluntary groups that would play this role.

<sup>68</sup> Potential employee's inability to offer a collateral often leads to no transaction. Effective institutions would invigorate transactions in labor markets.

other factors, on individualism. Rationalism, at least as defined in economics, has its roots in individualism.

Cultural collectivism, a large power distance, importance attached to personal ties, and paternalism can have major implications for the functioning of formal economic and political institutions. Discretion, rather than rules, in the private and public spheres, can adversely affect entrepreneurs' investment decisions. Group-orientation can affect the nature of economic and political competition.

Formal institutions in developing countries should be designed with a full recognition of how they will interact with collective values. To this end, it is not enough to take into account human nature, which is universal. It is necessary to take into account dimensions of a country's culture in which the formal institutions would be set up. Therefore, institutional challenges for developing countries in this regard are twofold: (1) How do governments design and adopt efficient rules? (2) How do governments implement the rules? The remainder of this paper addresses these questions in reverse order, focusing on several issues that need to be considered in building formal institutions for economies with a collectivist culture. Some of these issues do not emerge in economies with an individualist culture. The paper highlights issues and offer historical examples, but not a blue print for reform.

### **6.1 Rule making vs. rule implementing, collectivism, and factionalism**

Both rule making and rule implementing are demanding tasks.<sup>69</sup> Many culturally collectivist countries have inadequate rules that need to be reformed. In a collectivist culture, however, the adoption of efficient rules does not necessarily guarantee their nondiscretionary implementation. Group rivalry and factionalism in a collectivist culture can be particularly damaging not only to making sound rules, but also to their proper implementation. De jure political and economic rules deviate from their de facto counterparts. It is much more difficult to monitor de facto rules than their de jure counterparts, particularly when rule implementation is not transparent.

The organization of a well-functioning government is based on at least two principles: (1) separation of powers and (2) checks and balances. A system of checks and balances forces the legislative, executive, and judicial branches to be interdependent.<sup>70</sup> This system is designed to separate law making functions from law-implementing functions. If laws were the only rules, this system also would help separate rule making functions from rule implementing functions. This formal system functions well when nested in a culture of individualism.

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<sup>69</sup> In this section, rules refer to formal rules, unless otherwise indicated.

<sup>70</sup> Some writers have distinguished between two conceptions of freedom: (1) the English idea emphasizing impartial administration of laws through the separation of powers between law making and law implementing and (2) the American idea emphasizing checks and balances, particularly constraints imposed on law making by the judiciary; see la Porta, Lopez-de-Silanes, Pop-Eleches, and Shleifer (2001). This paper, however, stresses (1) the similarities among the western systems of a rule of law and (2) the discrepancy between de facto and de jure legal institutions.

## 6.2 Checks and balances in a collectivist culture

In a collectivist culture, this system may not function as intended:

- Hofstede's findings imply that those who implement rules in a culturally collectivist country tend to use *discretion* more than those in a culturally individualist country do. Members of different government branches can have loyalty arising more from party membership, school-ties, or regional affiliation rather than from their official duties. This loyalty weakens checks and balances intended in the separation-of-powers principle. In a collectivist culture, a large threat to nondiscretionary rule implementation often comes from the political party in power. A collectivist culture can insist that party members put party loyalty above checks and balances intended for the functioning of government agencies in the separation-of-powers principle.<sup>71</sup> This is particularly true when political parties are formed less for shared interests in common policy agenda than through personal ties around leading political figures.
- Rule implementation is also undermined by the fact that many functions of the executive branch often mix rule making and rule implementing. For example, around the world, finance ministries not only formulate rules (e.g., tax policy, budget, and regulatory measures), but also often implement them. While a separate tax administration agency exists in many countries, the head of the agency often reports to the finance minister. Without a strong tradition of a rule of law and without a transparent system of the public monitoring of rule implementation, reasonably efficient rules that have been formulated with public scrutiny may be implemented through a series of nontransparent, discretionary actions. The results are discrepancies between de jure and de facto tax, regulatory, and other regimes of economic rules. How do culturally collectivist societies build a tradition of nondiscretionary rule implementation? The present governmental organization in the western world works reasonably well because the formal system of checks and balances is nested in hospitable values rooted in individualism. The government structure in a culturally collectivist society may have to be different.

## 6.3. Issues in institutional reform for nondiscretionary rule implementation

To ensure nondiscretionary rule implementation, the relationship of rule implementing agencies may have to be redefined vis-à-vis their rule making counterparts. The following are several questions that should be considered.

Is it feasible to separate rule making and rule implementing functions? Clearly, it would not be easy to separate all rule making and rule implementing functions into two mutually exclusive groups. A system of rules encompasses numerous subsystems of rules. It seems feasible, however to isolate a set of critical rule implementing functions. Here are only a few examples:

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<sup>71</sup> Public choice theory suggests that an independent civil service can make it difficult for an elected government to pursue promised policies; see, for example, Tullock (1987). In countries with a collectivist culture, however, an excessive loyalty of bureaucrats to elected politicians can be a source of discretion in rule implementation.

