

## ECONOMICS AND CULTURE

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### ABSTRACT

The notion that something that cannot be measured does not exist seems to apply to the absence of consideration of culture in economics, where the role of institutions is at the center of the link between the two. Yet, economic prosperity, crisis, and deprivation result from human behavior, reflecting the outcome of social learning—a central concept of culture. Institutions and culture interact and evolve in complementary ways. Each can affect the process of exchange and transaction costs, which in turn determine economic performance. Although more work has been done to better understand the interrelation between economics and culture, most falls on deaf ears among mainstream economists, despite the fact that real-world cases show the critical role of this interrelation. This paper discusses demonstrates a deficiency of mainstream economics in its disregard of the role of culture and institutions.

*Keywords: Cultural economics; Social capital; Transaction costs; Economic performance.*  
**JEL Classification: B1; O30; Z10; Z13.**

#### *Article history:*

Received : December 10, 2018  
Revised : March 11, 2019  
Accepted : March 31, 2019  
Available online : April 30, 2019

<https://doi.org/10.21098/bemp.v22i1.1035>

## I. INTRODUCTION

*“If we learn anything from the history of economic development, it is that culture makes all the difference.”* — (David Landes (1998), “Max Weber was right on”)

Following the tradition of the marginalist school, abstraction in economics received a big push during the late 19th century, led by Stanley Jevons and Auguste Walras. This occurred despite Adam Smith’s strong belief in the significance of culture and Robert Malthus’ deep sense that culture affects the dynamics of population. David Ricardo was most instrumental in reducing economics to a culture-free abstraction. Alfred Marshall, at least judging from his early work, was another proponent of this view, although his subsequent “Industry and Trade” shows an increased awareness toward the complex cultural reality behind the abstraction of supply and demand, with a strong institutional flavor in the analysis.

This is rather puzzling because the core of economics is actually exchange, and the terms that permit an exchange are called the terms of trade, that is, the ratio of the price producers are willing to receive and consumers are willing to pay for the exchange. Indeed, while exchange is a fundamental part of economic behavior, perhaps with the exception of game theory and transaction cost theory, remarkably little attention is given to analysis of processes of exchange in the economics literature. Cornelisse and Thorbecke (2010) argue that the item exchanged, the actors engaged in the decisions, and the physical, social, technological, and legal environment within which the actors operate, matter in understanding transactions and outcomes. The combination of those elements, the formation process of the exchange, and the resulting transaction are considered an *exchange configuration*.

Mainstream economists contend that when there is a divergence between the equilibrium price and the actual price at which the exchange takes place, either excess demand or excess supply will be eliminated by price changes. But the actual process of adjustment in the exchange is not satisfactorily explained, despite the fact that, in reality, the whole process captures the satisfaction of those who trade. Such satisfaction is a complex subject, but is necessarily an integral part of any set of cultural relations involving trust, regret, deception, persuasion, and learning processes.

The difficulty of identifying the relation and causality among culture, institutions and economic performance has led to some work in this area. Becker and Murphy (2001); Akerlof and Kranton (2010); Streeten (2006); Bénabou and Tirole (2006); and the classic North (1990) on institutional economics are among the most influential in this area. More narrowly focused and applied work is also prevalent. Ang (2018); is one of many examples that tries to quantify the relationship between culture (individualism) and economic development (technological innovation), presumably through individual beliefs about the importance of innovation and creativity. Nevertheless, most work on cultural economics continues to fall on deaf ears among mainstream economists.

This paper discusses a deficiency of mainstream economics in that it overlooks the role of culture and institutions, which should be an integral part of economics.

## II. MAINSTREAM AND CULTURAL ECONOMICS

Despite their arguments that clearly foreshadow cultural economics, it is unclear why institutionalists like Thorstein Veblen (in the US) and Max Weber (in Europe) failed to influence the mainstream of economics during the time. Indeed, one of the critical questions in cultural economics is about the extent to which a particular system of institutions that produce changes in culture will survive or fail precisely because of such changes. Theoretically, it is the institutional system of legitimacy that will survive and dominate, not the dynamics of power and wealth; without legitimacy neither power nor wealth can be preserved.

