

Cultured economic theory: oxymoron or incipient reality?

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According to the anthropologist, Arjun Appadurai, cultural processes are those that “permit individuals to communicate and relate with one another in a manner that *creates and mobilises differences between themselves and others* (Appadurai[6], Appadurai [7].)” Thus culture creates distinctions, endows identities and engenders collective action. That cultural processes exist and contribute greatly to the richness of human existence is not in doubt. Yet whether cultural distinctions are essential to economic problems, or instead obfuscate the essence, has long been subject to debate.

For well over a century, economists have grappled with the importance of culture in influencing and coordinating human behaviour. A history of old flirtations and new dalliances suggest that economists can both bring new insights to the examination of cultural processes, and in turn, be enriched by doing so. Yet, as a discipline defined more by its method than by its scope of inquiry, economics has struggled when trying to incorporate cultural specificity within its approach.

From the nineteenth century until relatively recently, economists’ perspectives on culture- and indeed to “development” in general- were heavily influenced by the German Historical School, a movement largely disregarded within the mainstream. Since the 1950s, however, the discipline has increasingly recognised the importance of cultural identities and institutions in influencing outcomes. This recognition has led to a remarkable expansion of the scope of economic inquiry beyond its traditional competencies, with the development of new theories of social interactions and community enforcement. Yet, culturally- informed studies are still rare, and a number of research directions remain open.

1 Culture and economics in an imperial world

Economics has not always been an essentialist discipline. The nineteenth century, in particular, was characterised by strong differences of opinion with respect to the relevance of abstract modelling techniques. While economists in Victorian England, Austria and the United States were developing the formal underpinnings of modern economic theory, the chairs of political economy in Germany were held by members of the Historical School, founded by Wilhelm Roscher, Bruno Hildebrand and Karl Knies. With its strong neo-Hegelian view of history, this school was able to set the agenda for development economics, institutionalism and sociology for much of a century.

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1.1 The Historical school and development.

The “elder” Historical School argued that economic “laws” depended critically on cultural and historical circumstances, and that economic inquiry should be based upon the detailed study of the past (Blaug [23].) The elder Historicists viewed the economy as being similar in nature to a living being, with its cultural development obeying innate “biological” laws (Veblen [78].) These laws manifest themselves in broad similarities in the path of economic development across nations. Their theory was called the *Dreistufenlehre*- named for the “three stages” that economies had to undergo on their way to modernity.

“Primitive economics” and its post-colonial avatar, “development economics”, were heavily influenced by the three stages theory. With non-industrialised economies largely ignored by both the classical and neoclassical schools, colonial and later development policy was informed largely by variations on the Historicist position. Indigenous peoples and imperial subjects were considered to be on one step or another on the path to the “full culture” present in Europe. According to one popular classification, cultural progression came from the range of exchange, with the giving of gifts by subsistence producers leading to barter, to currency-based transactions and ultimately to the Bourse (Firth [40], Mauss [58].)

Though debated even at the time, it was widely held that all economies- and cultures- for these terms were largely considered interchangeable- were simply at different points on the same development trajectory. The use of the terms *primitive* and *backward* by economists, including Alfred Marshall, to describe non-European cultures was actually progressive for the time, as it suggested that these economies could and would develop even without imperialist intervention (Firth [40].)

What is remarkable is the persistence in the single trajectory manner of thought throughout much of the twentieth century. The stages of growth theory was later resurrected and popularised by development theorists, particularly Walt Rostow [68], who replaced the cultural antecedents of each stage of growth with requirements for capital accumulation. The Harrod-Domar model of growth was based explicitly on stylised facts emerging from the experiences of the United States and the United Kingdom. The Solow model, a benchmark of neoclassical growth theory, was also interpreted from the stance of economies following the same path, with investment rates determining the steady state at which growth will end. Indeed, even today, economists in this tradition continue to look for evidence of *convergence* among growing economies. It is only relatively recently that macroeconomists have considered the possibility of path dependency, or even the possibility of different steady states and growth trajectories existing for different developing economies.¹

Development practice followed the single trajectory approach equally closely.² Since it was believed that modernity required a European-style industrial revolution, developing countries were encouraged to create new heavy industries. Given that trade with advanced economies would drive these nascent industries out of business, strong protections were required. The resulting policy- “import substitution”- was popular until the 1970s (Bruton [32].) It is an ultimate irony that the German Historicists, advocates of contextual research, were authors of

¹For a good overview, see Temple [75].

²It is telling that the debate that did emerge was between the modified Historicist view- that countries at the same “stage of modernity” had similar problems, while those at other stages faced different challenges- and the view that neoclassical economic reasoning, though mainly developed to explain the circumstances of the United Kingdom and the United States, was universally applicable. See for example, Dalton [37]. The institutionalists appear to have won the debate, since their arguments in favour of classifying countries as “least developed”, “developing”, “newly industrialising” and “industrialised”, all steps along the single path to development, have been largely adopted.

a theory that would later be used to justify a blanket solution– savings, import substitution and capital accumulation– to the problems of development throughout the world.³

1.2 Sociology and “Old” Institutionalism

The “elder” Historical School left its legacy in other areas as well. Its direct descendant, the “Verein”, led by Gustav von Schmoller, continued to use a contextual approach. Like many economists since, the Verein adopted a functionalist view of contemporary practices. They viewed the economic institutions of Bismarckian Germany with the benevolence that came from a belief in their efficiency (Schmoller [70].)

Partly in response to the cosy relationship between the Verein and the Second Reich, Max Weber, who held the political economy chair at Freiburg, adopted a positivist approach. Among his many contributions, Weber argued that economic performance, particularly the extent to which capitalism took root and flourished in different nations, could be explained by cultural factors. Weber [81] suggested that in Protestantism lay a code of ethics that, once internalised, lent itself readily to capitalism and impersonal market exchange. To study both economy and society, Weber emphasised the importance of *ideal types* as the basis of analysis, an admonition that economists took to heart.