- Many countries have the office of government prosecutors, mandated with law enforcement. This function can be separated from not only law making, but also law enforcement policy formulation.
- Tax administration can be separated from tax policy formulation and legislation; many countries have a tax administration agency as an agency separate from the ministry of finance, which has a tax policy department.
- It is feasible to separate agencies that implement regulatory measures (e.g., antitrust, banking supervision) from those that formulate them and send them to the legislative branch.
- Budget execution can be separated from budget formation; many countries have a treasury, which is devoted to budget execution, as an agency separate from a budget department, which prepares budget proposals for the legislative branch.

It is crucial for a rule making agency to co-ordinate and co-operate their work with the agency that implements the rules; its appears not essential, however, for them to be a same agency. Is it desirable? If the principle of separation of powers is applied to making and implementing rules defined to include not only laws, but also policies, regulations, and decrees, there is a case for institutionally separating the two types of functions. In a society with a collectivist culture and a large power distance, prosecutors may be unduly loyal to those who appoint them.<sup>72</sup> This would misguide their law enforcement. One way to reduce this possibility would be to make those who implement them autonomous vis-à-vis elected officials, but subject to strict performance standards and checks and balances aimed at limiting the chance of their abuse of authority.<sup>73</sup> Autonomous agencies would have a greater chance of resisting the political pressure to use their discretion in their administration of a regulatory, tax, or budget policy regime. In a culturally collectivist country, such agencies would have a greater chance, than those headed by officials reporting to political appointees do, to maintain the political neutrality and impartiality of rule implementation. Separating rule making from rule implementing has received attention both in countries with an individualist culture and in those with a collectivist culture. Here are some examples of institutions based on this principle:

Many countries have an independent civil service. The United States introduced the Civil Service Commission, now the Office of Personnel Management, in 1883 to replace the ‘spoils system’ with a ‘merit system’.

New Zealand's public expenditure management system is based on separating the role of ministers, who are responsible for policy making, from the role of departmental chief

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<sup>72</sup> In a society with a strong tradition of a rule of law, a prevailing norm requires that the prosecutors resist the political pressure of elected officials (e.g., the minister of justice, prime minister, or president) who appoint them.

<sup>73</sup> The judicial independence is based on this principle. In the United States, federal judges are appointed for a lifetime tenure and cannot be removed from office without an impeachment and conviction. In culturally collectivist countries, however, judicial independence might not be sufficient for efficient law enforcement. Even in such an individualist countries as the Unites States, there are views stressing strict constructionism over judicial activism to ensure the integrity of law enforcement.

executives, who are in charge of policy implementation. Ministers specify performance requirements for chief executives to provide clearly specified services to the public. Unlike the proposal in this paper to make rule implementing functions autonomous, chief executives in New Zealand report to ministers. The nonpolitical nature of chief executive positions, however, is illustrated by New Zealand's willingness to hire chief executives from abroad.<sup>74</sup> In this example, elected rule making officials hold appointed rule implementing officials accountable through performance contracts. The ministers are held accountable to the prime minister and to the parliament. This system would not work well in a collectivist culture, in which rule makers are a source of discretionary rule implementation.

In Brazil's new programme budget system, a programme manager, who is in charge of implementing a budgeted programme, does not report to the line ministers who supervise programme activities and control the budgetary resources that are used as inputs for the programme. Brazil is a collectivist country. This system, in part, adds a layer of checks and balances, in the process of budget execution, in addition to the one provided by parliamentary oversight.

Individualist societies try to ensure the political neutrality of some rule implementing agencies (e.g., an independent judiciary, an autonomous tax collection agency, a professional civil service).<sup>75</sup> Culturally collectivist societies require a more rigorously designed system of autonomy for rule implementing agencies. These societies require autonomous rule implementing agencies in areas for which such agencies are not required in individualist societies. For example, judiciary independence may not be sufficient; an autonomous unit of prosecutors might be necessary for nondiscretionary law enforcement.

How can local rule implementation be nondiscretionary? In a collectivist culture, local government operations may be easily influenced by local interest groups with personal ties

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<sup>74</sup> Scott (1996).

<sup>75</sup> The regulatory agencies in the United States are intended to be independent of the political goals of a particular president, and the heads of many regulatory agencies cannot be removed from office by the president unless for breaking the law. Some governments entrust an autonomous central bank to conduct, with a considerable degree of autonomy, monetary policy aimed at price stability. The goal is to strengthen *rule-based* macroeconomic policy (i.e., without political interference), although the arrangement allows the central bank to conduct *discretionary* monetary policy; see Elster (1994). For example, the central banks (e.g., the Federal Reserve Bank in the United States) are mandated to use discretionary monetary policy to achieve price stability. The data in legal institutions reported in la Porta, et al. (2001) indicate that many developing countries, which often do not have a firmly established rule of law, have a legal system based on a lifelong tenure of supreme court justices, suggesting that formal rules ensuring a lifelong tenure of law-implementing officials may not be a sufficient condition for a rule of law. It is notable, however, that virtually all western countries have a system of a lifelong tenure of supreme court justices. It is also notable that the findings of la Porta, et al. (2001) suggest that both English and American ideas of freedom, when instituted effectively, are important guarantees of freedom and that the differences between them are not conclusive.

to local government officials.<sup>76</sup> While local political processes, in principle, should dictate local policy formulation, should local policy implementation in key areas be assigned to professional administrators independent of local political interests and without personal ties to local interest groups? Should such professional administrators belong to the central government, subject to appropriate checks and balanced vis-à-vis local political authorities?<sup>77</sup> These are relevant issues to consider in designing a system of local rule implementation.