This is particularly clear in monetary economics, where the use of formalistic mechanical models is prerequisite and there is an almost complete lack of interest in the cultural aspects within which the institutions of money and banking actually operate. The models are filled with statistics and correlation (often confused with causation) with little attempt to examine the actual processes involved. This is irrespective of the fact that one cannot truly understand what is going on in the banking sector unless we treat bankers as human beings and try to understand how they really think. The same applies to players in the capital markets.

The move from partial equilibrium to general equilibrium in economics is another example of neglect of the cultural dimension. While the overall quantities produced and consumed are (correctly) not taken as resulting from individual producer and consumer decisions (but rather the result of the interactions of such decisions), it is often assumed in the corresponding model that the choices of a "representative" utilitymaximizing individual coincide with the aggregate choices. The Dynamic Stochastic General Equilibrium (DSGE) model, a poster child of central bank's tool for policy analysis, is a noted example. The heterogeneity of agents' behavior and culture is considered irrelevant. This is not only unjustified but also ill-suited for a serious policy making that deals with problems involving coordination failures such as unemployment, under-utilization, inequality, financial instability, and bankruptcy.

For most mainstream economists, when complexity increases and interdependence grows, new variables, parameters and equations are added and non-linearity is introduced, with the expectation that the model's predictive power will strengthen. Little effort is made to delve into the changing patterns of behavior as part of possible mutations in the social system, where the process of selection may involve increased vulnerabilities, bankruptcies, crisis, or simply a loss of legitimacy.

Even in taxation, a system that emerges from the interaction of different governmental subcultures, and where the tax system itself is the result of a long historical process involving the changing culture of governments, and members of parliament and their constituents, the efficiency of "one-way transfer" depends not only on the perception of threat (legal sanctions for failure to pay tax), but also the culture of tax collectors. The great mass of individuals paying taxes with a fair degree of fidelity is itself clearly a cultural phenomenon. Yet, most research on tax issues tends to be exclusively financial and economics-based, void of any cultural context.

In a more micro and industrial organization subject, research works have actually come very close to directly connecting culture and economic concepts,

although these are more of the business schools' domain, e.g., marketing, industrial organization, and labor economics, where there is a long tradition of studying such areas as collective bargaining, labor unions, culture of firm and factory. However, even in these fields, mechanistic approaches have encroached on the analysis to the point where no collaborative work with sociologists.

Yet, in supply–demand theory, for example, when excess supply occurs, producers may alter their preference by avoiding efficiency efforts, and consumers may not follow the standard law of supply–demand, as they may not increase their consumption despite the downward pressure on price. In such circumstances, preferences should not be taken as the only determinant of an economic process as in a standard optimization model; rather, it should be learned during the process of cultural transformation. Thus, the culture-affected learning process could generate outcomes different from a standard solution.

The emphasis on learning is the crucial difference between mechanistic economics and cultural economics, implying that cultural economics is evolutionary in nature. Learning is part of social evolution, which is more complex than biological evolution. It occurs more slowly because people, let alone societies, are not willing to change easily, due to their realistic appraisal of the uncertainties arising from such change, which is a standard problem in economic development.

In contrast, mechanistic economics relies on its predictive power based on the derived parameters (assumed stable) of difference or differential equations. This contradicts the fact that in any dynamic process, when strain increases, the parameters in the system change. More importantly, the implied adjustment may create further strain in the same part or in other parts of the system. If a crisis eventually occurs, the absence of stability (order) with constant parameters may not tell us much about the stability that is absent. Even if no adjustment is taking place, something important about the social system may have been generated by the absence of such adjustment. That is, what does not happen can be more interesting than what does happen.

### **III. CAUSALITY**

As in any relation between two components, culture and economics, the third, fourth and other components may have some role as intermediate variables. This applies to the link between culture and economic performance as well. There is also the common problem of direction of causality.

