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Thrift culture and the size of government

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ABSTRACT

We consider the role of culture in determining the size of government. To that purpose, we develop three theoretical hypotheses on the relationship between "thrift" (our proxy of culture) and government consumption. We then test these hypotheses using panel data for 62 countries. Our main finding is that government consumption is higher in thriftier countries. The positive effect of thrift on government consumption weakens in more corrupt or more democratic societies.

1. Introduction

The widespread use of fiscal policy in response to the Global Financial Crisis (GFC) and the subsequent debt crisis observed in various European countries has reignited the debate on the size of government. The existing literature explains government size in terms of economic variables (see for instance Calderon et al., 2004; Easterly and Rebelo, 1993; Rodrik, 1998; Shelton, 2007) and politico-institutional factors (e.g. Alesina, 1988; Baskaran, 2013; Drazen, 2001; Perotti and Kontopoulos, 2002; Persson and Tabellini, 1999; Roubini and Sachs, 1989). The purpose of this paper is to extend the analysis to consider the role of culture. More specifically, the paper investigates how one particular cultural trait, "thrift", affects government expenditure. Thrift is the wise-management of money and resources and it is also a summary concept for all psychological factors that affect saving (Anderson and Nevitte, 2006). On the one hand, thriftier individuals are likely to prefer more parsimonious governments, implying a negative effect of thrift on government expenditure. On the other hand, thrift could also mean that individuals prefer to substitute their own consumption with government consumption; in this case thrift would result in increased private savings and larger governments. We present evidence from a large panel of countries to show that, on average, the second effect prevails. However, the overall impact of thrift on government expenditure is moderated by the level of corruption and quality of the polity.

The paper fits within an emerging branch of the literature that links culture and institutions to explain economic outcomes and processes. In fact, the literature on the economic effects of culture (Knack and Keefer, 1997; Guiso et al., 2006; Tabellini, 2008) and the literature on the politico-economic determinants of fiscal policy (as aforementioned) have so far developed largely in isolation of each other. The innovative contribution of this paper is to bring these two strands together in order to analyze the role of culture in fiscal policymaking. Culture is here taken as an underlying driving force that shapes both (aggregate and individual) preferences over policy and the institutions that broadly determine the policy decision-making process.

Two main theoretical considerations of the role of culture underpin our empirical exercise. Firstly, culture reflects people' values and beliefs, which directly influence their economic preferences and hence contribute in shaping governments' preferences and actions in both democracies and non-democracies. The decisions of policy-makers themselves also depends on their own values and beliefs, which are bounded by their country's culture (Guiso et al., 2016). Secondly, culture influences institutions, which in turn affect the policy making process of a nation (Tabellini, 2008; Alesina and Giuliano, 2015). Therefore, culture is potentially a critical determinant of fiscal policy in general. However, previous empirical work has focused on explaining how culture affects the extent of redistribution/welfare support in a society (Alesina and Glaeser, 2004; Alesina and Angeletos, 2005b; Alesina and Giuliano, 2015; Giuliano and Spilimbergo, 2014). The cultural variables used in these papers focus on redistribution preference or luck versus effort beliefs in wealth generation. To the best of our knowledge, no previous paper has looked at the relationship between culture and government expenditure or, more specifically, the relationship between thrift (our proxy for culture) and government size.

The rest of the paper is organized as follows. Section 2 develops some theoretical hypotheses. Section 3 introduces the methodology. Section 4 presents the empirical results. Section 5 concludes and proposes further research directions.

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2. Hypotheses

The literature concerned with the economic role of culture has so far focused on how cultural values affect individuals' preferences over economic outcomes. Provided that a link between economic outcomes and policies exists, and that individuals are aware of it, then preferences over outcomes must correspond to preferences over policy. The extent to which preferences over policy translate into actual policy actions is a function of the responsiveness of government to citizens, which in turn might depend on institutional and governance quality. Hence, cultural values, by influencing individuals' preferences over economic outcomes and hence policies, should ultimately drive policymaking.