How can autonomous rule implementing agencies be held accountable? There is no easy answer to this question. Clearly, autonomous rule implementing agencies can abuse their authority. It is not easy to determine the degree to which they should be independent. Should they be independent of ministers, of the prime minister, or even of the president? This question cannot be answered generally. Different countries would have different circumstances. In general, cultural collectivism may require a separate layer of checks and balances. A right question to ask is whether the possibility of their abuse of authority is relatively more tolerable than the elected officials' abuse of rule implementing agencies' loyalty for their own political gains.

#### **6.4. Making new rules to tame factionalism: three historical episodes**

Rule implementing should be politically neutral, but rule making should be subjected to political competition. Rules should be an outcome of such competition. Public choice theory views political competition as an exchange process in which promises of political services are traded with votes. The theoretical and empirical findings of research in this area have suggested many problems of political processes: (1) impossibility to translate individual values to collective preferences; (2) constituents' lack of interest in voting and in informing themselves of general issues, and (3) politicians' tendency to seek re-election chances and to pursue populist actions that are not necessarily well-founded.<sup>78</sup>

Through history, building political institutions has challenged many societies.<sup>79</sup> As Nevins (1956) has noted: 'From the beginnings of parliamentary government in western Europe one common weakness appeared on which many nascent legislatures foundered. Almost all the various assemblies of estates were formed of self-armed aristocratic groups, quite as jealous of their rights and privileges as of their duties. This was true of England, Scotland, France, Castile, Scandinavia, and later Prussia. The constituent groups naturally regarded their representatives as so many attorneys to protect their interests..'. In countries with a collectivist culture, rivalry among political groups and factions has been, and continues to

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<sup>76</sup> This system would be in line with the Grameen Bank's policy to rotate loan officers throughout the country regularly to prevent them from developing personal ties with local borrowers.

<sup>77</sup> In some countries, it is not unusual for the central tax administration agency to collect *local* taxes on behalf of local governments.

<sup>78</sup> See Tullock (1987).

<sup>79</sup> See North (1998) for a discussion of how competition among , as well as within, evolving nation states determined the features of economic development. Competition among states forced some of the crowns to trade rights and privileges; see also North (1973).

be, a critical additional obstacle to establishing a system of orderly, productive political competition.

The success stories discussed below, however, indicate that it is not uncommon for politicians to defy the parochial interests of their constituents for broader public welfare. In these stories, stable frameworks for political competition have emerged from the interplay of not only vested interests, but also ideas of both groups and individuals. In these stories, new political institutions have effectively helped a society tame factionalism and encouraged competing groups to put the interests of the entire society above those of groups. Individuals, as well as groups, have played key roles in helping a society establish effective political institutions. The following cases illustrate how three countries softened factional rivalry through political reform.<sup>80</sup> The new institutions helped the countries achieve sustained economic growth. Institutional entrepreneurs were involved in the design of the constitutions.<sup>81</sup>

Cleisthenes' constitution for ancient Athens.<sup>82</sup> In 682 BC, Athens abandoned monarchy and adopted a government of elected officials (*archons*), but had serious economic, social, and political problems—most of all, strife among tribes, between low-income groups and wealthy aristocrats, and among regions. In spite of Solon's reform, including debt cancellations, Athens fell into the hands of tyrants. Some of these tyrants pursued land reform and other populist policies, but could not resolve deep-rooted factionalism and economic stagnation. In 510 BC, Athens turned to Cleisthenes, the head of a prominent family, to lead a constitutional reform effort. Cleisthenes designed and implemented a constitution that established a new system of political competition.

The constitution required all men 18 years or older to belong to one of the villages (*demes*), which numbered about 170 throughout Attica; divided Attica into three regions, which had a common agricultural basis, but represented Attica's divergent interests: handicrafts, fishing, and timber; organized each of the three regions into 10 groups or thirds (*trittyes*) in such a manner that the *demes* of a single group were not necessarily contiguous pieces of land, thus creating 30 groups in Attica; formed 10 new artificial tribes (*phyle*) by drawing by lot three groups from each region; and formed a council of 500 representatives.

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<sup>80</sup> In present day standards, the systems were not without problems. For example, the Cleisthenes Constitution accepted slavery, excluded many from citizenship, and did not allow women to participate in the political process. It is notable that human knowledge and values, which provided ancient Athens with a basis for the Cleisthenes reform, still supported slavery and kept it for more than 2,000 years—through the Constitutional Convention and the Civil War in the United States. North stresses that ideas mattered in the abolition of slavery; see North (1990: 85). The recent series of financial crises around the world indicate that countries that have an advanced technology and human resources that enabled them to produce sophisticated electronics and other manufactures can still be institutionally too fragile to prevent a financial crisis.