On the first issue, at the outset, it is necessary to define culture and economic performance. Various narratives for culture have been proposed, from which the following elements are relevant: customary beliefs and values, preferences, long duration of consistency in cultural traits and groups—whether social, ethnic or religious. The relevant elements in economic performance are level and growth of output or income, savings, and income distribution. In some cases, the probability of something positive emerging is also used, such as having a greater number of entrepreneurs.

Intermediate components relevant to identifying the link between culture and economic performance include prior beliefs, religion, ethnicity, preferences, and trust. Individually, these components may not have an independent role, but they

can function as a coordinating device to make societies play the same “game” in the face of different conditions and focal points.

The importance of prior beliefs cannot be overstated, as many decisions (and thus the corresponding outcome and performance) are based on such priors (e.g., which technology to use, what measures to adopt to mitigate the effects of climate change, how to deal with different economic shocks, what strategy to adopt to cope with an aging population). Here, culture plays a major role in forming individual beliefs, even in new environments and across generations. Thus, prior beliefs can be an important channel of cultural influence on economic performance. Yet, economists generally do not have much to say about such priors. They typically assume that individuals have common priors.

Trust is an important component arising from priors. Many even believe that it is through the concept of trust that culture enters the economic discourse. Research demonstrates the contribution of the level of trust in a community to economic performance (e.g., La Porta et al., 1997; La Porta et al., 1999; Zak and Knack, 2001), although most such research does not elaborate the mechanism through which measured trust is positively correlated with economic performance. What remains debatable is whether trust is an inherited cultural variable or is developed through adoption of a proper legal system. Some also argue that trust is the outcome of individual or societal interactions.

The significance of trust in economics is made clear by Arrow (1972): “Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time.” International trade is an example of an area where trust is quite important. But it was the seminal work of Putnam (1993, 2000) that put trust at the center of the discussion by considering it as a form of social capital capturing the value and relationships of resources, where social networks play a central role in the production of public and common good. The constituent elements of social capital, over which people have more control than over culture, are trust, norms, and networks.

In the current era of information technology, priors including trust can be influenced or enhanced by the availability of information (e.g., “big data” and “internet of things”). Examples of online trade and transactions abound where reviews and reputation may alter the beliefs of people or customers. Even in political elections, the use of “big data” combined with complex algorithms has become widespread, and it has proven fairly effective.

The problems with causality are no less critical than the problems of definition. The first problem is the difficulty in separating culturally based beliefs from rational expectations. Whether trust is culturally driven or rational-prior driven by environment with a prevailing degree of trustworthiness is not easy to determine. It is generally the case that the idiosyncratic component of trust tends to increase when societies share the same cultural trait (e.g., religion), and decreases with genetic distance in terms of ancient cultural aspects. Level of education also matters: the role of inherited cultural aspects in the formation of priors tends to diminish as society becomes more educated (reduced dependence of trust on cultural variables).

Even if cultural variables and measures of economic performance are highly correlated, one does not necessarily cause the other. Two events occurring simultaneously does not imply causality.

Another serious conundrum is with regard to the direction of causality, or what econometricians label the endogeneity problem: “which affects which.” The debate about whether culture affects economics or vice versa has a long history. Some propose that technology determines the type of social structure and dominant culture. In supporting the argument that the steam-mill produces capitalism, Karl Marx (1859) held this view. In contrast, Max Weber (1905) and Polanyi et al. (1957) held the opposite line of thinking. To the extent that cultural aspects like religion are considered important to the establishment of markets as well as in moderating market excesses, these authors argue that culture—in this case religion—played a critical role in the development of capitalism. Their explanations are powerful, and the examples provided are quite persuasive; yet, they fell on deaf ears among mainstream economists.

As expected, each camp attempted to have their idea vindicated. Economists of the Chicago School tried hard to endogenize beliefs and preferences (Lucas, 1976; Stigler and Becker, 1977). Some went further by showing that religious and social norms are the result of a group-level optimization. Others extended the theory of human capital by emphasizing investment in social skills and social interactions. Those who were more econometrically inclined emphasized the use of proper econometric techniques to identify the direction of causality, among others by employing a set of intermediate variables as the “instrumental variables,” or by examining historical exogenous shocks in their models. But the presence of complementarities between culture and economic performance often hinders identification.

