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Book Reviews

Editor's Note: Guidelines for Selecting Books to Review

Occasionally, we receive questions regarding the selection of books reviewed in the *Journal of Economic Literature*. A statement of our guidelines for book selection might therefore be useful.

The general purpose of our book reviews is to help keep members of the American Economic Association informed of significant English-language publications in economics research. We also review significant books in related social sciences that might be of special interest to economists. On occasion, we review books that are written for the public at large if these books speak to issues that are of interest to economists. Finally, we review some reports or publications that have significant policy impact. Annotations are published for all books received. However, we receive many more books than we are able to review so choices must be made in selecting books for review.

We try to identify for review scholarly, well-researched books that embody serious and original research on a particular topic. We do not review textbooks. Other things being equal, we avoid volumes of collected papers such as festschriften and conference volumes. Often such volumes pose difficult problems for the reviewer who may find herself having to describe and evaluate many different contributions. Among such volumes, we prefer those on a single, well-defined theme that a typical reviewer may develop in his review.

We avoid volumes that collect previously published papers unless there is some material value added from bringing the papers together. Also, we refrain from reviewing second or revised editions unless the revisions of the original edition are really substantial.

Our policy is not to accept offers to review (and unsolicited reviews of) particular books. Coauthorship of reviews is not forbidden but it is unusual and we ask our invited reviewers to discuss with us first any changes in the authorship or assigned length of a review.

A General Economics and Teaching

Beyond the Invisible Hand: Groundwork for a New Economics. By Kaushik Basu. Princeton and Oxford: Princeton University Press, 2011. Pp. xv, 273. $29.95. ISBN 978–0–691–13716–2. *JEL 2011–0001*

A good magician hides nothing; he succeeds by drawing spectators' attention to what he wants them to see—the rabbit jumping out of the hat—while distracting their attention from other things—how the rabbit got into the hat in the first place. In *Beyond the Invisible Hand: Groundwork for a New Economics*, Kaushik Basu argues that "the central tendency" of journalists and the economics profession is to draw attention to the efficiency properties of the textbook model of a perfect market system, and to distract attention from the conditions that must be met for those efficiency properties to hold: "In some ways it is like a magic show" (pp. 4, 15). The fundamental theorems of welfare economics provide conditions under which selfish behavior leads to efficiency, but these conditions are never and can never be met. To emphasize what often goes unnoticed or, if noticed, is quickly suppressed or forgotten, Basu restates the first fundamental theorem (the "invisible hand" theorem) in this way. Assuming purely self-interested individuals, "[*i*]*f we have a competitive economy where the*

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freedom of individuals is restricted so that they are not allowed to choose from all the alternative actions available to them but instead are simply allowed to choose a point from their budget set, then . . . the resultant equilibrium will be Pareto optimal" (p. 25).

This if-clause is extremely restrictive. It is not just that many, if not most, interactions involve noncompetitive elements, which is a well-understood limit on the invisible hand theorem. It is also that individuals do many other things besides choosing bundles of goods in their budget sets: they create norms, form group identities and foist such identities on others, discover ways to expand the opportunity set, steal, spread rumors about their competitors, and so on. Moreover, many individuals are not purely self-interested.

Basu argues that most economists and journalists do not focus on the highly restrictive "if" clause in the theorem but allow the "then" part of the proposition to become a part of their reality. There is no general result that, in the larger action space that Basu describes, outcomes of markets will be efficient—either with respect to self-interested preferences or with respect to a richer set of preferences. Moreover, the recent experience in Russia suggests that economists know little about how to create the legal foundations on which a market economy depends (Karla Hoff and Joseph E. Stiglitz 2008). These grand illusions are not harmless. They have implications for the way societies craft policy and think about globalization.

Basu's stated purpose in this book is two-fold. First, he wants to change popular intuitions about the economy in order to disabuse individuals of their illusions about the invisible hand. Second, he wants "to provide theoretical foundations, however rudimentary," that could lead to an understanding of a fairer economic system and to the activism to bring it about (p. 197). The book addresses, in nontechnical language, a wide range of issues: the limited power of the law, the importance of norms, the "chemistry of groups," the justifiable limits to the principle of free contract, and globalization. These discussions would be of interest to professional economists as well as general readers.

Basu presents, a number of times, examples in which an invisible hand (every one acting individually to do the best for himself) leads to a Kafka-like social outcome that is perverse and unfair. To wit: New firms come to an area. Their activities lower the groundwater level. As farmers' incomes decline from the resulting shortage of water, the farmers shift to working for the firms. *This looks like economic development, but in fact the workers are worse off.* There is an interesting relationship to the analysis of Martin L. Weitzman (1974), who showed how most people could be worse off under the efficient enclosure of the commons than under inefficient free access rights. Whether the enclosure movement enhanced efficiency is itself controversial (Robert C. Allen 1982).