<sup>81</sup> A conventional term would be 'statesmen'. While Schumpeter's entrepreneurs largely seek profits, institutional entrepreneurs do not seek profits.

<sup>82</sup> This summary is based on Mueller (2001) and Hammond (1986).

The constitution removed from the political process a source of tribal or other group rivalry. Thus, the reform ‘transformed Attica from a country of squabbling clans and geographic and economic interests with a political system that was preoccupied with zero-sum redistribution, into the world’s first democracy’.<sup>83</sup> When accepted, the 500 Councillors took the oath ‘to advise what is best for the state’.<sup>84</sup> The several decades following the institution of the reform include the Athenian Golden Age.

James Madison and the US Constitution: Following the Declaration of Independence, the 13 American colonies clashed over regional and sectoral interests. Some, such as Hamilton, advocated a strong federal government and a promotion of manufacturing; others, such as Jefferson, strong states and a promotion of agriculture. Madison’s role was critical in framing the US Constitution, including the crucial Bill of Rights. A guiding principle was to protect the constitutional process from factional influences. North stresses this aspect: ‘Thus Madison, in Federalist Paper Number 10, maintained that the constitutional structure was devised in 1787 not only to facilitate certain kinds of exchange, but also to raise the costs of those kinds of exchange that promote the interests of factions’.<sup>85</sup> Madison’s role was not limited to mediating between warring political rivals; he analyzed the constitutional experiences of ancient and modern confederacies and made specific proposals to craft a constitution without similar shortcomings.<sup>86</sup>

Lee Kuan Yew and housing and electoral reforms in Singapore. Singapore transformed itself in mere 35 years from a poor third world economy to a highly competitive, wealthy modern, rule-based economy. When Singapore became independent, few believed in its viability as a country.<sup>87</sup> Singapore is a culturally collectivist country, where Chinese, Malays, Indians, and other smaller ethnic groups comprise a diverse population. Racial strife was not uncommon. Establishing a rule-based economic system without abandoning a collectivist culture has been an important achievement.

Singapore’s success story, while fascinating, is a puzzle with regard to the institutional issues raised in this paper. The questions are complex: Is Singapore an exception to a rule-based economy’s requiring individualism? Alternatively, has Singapore’s emphasis on national interests over those of groups within the country succeeded in creating a culture that mimics individualism and led to a rule-based economic system? Lee has stressed the importance of Singaporean businesses abiding by ‘the rules of the game’ in ‘an open, transparent ... level playing field’.<sup>88</sup>

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<sup>83</sup> Mueller (2001).

<sup>84</sup> Hammond (1986: 190).

<sup>85</sup> North (1990: 47); see also Mueller (2001) for a similar view.

<sup>86</sup> Madison personally went through the books he had asked Jefferson to send him from Paris. Brookhiser (1996).

<sup>87</sup> Lee (2000). Lee shared this pessimism: ‘We inherited the island without its hinterland, a heart without a body (Lee, 2000: 3).

<sup>88</sup> Lee’s interview with *Forbes* (1998). In the interview, Lee also stresses that cronyism and corruption are ‘a debasement of Confucianist values. Confucianist duty to family and loyalty to friends should be discharged from private, not public, wealth’.



The following institutional reforms are notable. Under the leadership of Lee Kuan Yew, the government actively pursued policies to help Singaporeans put the interests of the nation above those of ethnic groups.<sup>89</sup> The government also instituted a housing policy aimed at promoting ethnically integrated neighbourhoods. To discourage one ethnic group from occupying an entire apartment building, the government imposed a quota for each ethnic group in each building in new apartment complexes. While helping Singapore achieve racially integrated neighbourhoods, however, this housing policy made it virtually impossible in Parliamentary and local elections for non-Chinese political candidates to defeat Chinese candidates customarily supported by collectivist-oriented Chinese majority voters. To ensure that minority groups are represented in the Parliament, the government instituted a system of group representation constituencies (GRCs), which were created by amalgamating three or four single-member constituencies and then contested by candidate groups each with three or four members. Each group of candidates had to include a minority candidate to receive support of minority voters.<sup>90</sup> In this example, formal rules were designed specifically to limit the problems arising from informal norms—ethnic groups' preference to vote for candidates of their own ethnicity.

### **6.5 Role of institutional entrepreneurs and values**

Role of institutional entrepreneurs. The three examples highlight the importance of ensuring that political competition promote the interests of the society as a whole, rather than interests of groups, factions, regions, or sectors. To this end, the three countries adopted formal rules: a new constitution in ancient Athens and the United States and a new election law in Singapore. In all three countries, institutional entrepreneurs played key roles.

How did these institutional entrepreneurs emerge? This is not an easy question to answer. It appears, however, that in all three countries, political and social conditions allowed open competition, although the openness was not unlimited. Leaders were chosen from the elite, but there was, to an extent, a relatively level playing field for them to compete. In ancient Athens, some 80 years prior to the Cleisthenes Constitution, Solon's reform had established, in what Aristotle called a mixed oligarchic-democratic system, an equality of political rights among all Athenians, regardless of birth and wealth, in the election of officials, although voters almost always chose aristocrats for leadership.<sup>91</sup> The American colonies also had a level playing field for political competition. The Founding Fathers in America, while most of them had had the best formal education available, were not 'like

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<sup>89</sup> Lee (2000).