While differences between the two camps may never be reconciled, active debate on the link between culture and economics continues. Most of this debate emphasizes the interaction between culture and institutions.

#### **IV. ROLE OF INSTITUTIONS**

Institutions are meant to facilitate human interaction by maintaining patterns that regulate societal behavior (North, 1990; Azis, 2000, 2008). These are the “rules of the game in a society” by promoting certain behaviors and prohibiting others. There are formal institutions (e.g., bank regulation, tax system, accounting rules) and informal institutions (e.g., codes of conduct, habits, traditions, norms).<sup>1</sup> While most analyses focus on the former, the latter can be more important in understanding the role of institutions in shaping economic performance. Enforcement is another critical component of institutions. Even well-established rules and regulations can be rendered ineffective if enforcement is weak. Two systems with similar institutions may produce different economic performance because of differing enforcement.

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<sup>1</sup> An organization, defined as a group of individuals bound together to achieve some objective, is also part of institutions. An organization like government can influence other institutions through which economic performance is shape

To the extent formal and informal institutions are shaped by ideas and ideologies, not created in a vacuum, culture enters the equation. Through culturally affected ideas, individuals use their subjective mental constructs to interpret the world around them and make choices. Arguably, institutions determine the extent to which ideas and ideologies, and hence culture, are important.

Informal institutions come from “socially transmitted information” and are part of a heritage or culture. In the case of formal institutions, they are also linked with the prevailing political system. For example, in federalist systems, markets are fostered through competition for economic organizations at the sub-national level. In other systems, room for pleasing powerful interest groups may be more ample. The resulting economic performance under different systems (hence different institutional arrangements) is likely dissimilar. In this respect, the resulting economic performance can be associated with the efficiency of the outcome.

Contrary to neo-classical economic theory, negotiations required to reach an efficient outcome are not costless. For example, there are costs for learning (by consumers) about the quality—and eventually the price—of goods to be exchanged. It may take some time before the actual exchange occurs. There can be also a bargaining process as part of negotiations. This also entails costs.

The problem of information asymmetry can cause observed costs to deviate from the true costs, making them more difficult to measure. Even if both parties are honest, there is always something with respect to enforcing the agreement that still needs to be specified, either implicitly or explicitly. This is also not costless. When a dispute arises and a settlement (requiring lawyers) is needed, the costs can further multiply.

All the above costs are known as transaction costs; they are usually high and not always reported (not internalized), especially in developing countries. In some cases, personalized transactions are still the rule rather than exception. High transaction costs lead to unfavorable economic performance. Since only at zero transaction costs can an efficient outcome prevail --the well-known Coase (1960) theorem, attempts to lower transaction costs are preferred. The most common method is through establishing clear property rights (also often deficient in many developing countries) to facilitate the smooth functioning of markets.<sup>2</sup>

High transaction costs can also be linked to the size of the unproductive informal sector. Small business operations and poor individuals, including poor migrants, are “forced” to remain small and informal. Transaction costs to enter the formal sector are too high (e.g., obtaining permits, which may require paying bribes and be very time-consuming). Unsecured assets and a lack of formal documents also diminish incentives to expand, and bank credit is difficult to obtain under such circumstances. Thus, informality persists. So do inefficiency and low productivity.

In a dynamic context, an institutional framework ensuring that technology can advance (‘creative destruction’) is also frequently absent in developing countries. Free-entry and free-exit hardly prevail. Firms with privileged access to those in

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<sup>2</sup> In this context, transaction costs can be alternatively defined as the costs of transacting activity, which includes defining, protecting and enforcing property rights to goods. It takes resources to measure the attributes of goods and additional resources to define and measure rights that are transferred (in an exchange). Such costs are uncharacteristically high because one party knows neither the complete attributes of goods and services nor the characteristics of the agent and the other party.

power survive by patronage through monopoly rights, soft budgets, or special concessions. For them, no innovation is needed to survive. More seriously, they resent any policy measures intended to enable innovation to raise productivity when such measures threaten their survival. Power and influence enable them to keep away potential competitors.