Here is a second example. Suppose that no individual has a taste for discrimination and the market is competitive. So far, so good. Now suppose that there are two cultural groups in the society and that the following (supermodularity) assumption holds: the gain to a customer from dealing with a given service-provider is larger if the provider can obtain credit from a lender, and the gain to the lender is increasing in the provider's ability to attract customers. In this case, a belief that *others* discriminate against a certain social group will lead each individual to discriminate against members of the group. This is simple business sense: if others discriminate against him, a service provider is less likely to gain credit and establish a large customer base and so he provides a less valuable service to everyone. There is a disjunction between individual motives and social consequences, but now the two outcomes are opposed, and the invisible hand is perverse. A collective belief that others wish to discriminate leads everyone to discriminate, even though no one has a taste for discrimination and no one even believes that the two groups are different in any material way.

Destructive of the mode of reasoning in standard economics are the examples in this book in which social outcomes change preferences. These examples run counter to a central doctrine in orthodox economics, that of methodological individualism. Methodological individualism is the doctrine according to which every social regularity is founded in individual motivations and behavior. To explain economic outcomes, one begins by characterizing the preferences of individuals and then goes on to describe the

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society that the individuals will create. The preferences remain the same regardless of the society that emerges. But there is recent compelling evidence (and also some theory) that preferences do not remain the same regardless of the society that emerges. Peer group effects, institutions, culture, role models, and even slight changes in social contexts that cue different views of the world and different self-concepts may all shape preferences in a given situation. (A review is Ernst Fehr and Hoff 2011.) A simple example that Basu provides is that if everyone in an economy wants to wear jeans if at least 60 percent of the population wear jeans, then to know what people want, you reason *back* from a society in which everyone wears jeans or no one wears jeans.

Empirical work on the effect of outcomes on preferences is difficult because either one needs to find changes in outcomes that are random, or else one needs to control for the large number of dimensions along which societies and groups typically differ. The case of Switzerland is well-suited to a study of the effects of culture on preferences since exactly the same legal system prevails on both sides of the within-state (i.e., canton) segments of the border that separates German and non-German language groups. This means that the supply of social insurance (e.g., unemployment insurance, the retirement system, maternity leave, etc.) is identical on both sides of this border. In addition, the wealth distribution, the probability of becoming unemployed, and other risks are similar on both sides of the border. Beatrix Eugster et al. (2011) use data from referenda over the period 1980–2009 and a within-canton regression discontinuity design to identify cultural differences in the demand for social insurance. They find a persistent difference in the demand for social insurance, with the German group expressing a much lower demand than the Latin group. These two groups *within Switzerland* are at opposite ends of the scale defined by average responses in different *countries* to the question whether government should do more to redistribute income. Eugster et al.'s findings suggest that, even among groups in the same economic environment, differences in culture can create large and long-lasting differences in the demand for social insurance.

The effects of identity—an individual's sense of belonging to a particular group—can have interesting implications in strategic games. Basu shows in a series of examples that the "public good urge"—the urge to do the things that, *if* done by everybody with whom one shares a common identity, leads to a reward for all—can transform a Prisoner's Dilemma (PD) into a coordination game (p. 108). Among individuals who share a common identity and who have a "public good urge," there is an equilibrium in which everyone cooperates. Basu uses this framework to shed light on the ability under colonialism of small groups of colonists to control vast populations. Suppose that there are two groups, e.g., the British rulers, who view themselves as sharing a common identity separate from that of the indigenous population, and the indigenous people in India whom the British wish to exploit. Suppose that all individuals have a "public good urge," as defined above. It is in the interest of the British to induce the indigenous people to play a PD cooperatively because that way they can be better exploited. A way to do that is for the British colonists to decide, collusively, to not *always* defect when playing with an Indian but sometimes to cooperate. In this way, they may delude the Indian masses into believing that they all share one common identity, and so the Indian masses may play cooperatively and often get exploited.

> It is in fact likely that some of the most successful colonial exploitations relied, deliberately or unwittingly, on strategies of this kind. For a ruling oligarchy or race keen on exploiting the masses, a useful strategy is to disrupt the formation of identity among the masses by picking out some from among them, and enriching them and giving them a modicum of power. This will create the feeling among the masses they can make it if they try. . . . Modern India's founding father, Gandhi, it is worth recalling, believed for many years that the Indians and British were equal partners in the subcontinent, and resisted the call for independence from early radicals. It took many incidents and actions on the part of the Crown before he changed his mind (Basu, pp. 114–15).

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Basu also explores the dynamics at play in response to the enactment of law. He takes the position that a law can change an outcome only if that outcome was already one of a set of possible equilibria for that society. In this view, law is only an equilibrium-selection device. This view might be extreme (since law has an expressive function, too), but it does call attention to the central role of social norms as a source of restraints on behavior. However, the textbook model of economics on which many politicians base policy does not acknowledge the importance of norms.

In misunderstanding what makes markets work well, economists influence how people behave and may make markets work even less well than they would have in the absence of false beliefs about the market system. "So much of standard economics was a celebration of selfishness," Basu (p. 109) writes, that we did not even make room for the fact that greater altruism is a useful trait and can contribute to economic efficiency." Economic historians have documented the usefulness of altruism in development. Joel Mokyr (2011) argues that, at the dawn of the Industrial Revolution, the ideal of the *gentleman* as someone who would be fair and cooperative in business dealings exercised a powerful hold on behavior, and did so not merely through self-interest. This ideal, which was supported by men's clubs through which gossip about miscreants could quickly spread, created an environment in which opportunism became taboo.