<sup>90</sup> Lee (2000: 206-10)

<sup>91</sup> Hammond (1986: 162, 190). Greek historians have described the openness of political competition in ancient Athens around that century. For example, Book II of Thucydides includes 'The Funeral Oration of Pericles', which, delivered about 80 years after the Cleisthenes reform, includes the following passage: '... If we look to the laws, they afford equal justice to all in their private differences; if to social standing, advancement in public life falls to reputation for capacity, class considerations not being allowed to interfere with merit; nor again does poverty bar the way—if a man is able to serve the state, he is not hindered by the obscurity of his condition'; see Finley (1959: 267).

anything that existed in England or Europe'.<sup>92</sup> Singapore has been a competitive, merit-based society.<sup>93</sup>

Role of values. Values also played a role. In a culturally collective Singapore, the government has intervened with paternalistic policy measures (e.g., a residential quota system aimed at racial integration, electoral reform, and a government white paper stressing the value of national social cohesion). In the west, the functioning of formal institutions has been reinforced by political values that sought a balance between respecting the will of the majority and resisting 'the tyranny of the majority...'.<sup>94</sup> These values have guided many politicians who, 'in behalf of principle and to defend the overall interest of the country, confronted the passion of ... a majority of the general public'.<sup>95</sup> Madison supported the Constitution, even if his support meant antagonizing Virginians, who were strong supporters of states' rights, and losing his bid for the first US Senate seat for Virginia. In the history of the western Civilization, Cleisthenes and Madison have not been isolated examples of politicians who stood against factionalism. This philosophy has had its roots in individualism, which values individual preferences, views, and convictions.

The analytical framework positing politicians' behaviour aimed at maximizing re-election chances or other self-interests cannot fully explain the working of either a well-functioning democracy or an emerging democracy rooted in a collectivist culture. As Keynes (1936) has stated: 'Madmen in authority, who hear voices in the air, are distilling their frenzy

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<sup>92</sup> Ellis (2000: 11) 'All of its members, not just those like Benjamin Franklin and Alexander Hamilton with famously impoverished origins, would have languished in obscurity in England or France'.

<sup>93</sup> Lee (2000: 59) describes how the Economic Development Board (EDB) selected its senior officials: 'For the first few months, the EDB had experts from the UNDP and the International Labor Office to help it... Hon Sui Sen was picked by Keng Swee as the first chairman ... and given the choice of the brightest and best of our scholars who had returned from universities in Britain, Canada, Australia, and New Zealand. These young men were inspired by Sui Sen, a quiet, outstanding administrator with an amazing ability to get the best out of those who worked for him'. In a number of speeches and interviews, Lee has stressed how he tries to nurture fair and open competition in Singapore.

<sup>94</sup> Mill (1859, ch. 1) in Himmelfarb (1982). Tocqueville has pointed to the 'absence of administrative centralization' in the United States, as well as American institutions and mores that temper the tyranny of the majority in the United States. However, Tocqueville's decentralized administration refers to a federal, rather than unitary, system of government; see Tocqueville (1848). Underlying the principle of checks and balances is a doubt about the role of 'enlightened statesmen'. 'It is in vain to say that enlightened statesmen will be able to adjust these clashing interests, and render them all subservient to the public good. Enlightened statesmen will not always be at the helm'; see Madison (1787). This view of human weaknesses contrasts sharply with more optimistic view of the role of well-intentioned leaders in a collectivist culture.

<sup>95</sup> Nevins (1956). Kennedy stresses the importance of US Senators' viewing issues from national perspectives. His volume includes accounts of American politicians (e.g., Daniel Webster, John Quincy Adams, Robert Taft) who, in the pursuit of their conviction, risked their political careers by defying the popular will of their constituencies (Kennedy, 1956). After John Quincy Adams left the White House in 1820, the voters of the Plymouth District asked him to represent them in Congress. He agreed on the conditions that (1) he would never promote himself as a candidate and (2) he would pursue a course in Congress independent of the party and his constituents (Kennedy, 1956: 44).

from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas’.

## 6.6. Issues in rule making

While developing countries with collectivist values face a difficult challenge in establishing political institutions that can tame factionalism, the three examples of political reform, together with the findings of new institutional economics, suggest several issues that should be addressed in political reform.

How can political groups be formed to represent societal, not factional, interests? The Cleisthenes reform institutionally ensured this outcome by dismantling existing tribes and forming artificial ones. The US Constitution balanced interests of the Union and those of states by instituting, among other means, a senate where small and large states are represented with equal votes. It also assured individual rights by adding the Bill of Rights. Madison drew the attention of the public to the harmful effects of factions (e.g., ‘a landed interest, a manufacturing interest, a mercantile interest, a moneyed interest’) and pointed out how the new constitution, while unable to remove its causes, would ‘control its effects’.<sup>96</sup> Singapore’s governmental white paper stresses the importance of the national interests over factional interests. Its electoral reform protected the political rights of the ethnic minority groups by instituting GRCs.