In short, culture-influenced institutions can affect transaction costs, and in turn economic performance, in a static and dynamic sense. The latter works through organizations' decisions about technology and innovation.

Note that one cannot claim a superiority of direction of causality between institutions and culture, because the two interact and evolve in a complementary way. The relation also involves mutual feedback effects: depending on the type of institutions, culture may evolve in differing ways, and different cultures may cause institutions to function differently.

In this context, a more relevant economic performance measure is productivity. While it is less directly observable compared to standard variables like output and income, productivity involves attributes highly relevant to cultural traits and cultural capital, particularly social capital.

In prosperous communities, Putnam (1993) argues that social capital is like "physical capital and human capital—tools and training that enhance individual productivity." This author goes on to state that social capital refers to "features of social organization, such as networks, norms, and trust, that facilitate coordination and cooperation for mutual benefit." This description is unarguably loaded with important implications.

By giving it the "same status" as other traditional inputs (capital and labor), social capital contributes to productivity through a production–function setting used extensively by economists. It also highlights the significance of individuals' "participation," which will form the group's ability to work jointly through "collaborative effort," as capital. Failure to do so will result in disappointing "productivity performance." Absent trust-based relations, the system tends to focus on "short-term self-interest" and individual transactions, eliminating the potential and opportunity for accumulation and "innovation" processes as in standard capital theory. While networks of institutions are important, their presence in no way assures collaboration when "commitment and coordination" is limited. This translates into obstacles for many developing and emerging markets, where weak capacity, including the state's capacity to effect "coalition building" needed for "institutional upgrading" to support innovation must face a "growing and diverse power of influence among social groups and business communities."

All the above requisites and conditions (designated with quotation marks) reflect institutional quality and social capital, which, through implied transaction costs, determine the extent to which a country is able to sustain productivity growth to improve society's welfare.

## V. CONCLUSIONS

Culture and economics are closely linked. Yet, economists have long been reluctant to study the interrelation between them. This is partly because a testable hypothesis with measured data that can be proven or disproven is hard to construct, let alone



the difficulty in defining the term “culture.” This is unfortunate, as it reflects the notion that something that cannot be measured does not exist. The reality is: attempts to alter the incentive system through a policy may not on its own be enough to improve the economic performance when the process is incompatible with the prevailing cultural and institutional factors.

Faced with the reality of more complex relations and growing interdependence, mainstream economists opt for adding new variables, parameters, and equations. When pressed further, they introduce non-linearity into their models. Little effort is made to delve into behavior that reflects the outcome of social learning—a central concept of culture—where a set of cultural relations involving a learning process as part of social evolution, which is more complex than biological evolution, is important. The emphasis on learning implies that, unlike mechanistic economics, cultural economics is evolutionary in nature.

The role of institutions lies at the center of the link between culture and economics, particularly in the direction of causality. Institutions and culture interact and evolve in a complementary way, not through a one-way causality. Culture-influenced institutions can affect transaction costs, and in turn, economic performance. In a dynamic setting, through organizations’ decisions about technology and innovation, a set of requisites reflecting institutional quality and social capital has an important role in influencing productivity growth and hence societal welfare. One such requisite is individual participation, which will form the basis of the group’s ability to work jointly through collaborative effort. The required trust relation is in sharp contrast with short-term, self-interest driven transactions.

Although more work has been carried out to better understand the interrelation between economics and culture, albeit deficient of the precise mechanism how the interrelation really works, most such work falls on deaf ears among mainstream economists. Abstract culturalism and economic determinism should neither be separated nor contrasted. It is mind-boggling how economics can be reduced to a culture- and institution-free abstraction when there is abundant evidence from real-world cases that shows otherwise.

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