> What mattered for the success of entrepreneurship in Britain was that if everyone could think of themselves as *noblesse*, everyone was, at least pro forma, *obligé* by a gentlemanly code of behavior. The typical entrepreneur in the Industrial Revolution was hardly the ferocious, unscrupulous, merciless money-grabber that some of the more sentimental accounts make him out to be. . . . [Within this secure environment] Boulton found his Watt, Clegg his Murdoch, Marshall his Murray, Muspratt his Gamble, and Cooke his Wheatstone. Entrepreneurial success was based less on multitalented geniuses than on successful cooperation between individuals who had good reason to think they could trust one another (Mokyr, pp. 384, 386).

Minimally, Basu argues that a proper understanding of economics requires recognizing that our economic relations are part of a larger sphere of social and cultural interactions. He hints that one could go further and construct a rigorous economics that broke away to a greater extent than current work in economics does from methodological individualism (p. 101). Culture tends to form around institutions, and together institutions and culture shape the cognitive frames through which we understand the world and ourselves. These frames—e.g., the category systems we use in distinguishing people—are the outcome of activities of many people and are irreducibly social. Hoff and Stiglitz (2010) analyze racial categories in this way.

Using this language, I would characterize Basu as seeking in this book to change the cognitive frames through which people view the market system. The first step he takes (chapters 1–4) is to try to disabuse readers of the illusion that the free market system as it exists in the real world is either fair or efficient. The second step (chapters 5–7) is to show how to integrate into economic thinking certain social elements (such as group identities and basic rights that limit the exercise of the principle of free contract). The last step (chapters 8–10) is to consider the ways that economic globalization diminishes global democracy.

Basu wants individuals to entertain the idea that the free market system with separate national economies is not the only possible system for the foreseeable future. He writes that "The world is poised on a dangerous ledge. There is a risk that we will go headlong into a mean, materialistic future" (p. 7). The first sentence in this passage, perhaps not by coincidence, follows the cadence of a line in Matthew Arnold's elegy, "Dover Beach": "And we are here on a darkling plain." The urgency that Basu expresses gains some support from the research on whether money brings happiness. The current state of the debate on the long-run relationship between GDP growth and subjective well-being in rich countries has been summarized this way: "one cannot reject the null that the correlation coefficient is equal to zero, but this does not mean that one can reject the null that it is greater than zero" (Andrew

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E. Clark and Claudia Senik 2011). The reasons that have been suggested to explain the possibly zero correlation coefficient are that happiness (above some income threshold) depends on relative, not absolute, levels of income; if all move up, no one is happier. Further, above a certain income level, individuals might adapt to a new base income without any gain in subjective well-being. If these effects are sufficiently powerful, then the quest for higher living standards is just a rat race. Daniel Luban (forthcoming) finds that long before the Gallup Poll and World Values Survey on happiness, Adam Smith had drawn this conclusion in his *Lectures in Jurisprudence,* delivered in 1762–63:

> But economic interest for Smith only superficially aims at an absolute increase in material goods, and more fundamentally aims at a relative increase in social status. And social status, of course, is a "positional" good, or one that is zero-sum by definition. In "this generall scramble for preeminence, when some get up, others must necessarily fall undermost" (Smith 1978,(A) vi.54). On an aggregate level, therefore, the pursuit of economic interest will always be futile in terms of the goal that it sets for itself.

Basu proposes that the yardstick against which governments should measure their achievements is not growth in per capita income, but instead growth in the income of the bottom quintile. If there were better understanding of the extent to which positional goods undermine the link between income and happiness, of the weak relationship between an individual's income and his productivity, and of the way poverty narrows individuals' chances to become productive at all, it might be possible to reach a political consensus to use the bottom quintile's income as one measuring rod of a nation's economic success.

Basu does not offer a grand new paradigm, though he would certainly like to push the economics profession to create one. What he offers here is a thoughtful discussion of reasons why the market system is less efficient and fair, and less able to function without cooperation, trust, and opportunism-constraining norms, than many economists think it is.

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Bourgeois Dignity: Why Economics Can't Explain the Modern World. By Deirdre N. McCloskey. Chicago and London: University of Chicago Press, 2010. Pp. xvi, 571. $35.00. ISBN 978–0–226–55665–9. *JEL 2011–0003*

Bourgeois Dignity: Why Economics Can't Explain the Modern World is the second of six intended volumes by Deirdre McCloskey on the *Great Fact*, namely, the spectacular rise in living standards first experienced by North European countries in the eighteenth century and also later, although less dramatically, by most of the remaining countries in the world. McCloskey's basic premise is that economic factors, such as international trade, savings, education, and institutions, cannot explain *the Great Fact*. Instead, McCloskey offers a rhetoric-based theory in which attitudes and philosophy reflected in the speech of the day set

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