How can political groups engage in orderly competition? Game theory suggests that competing political groups will engage in transactions with one another if competition is viewed as a repeated game, if the performances of the competing groups are well known, and if the number of groups is small. These conclusions indicate the following conditions:

- Competing political groups (e.g., political parties) and their members not only should be interested in long-term political payoffs, but also be able to define the future streams of their respective political payoffs.
- They should have well-defined, enduring policy agenda. Competing political groups should be associated with these policy agenda. A collectivist culture and a large power distance can pose as an obstacle for their establishing such agenda. Political groups may be formed more around leading political figures than around enduring policy agenda. From an election to another, politicians may reorganize political groups, change the characteristics of the political groups, and blur their political identities. This makes it difficult for political competition to be established as a repeated game.
- The number of competing political groups should be limited.

The problem is complex. Political groups play games not only among themselves, but also with constituents. The dilemma is that sound formal rules (e.g., laws) are required to achieve these conditions, but cultural collectivism, group rivalry, and discretion are obstacles to establishing and implementing such rules. The efforts, however, should be on creating a rudimentary framework for promoting exchanges among competing political groups. Public choice theory offers some useful suggestions to this end. As Singapore’s electoral reform has demonstrated, the design of an electoral system can influence the

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<sup>96</sup> Madison (1787).

nature of political competition. For example, the number of competing political groups tend to be determined by 'district magnitude,' threshold of representation, threshold of exclusion, and whether the electoral system is based on proportional representation or majoritarian rule.<sup>97</sup>

How would political groups agree on the reform of rule implementation? Clearly, rival political groups will not agree to adopt the system of rule implementation outlined in Section 6.2 above unless they believe that the system will benefit them, if not now, over time. Conditions should be created for each competing political group to recognize that the discounted present value of the future stream of its political payoffs is greater in the new regime than in all counterfactual regimes, including the status quo. A challenge is to identify and create these conditions.

How do countries establish a level playing field for political competition? The soundness of political competition depends on the soundness of not only intergroup competition, but also intragroup competition. In an individualist culture, a key question in this regard is campaign financing. In a collectivist culture, this is much more than a campaign financing issue; a large power distance, and the authority of established politicians, can be an effective barrier to new politicians' entry into political markets.

## **7. Learning from game theory to promote efficient economic and political transactions**

### **7.1 Transactions as nonco-operative games in a society with weak rules**

As mentioned in Section 2, economic and political transactions in developing countries often have elements of a nonco-operative game. They either do not take place or break down because the three conditions mentioned in Section 2.4 above for successful nonco-operative games are difficult to establish. When they take place, they do without the benefit of effective rules enforced by the third party. They take place as a series of one-off games, rather than as a repeated game, and are inefficient.<sup>98</sup> This paper is suggesting that game theoretic analyses can offer useful insights for promoting economic and political institutions over time in developing countries.

Standard game theoretic analyses assume, among other conditions, individualism—a condition that does not exist in many developing countries. Are the results of such analyses relevant for culturally collectivist developing countries? They definitively are relevant for

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<sup>97</sup> See Grofman and Reynolds (2000) for a review of the main findings.

<sup>98</sup> Transactions often have elements of the game of a prisoners' dilemma. Outside their communities, buyers and sellers are reluctant to offer credits or employment contracts because they do not consider their relations will continue, although doing so would pay off to all players in the short run, as well as over time. Employees often demand unrealistically large increases in wages, and the management responds by work stoppages, although moderate wage awards and uninterrupted production would benefit both. Political parties often prefer a status quo rather than agreeing on a reform legislation that would benefit the whole society over time.

the games played by economic groups (e.g., among groups of borrowers and lenders, interest groups, or rival political groups) in developing countries. The games among rival groups, each comprising culturally *collectivist* members loyal to one another, mimic the games among individualistic players. What do game theoretic analyses suggest for promoting repeated economic and political transactions?

## 7.2 Promoting co-operative dimensions in nonco-operative games

Axelrod's (1984) suggestions provide a helpful guide for a reforming government.<sup>99</sup> Ineffective rules can make a better impact on transactions in this manner. The following ideas are based on his suggestions.

**Make the future count.** In Axelrod's words, this is 'enlarging the shadow of the future'. A reforming government can take two practical steps: making interactions durable and making them frequent. The Grameen Bank's microcredit programme has these elements. Promises of rewards and threats of punishments make productive interactions durable. The Grameen Bank allows its clients to borrow and pay back a series of small amounts frequently, rather than one large amount occasionally; this policy allows borrowers and the Grameen Bank to maintain frequent contacts. When borrowers borrow and pay back a series of relatively small amounts, with a threat of cutting off the borrowing privilege, the gains from *not* paying back each borrowing are small relative to the stream of gains from a series of future borrowing. Such a lending scheme reduces the possibility of defaults. A government contemplating a microcredit legislation should ensure that it include these elements.

**Set payoffs appropriately.** The penalties for the violators of rules should be sufficiently large. Many banks impose severe punishments (i.e., cutting off credit lines, demanding an unusually high interest rate) for delayed loan repayments. The government in many well-functioning economies imposes credible penalties for the violation of tax laws and other laws. The government in poor countries often has a tax system that offers real benefits to late payments.