While there are studies that link culture to preferences over redistribution and welfare, as noted above, there is no study that specifically investigates if culture is a driver of fiscal policy. However, one can think of several cultural traits that influence an individual's view over the use of public money. Cross-country differences in these cultural traits might then contribute to explaining observed differences in the size and scope of government, the level of public deficit and debt, and the composition of government expenditure. In this paper, we narrow our analysis to a particular cultural trait and its impact on a specific dimension of fiscal policy. The cultural traits we are interested in are the attitude of individuals towards money, how much they value money, how wisely and carefully they spend and save, and how willing they are to delay what they would like to do with their money today in exchange for a better tomorrow. We use the notion of "thrift" to summarize those traits: thriftier individuals are more willing or likely to delay gratification and to use wealth wisely and parsimoniously.[1] The specific dimension of fiscal policy that we consider is public expenditure. We take this as a broad measure of the size of government. We also consider some particular categories of spending (like health and education), which can give us some indicator of the scope (in addition to the size) of government. We acknowledge at the outset that a study of how thrift might affect other dimensions of fiscal policy (like taxation and debt) is an interesting avenue of future research. In the rest of this section, we develop three hypotheses on how thrift is expected to affect the level of public expenditure.

The preference of thrifty individuals towards government expenditure can be of two types. First, they might prefer a government that shares their view on money; that is, a thrifty government that spends wisely and, presumably, cuts costs. Second, they might prefer a government that is less parsimonious and that spends on their behalf; that is, a non-thrifty government that provides them with consumption opportunities that they would not be willing to finance out of their own pocket. We argue that there are two reasons why the second type of preference is likely to prevail:

1. There are goods and services that thrifty individuals are likely to want to consume that a non-thrifty government can supply at a lower cost (for individuals) than the cost individuals would incur if they were to supply these goods and services privately. For instance, public education is likely to cost less to a thrifty individual than private education (the cost of public education being taxes). So, a thrifty individual would like to have a government that is prepared to spend more on public education, because the cost of taxes is less than the cost of having to pay for education privately. The same applies to other public goods and services, like health and, in all likelihood, infrastructure.
2. If individuals' utility is determined by total consumption (i.e. consumption of public and privately supplied goods and services) and private and public consumption are substitutable (at least to some extent), then rational, thrifty individuals would prefer a government that spends more so that they are able to achieve the optimal level of consumption with less private consumption. This in turn gives the thrifty individual the opportunity to save more today and use savings in the future or to pass them on to the next generation.

The preference for a non-thrifty government would then result in a positive effect of thrift on government expenditure. Our first hypothesis can be therefore formulated as follows:

H1. Countries with a stronger thrift culture have larger government expenditure, particularly on "big-ticket" items such as public education and public health.

There are two important qualifications to this argument, which generates two additional hypotheses. The idea that thrifty individuals prefer the government to spend on goods and services that they would be able to supply at a higher cost holds to the extent that the quality of publicly and privately supplied goods and services is comparable. In other words, thrifty individuals might be willing to allow the government to spend on their behalf, but only if the government is capable of spending "well". This suggests that if a government is perceived as incompetent, or corrupt, and hence unable to use public money to supply good quality goods and services, then thrifty individuals are less willing to let it spend the money collected from their taxes.[2] Accordingly, we formulate a second hypothesis:

H2. The positive effect of thrift on government expenditure weakens as the quality of governance decreases; that is, bad governance reduces the extent to government expenditure increases in countries with a stronger thrift culture

The second qualification concerns the possibility that points 1 and 2 above emerge not as individuals' preference, but as governments' preference. If thrifty individuals do not internalize the positive externalities of investment in education and health, or the need to achieve a certain level of total consumption in order to support aggregate demand, then they might prefer a thrifty government to a non-thrifty government. The government instead internalizes the cost of low consumption levels and would choose to increase public expenditure in response to low private consumption. However, its ability to do that is constrained by the risk of being voted out office. For this reason, the effect of thrift on the size of government might actually be stronger in autocracies, encapsulated in our final hypothesis below:

H3. The positive effect of thrift on government expenditure is stronger in less democratic polities.

3. Data and methodology

This section describes the data and methodology used to test the hypotheses. It starts with regression equations followed by a discussion on estimation issues. Finally, data is presented alongside descriptive statistics.

3.1. Estimating equation and estimation issues

The baseline model is as follow:

$$y_{i,t} = \beta_0 + \beta_1 x_{i,t} + \beta_2 Z_{i,t} + \varepsilon_{i,t}$$

where i denotes a generic country and t denotes time, y is a measure of

[1] Thrifty individuals have different saving motives. In general, saving is used for future consumption (life-cycle motive or inter-temporal motive) or passing along to next generation (bequest motive) (see Browning and Lusardi, 1996; Canova et al., 2005; Gale and Scholz, 1994 for details).

[2] Dzhumashev (2014a) shows that corruption shapes that effectiveness of public consumption. Rajkumar and Swaroop (2008) present empirical evidence that public consumption has no impact on health and education outcomes in corrupted countries. Thus, voters' preference on government size would depend on institutional quality.