

# Corporate Culture, Societal Culture, and Institutions<sup>†</sup>

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According to North (1991), institutions foster cooperation in settings without full information and repeated interaction. North classifies institutions as informal (sanctions, taboos, customs, traditions, and codes of conduct) and formal (constitutions, laws, property rights). Informal institutions, which we will refer to as culture, comprise societal values (which affects intrinsic motivations) and social norms. In primitive and simple societies, where personal ties and ostracism are enough to enforce cooperation, culture is the only mechanism. Intrinsic motivation and social norms work well when the rules they prescribe are simple to apply, when they are widely shared, and when social sanction (ostracism or exclusion) is a powerful threat. While these conditions hold in small primitive societies, in most modern societies, they do not. To function, modern economies need rules that take into account many contingencies. These complex rules make the verification process difficult requiring specialized (and dedicated) agents. Also, the development of long distance trade requires more impersonal contract enforcement mechanisms that are formalized through political and legal institutions. When economies evolve, formal institutions replace many informal mechanisms of enforcement. Indeed, a dominant thesis argues that the economic success of nations is not driven by culture or value systems but rather by inclusive political institutions (Acemoglu et al. 2001) or by effective legal institutions (La Porta et al. 1998).

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## I. Culture Matters

Yet, evidence shows that culture still plays a direct role even in societies characterized by sophisticated formal institutions. Guiso, Sapienza, and Zingales (2004) show that more cooperative social norms affect the use and the availability of financial contracts in Italy. Social norms not only affect individual beliefs and expectations, but are also transmitted to future generations (Bisin and Verdier 2000; Tabellini 2008), as the literature on the behavior of immigrants has documented (e.g., Giuliano 2007; Guiso, Sapienza, and Zingales 2006; Algan and Cahuc 2010). This intergenerational transmission is what makes culture so persistent (Guiso, Sapienza, and Zingales 2008a). One culturally-determined dimension is generalized trust (GS), the expectation that a random member of an identifiable group is trustworthy (Guiso, Sapienza, and Zingales 2009). GS is correlated not only with aggregate economic outcomes, but also with micro ones. For example, Guiso, Sapienza, and Zingales (2008b) show that individual trust toward others helps explain stock market participation in modern societies, especially among the wealthy. The evidence that cultural norms and beliefs affect economic behavior together with the evidence documenting the long lasting effect of social norms (Nunn and Wantchekon 2011; Voigtländer and Voth 2012; Grosjean 2011; Alesina, Giuliano, and Nunn 2013; Guiso, Sapienza, and Zingales 2008a) suggest that culture must play a role in explaining persistent differences in the economic success or failure of nations. But how does it relate to legal institutions?

## II. Culture As a Primitive

La Porta et al. (1998) identify a remarkable pattern of correlations between a country's legal origins and its protection of property rights. They attribute it to the difference in legal traditions. To what extent does this difference

simply reflect cultural differences? After all, many countries (such as Japan and China) chose which legal tradition to adopt based on cultural affinities. Others, for the same reason, shifted legal traditions (like Italy). Similarly, Acemoglu, Johnson, and Robinson (2001), attribute economic success to the type of legal institutions designed by the colonizing power. Yet, if this was the only factor, it would suffice to imitate the US Constitution to prosper. Many Latin American countries tried and failed. Social norms are needed to sustain legal norms. When laws are in conflict with norms, compliance and enforcement are weaker (Acemoglu and Jackson 2014). In the United States the cultural foundation of the law is illustrated by the power of the jury to disregard the law in convicting or absolving (jury nullification).

### III. Direction of Causality

Thus, culture underpins and colors the law, but legal institutions can shape cultural norms.

Despite the abundant literature on the role of culture, it is difficult to sort out the direction of causality. One of the key issues is where culture comes from. One source is production technology, such as the plow (Alesina, Giuliano, and Nunn 2013). Another is a political or military shock such as slave-trader raids (Nunn and Wantchekon 2011), a despotic foreign domination (Putnam 1993; Guiso, Sapienza, and Zingales 2008a; Grosjean 2011), or the adoption (or imposition) of a new religion (e.g., Basten and Betz 2013). But these “cultural revolutions” are rare events, often taking place over several centuries with many other things occurring at the same time. Lacking sufficient observations of cultural changes, to try to identify the effects of culture on economic (and other) outcomes, economists have compared the behavior of individuals who live in the same country or region (and thus share the same institutional environment) but moved there from countries or regions with different cultures (e.g., Guiso, Sapienza, and Zingales 2004), relying on the fact that culture, unlike institutions, moves with individuals and persists. This empirical strategy contrasts how behavior varies as culture differs across individuals but says nothing about what leads culture to change. Yet, without clear knowledge of what triggers cultural change and how new norms and beliefs

replace older ones, it is impossible to understand whether and when cultural norms can be relied upon as policy instruments and how they relate to legal norms. Do cultural norms crowd out or strengthen legal norms? Which type of norms—cultural or legal—are more effective in pursuing a certain policy, such as increasing tax compliance or fighting corruption? If new cultural norms and beliefs clash against existing ones, how does the political economy of cultural revolutions work?

The role of culture and what leads it to change have a greater hope to be identified and understood where the environment is simpler, culture can change at a higher frequency, and it is easier to identify the agent that can trigger the change. Corporations provide such an environment.

### IV. The Corporate Culture Lab

Corporations are micro societies. On a smaller scale, they share the same challenge to foster cooperation. Like larger societies, they try to use both intrinsic motivations and norms (Kreps 1990; Kreps 1997; O’Reilly and Chatman 1996; Erhard et al. 2010; Guiso, Sapienza, and Zingales 2014), as well as formal incentives (compensation schemes and promotion), which can be thought of as the formal institutions of a corporation. Unlike large societies, however, corporations offer hopes identify the link between culture and formal institutions.

First, the creation of a firm is a moment in which the founder has the power to set values on a blank slate. Identification of this moment is easier (it is recorded, it is recent) than identifying when and who sets the values of a large community (e.g., a country). Second, culture is easier to change in a corporation. Through hiring and firing, corporations can select values by selecting people, avoiding the more difficult strategy of changing their minds, and can punish them if they do not adapt (e.g., by deferring promotion). In large societies, only the difficult strategy is available, and slow adaptation is hard to punish, unless slow-adapters are outlawed, which makes culture and law indistinguishable. Third, it is easier to establish the link with performance. Performance is continuously recorded, for the corporation as a whole and often for its segments and divisions in order to implement compensation schemes. Hence, one can study the role of shared norms and beliefs

while controlling for the power of economic incentives. Finally, because firms break up and merge much more often than countries, an observer can collect exposure of a firm to a new culture much more often than one can for larger societies.

## V. Conclusions

In the last 20 years, economists have resorted to the role of institutions to explain the causes of national prosperity. Thus far, the emphasis has been on formal institutions. We claim that informal institutions (culture) are at least as important. While disentangling the effect of the two is difficult in large societies, it can be done inside corporations. Thus, corporate culture is not only interesting per se, but also a laboratory to study the role of societal culture and the way it can be changed.

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