**Make the players' past records effectively available to all players.** Axelrod suggests improving 'the ability [of players] to recognize the other players from past interactions, and to remember the relevant features of those interactions'. More broadly, the government can disseminate such information. For example, the government can make borrowing groups' credit histories effectively available to all micro-credit suppliers. The transaction system focusing on groups, as suggested in this paper, rather than on individuals, would be less taxing for developing countries with limited administrative resources.

**Other suggestions:** Axelrod has two other suggestions: teaching reciprocity and altruism to players. Reciprocity and altruism can be contradictory. Reciprocity means matching other player's action with a similar action—a strategy that defies altruism when the actions are hostile. Reciprocity can also lead to a destructive process of economic or political transactions. To an extent, reciprocal altruism could mean moving away from rationalism (i.e., moving away from seeking self-interests). However, reciprocal altruism is compatible

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<sup>99</sup> See Chapter 7, 'How to Promote Co-operation'.

with the promotion of the *societal* interests (rather than factional interest) both Madison and Lee sought in establishing rules in the United States and Singapore.

## 8. Summary and conclusions

Economic prosperity in the western developed countries is a result of sustained economic growth, which has been based in part on their efficient institutions, or rules, encompassing, among other things, an efficient transaction system, supported by an effective judicial and political system. Their economic prosperity reflects the efficiency of their rules. Macroeconomic and microeconomic relations are supported by efficient formal economic and political rules, which in turn are nested in hospitable values and behavioural norms.

Certain dimensions of culture, such as individualism-collectivism, power distance, and uncertainty avoidance, affect the efficiency of rules. In particular, individualism is a critical factor that helps a country establish and maintain rule-based transactions. Cultural collectivism in most developing countries tend to promote the use of discretion, to undermine rules, and to cloud the prospects of economic growth.

History provides developing countries with important lessons for promoting growth and poverty reduction. Before they reach the final stage of institutional development, in which efficient third-party enforcement supports widespread transactions, developing countries can benefit from the arrangements that have promoted intercommunity transactions without strong intercommunity transaction institutions. The experiences of the Community Responsibility System, the Grameen Bank, and the Korean chaebol system suggest a useful interim step toward establishing transaction institutions for economic growth, although these arrangements have critical weaknesses and eventually must be replaced with more efficient institutions.

In building efficient public institutions in a collectivist culture, it can be useful to make a clear distinction between rule making and rule implementing and to identify groups of important rule implementing functions of government. Examples include law enforcement, tax administration, and budget execution. To promote nondiscretionary rule implementation, developing countries may consider mandating some organizations only with these rule implementing roles and making them autonomous from interest groups and even from elected government officials. Of course, these organizations must be held accountable to the public on the basis of strict and transparent performance requirements. They should have well defined, accountable selection and removal procedures for their officers.

Legislation, policy formulation, and other rule making must be an outcome of a political process. Political reform in a collectivist culture should be aimed at taming factionalism and at promoting the interests of the whole society, rather than of factions, sectors, or regions. Political competition can be considered a game. The assumptions of individualism and rationalism underlying game theoretic analysis extend realistically to the games among competing groups in a culturally collectivist society. Therefore, the conclusions of game theoretic analysis can provide a useful guide for institutional reforms in a collectivist society. Political reform should be aimed at lowering barriers of entry for political competitors into political markets. Political reform should be designed to provide a

framework for competing political groups to play a *repeated* game as a learning experience. To this end, the examples of ancient Athens, colonial America, and contemporary Singapore provide good lessons. If building institutions is a game and a learning process, it is important to pay attention not only to what institutions to build, but also how to build them.

The Grameen Bank experiences offer interesting points. The Grameen Bank started to lend small amounts and gradually increased the amounts as borrowers accumulated their credit standings. The Grameen Bank and its borrowers played a repeated learning and lending-borrowing game, while capitalizing on local values. The collective punishment scheme was consistent with the collectivist culture of the Bangladesh society.

The particular values discussed in this paper are only a part of the systems of values guiding human behaviour in different societies. The paper has not judged these values. Rather, it has offered an analysis of economic implications of these values. If values have these implications, economists, and other social scientists, should integrate these implications into their analysis of economic growth more explicitly. Rule making should also take them into account.

Annex Table 1  
Dimensions of Culture and General Human Behavioural Norms

Individualism-Collectivism (IC) Dimension		
	Collectivist	Individualist
Family, school, and work place		
Identity of a person	Based in the social network	Based in the individual
Loyalty to group	Strong	Weak
Virtues in interpersonal relations	Harmony	Speaking one's mind
Communication	High context	Low context
Consequences of trespassing	Shame	Guilt
Relationship vs. task	Relationship over task	Task over relationship
Politics and ideas		
Prevailing interest	Collective	Individual
Laws and rights	Supposed to differ across groups	Supposed to be the same for all
Role of state	Dominant	Small
Political power	Exercised by interest groups	Exercised by voters
Governance	Rule of man	Rule of law
	Discretion	Rules
Prevailing ideology	Equality over individual freedom	Individual freedom over equality
Societal goals	Harmony and consensus	Self-actualization
Power Distance Dimension (PD)		
	Large PD	Small PD
Family, school, and work place		
Inequalities among people	Are expected and desired	Should be minimized
Values	Authoritarian	Not authoritarian
Preferred organization	Centralized	Decentralized
Ideal boss	Benevolent autocrat	Resourceful democrat
Politics and ideas		
Privileges	Justified for the powerful	Not justified for the powerful
Sources of power	Ability to use force	Ability to give rewards
	Family and friends	Formal position
Means of reform	Changing top people	Changing rules
Political spectrum	Weak centre and strong wings	Strong centre
Prevailing philosophy	Hierarchy and stratification	Equality

table continues...



## Annex Table 1: continued

### Uncertainty Avoidance (UA) Dimension

	Strong UA	Weak UA
Family, school, work place		
Uncertainty	Feared	Tolerated
Rules	Emotional need for rules, even if they do not work	Minimal need for rules
Innovation	Resistance to innovation	Tolerance of innovation
Politics and ideas		
Laws and rules	Many and precise	Few and general
Citizens' attitude toward institutions	Negative	Positive
Citizens' protest	To be suppressed	To be accepted
Civil servants' attitude toward political process	Negative	Positive
Ideology	Nationalism	Internationalism
Nature of the truth	Absolute	Relative

Source: Compiled from Hofstede (1997).

Annex Table 2  
Data

	Dimensions of culture			Effectiveness of rules		
	Individualism -collectivism	Power distance	Uncertainty avoidance	Rule of law	Burden of regulation	Tax evasion
Range	6-91	11-104	8-112	2.8-6.8	1.9-5.2	2.3-6.1
Meaning of high index	Individualist	Large PD	Strong UA	Effective rules	Low burden	Low evasion
Africa	37	63	52	5.1	2.9	3.1
East Africa	27	64	52			
West Africa	20	77	54			
Mauritius				5.1	2.8	3.9
Zimbabwe				4.7	2.4	2.2
South Africa	65	49	49	5.6	3.5	3.1
Hindu	48	77	40	5.2	2.8	2.6
India	48	77	40	5.2	2.8	2.6
Islamic	23	79	56	4.4	3.7	3.3
Arab countries	38	80	68			
Egypt				4.6	3.8	3.4
Malaysia	26	104	36	4.5	4.0	4.3
Pakistan	14	55	70			3.0
Indonesia	14	78	48	3.3	3.2	2.4
Jordan				5.1	3.8	3.4
Latin American	19	71	84	3.7	3.0	2.6
Argentina	46	49	86	3.8	3.3	2.1
Brazil	38	69	76	4.7	2.9	2.3
Uruguay						
Mexico	30	81	82	3.8	3.2	2.3
Salvador	19	66	94	3.8	3.7	3.6
Peru	16	64	87	2.8	3.0	3.0
Cost Rica	15	35	86	4.9	2.8	3.0
Colombia	13	67	80	4.1	4.6	2.9
Venezuela	12	81	76	2.8	2.2	2.7
Panama	11	95	86			
Ecuador	8	78	67	2.8	1.9	1.8
Guatemala	6	95	101			
Bolivia				3.0	2.8	2.3
Orthodox	27	76	88	3.1	3.0	2.2
Yugoslavia	27	76	88			
Bulgaria				3.7	3.0	2.4
Ukraine				2.9	2.6	2.1
Russia				2.9	3.5	2.0
Sinic	27	64	54	5.5	4.3	4.7
Japan	46	54	92	5.6	3.2	4.3
Hong Kong, SAR	25	68	29	6.1	5.2	5.2
Singapore	20	74	8	5.8	5.2	6.1
South Korea	18	60	85	4.3	3.5	3.3

table continues...

Annex Table 2: continued

Western	70	37	60	6.2	3.7	4.0
USA	91	40	46	6.2	3.6	5.2
Australia	90	36	51	6.7	3.9	4.5
Great Britain	89	35	35	6.4	4.0	5.5
Canada	80	39	48	6.4	3.6	4.6
Netherlands	80	38	53	6.7	3.8	4.8
New Zealand	79	22	49	6.5	4.3	5.4
Italy	76	50	75	4.5	2.3	2.4
Belgium	75	65	94	5.9	3.2	2.4
Denmark	74	16	23	6.6	3.5	4.5
Sweden	71	31	29	6.0	3.6	3.3
France	71	68	86	5.6	3.0	3.5
Ireland	70	28	35	6.3	4.3	4.0
Norway	69	31	50	6.1	3.4	3.5
Switzerland	68	34	58	6.2	4.0	4.9
Germany	67	35	65	6.5	3.1	3.2
Finland	63	33	59	6.6	4.9	5.2
Austria	55	11	70	6.4	3.3	4.2
Israel	54	13	81	6.4	3.3	3.5
Spain	51	57	86	5.8	4.3	4.3
Greece	35	60	112	4.7	3.3	2.6
Luxembourg				6.8	5.2	4.8
Iceland				6.1	4.8	3.9
Slovak Republic				4.1	3.7	2.9
Czech Republic				4.0	3.5	2.9

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Sources: Hofstede (1997) and World Economic Forum (2000).

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