Thus the German Historical School, largely ignored by neoclassical economics, nevertheless left a large footprint in primitive economics and the newly-delineated field of sociology. Yet, as sociology began its long march to schism, it was in the United States, at the turn of the century, that the economic study of culture experienced a brief though lingering renaissance.

The Institutional approach, grandfathered by Thorstein Veblen, John Commons and Wesley Mitchell, views the economy as a dynamic evolutionary process, with cultural norms influencing individual outcomes and preferences. The institutions that exist are often legacies of the past– the embodiment of a *cultural lag* that constrains behaviour and mis-allocates resources. Veblen, in particular, argues that it is the outsiders to communities– those unencumbered by and skeptical of the cultural institutions that limit their insider counterparts– that succeed and innovate (Veblen [79].)

Institutionalists also view the market as a cultural process in and of itself, with market activities influencing social norms (Dugger [38].) For example, at a time where landowners were being supplanted by capitalists amongst the ranks of the affluent, conspicuous leisure was used to differentiate between the old elite and the newly rich (Veblen [77].) Institutionalism, though extremely influential up until the early 1920s, became increasingly supplanted by the approach of formal rigour and statistical method. Some bastions of institutionalism remain, their work published in journals now considered heterodox.

2 The expansion of economics

During and immediately following the second world war, economics advanced at a frenetic pace. With advances in combinatorial topology and the development of linear programming, the mathematical approach to “complete models” of the economy became ripe for rapid progress (Arrow [9].) While the great advances in theory of general equilibrium occupied the attention

³Note, for example the 1955 statement by W. Arthur Lewis [55]: “The central problem in the theory of economic growth is to understand the process by which a community is converted from being a 5 percent saver to a 12 percent saver.” (cited in Bruton [32].)

of economists, cultural issues remained absent in the academic discourse.⁴

This began to change in 1955, with Gary Becker's [13] dissertation on the economics of discrimination. Having successfully developed complete models with identical rational agents, economists began to expand the basic theory to countenance some differences, particularly in race, education and skills. The concept of *capital*- stocks of land and machinery that increased the productivity of labour- was expanded, allowing cultural phenomena to be analysed using existing tools. Among the new complements to labour that economists analysed between the 1950s and 1970s were "human capital", "appreciation capital" and "social capital."

The expansion of preferences and production functions to incorporate new phenomena brought new fields of study under the plough of economics.⁵ Yet, the fundamental theoretical machinery- individual rational agents interacting with each other in static markets- remained largely unchanged. Dealing with decision-making exclusively at the individual level, economists were ill-equipped to study the development of social norms and community-level sanctions, two common elements that appeared ever more important to the challenges of designing markets and institutions. Two new approaches emerged in response to these challenges. Social interactions models use techniques from physics and evolutionary biology to study the development of norms. The class of models within the ambit of the New Institutional Economics and its successor, Historical Comparative Institutional Analysis, instead study the role cultural institutions play in solving contracting problems, shedding new light on mechanisms of community enforcement.

2.1 The cultural consumer: new preferences, new roles and new forms of capital

In one of the first steps taken by modern economics to study the economic effects of identity, Becker [13] chose to imbue individuals with a "taste" for racial animosity. This device, path-breaking at the time, enabled him to examine how small preferences for discrimination on the part of different races interact in equilibrium. He found, for example, that racism against a minority would have little effect on their economic outcomes if they were able to successfully segregate themselves into minority firms. Similarly, he suggested that the ability of market competition to reduce discrimination in employment depended critically on the distribution of tastes for discrimination both among employers and among consumers (Becker [13], [20].)

New lines of research opened up as economics began to address the question of asymmetric information and the rational investment in education and skills, referred to as "human capital" (Schultz [71], Becker [14],[15].) An early innovation was the theory of statistical discrimination, developed independently by Arrow [8] and Phelps [64]. If there is a cost to assessing skills, rational employers that condition their decisions on observables - such as colour or sex - will attribute the average level of skills in the group as a whole to each candidate. As a result, minorities or women will not be compensated for investing in human capital above the average, and will choose to invest less. Therefore the average level of human capital falls amongst the minority group as whole, making the employers' beliefs about lower skills a "self-fulfilling

⁴A noteworthy exception is work in the institutionalist tradition by Gunnar Myrdal [61]. By chronicling the deleterious effects of segregation and New Deal policies- particularly the minimum wage- on African-Americans, Myrdal's work was important in influencing the Supreme Court decision in the case of Brown vs. the Board of Education of Topeka. However, Myrdal writes from the perspective, common at the time, that the racial heterogeneity was undesirable in America; hence the title of his book: *The American Dilemma: the Negro Problem and modern democracy*.

⁵For an overview of "imperialist economics", see Hirshleifer [48]

stereotype” (Loury [57].) As Akerlof [1] revealed, this unravelling result is a general property of such rational expectations models.

The expanding definition of “capital” received an additional fillip by the new theory of consumer behaviour, proposed by Becker [16],[18] and Michael and Becker [60]. They suggested that instead of passively maximising their welfare given the bundles of goods available, households consumed “commodities”, that they themselves produce using market inputs, time and human capital. This capital was broadly defined, from the skills necessary to convert ingredients into gourmet meals within the household, to the more garden varieties, like education.⁶

The device of the household production function provided a natural setting to expand the definition of capital still further. Becker and Stigler [21] hypothesised that tastes themselves could be cultivated. For example, an American, a Brazilian and an Indian, initially with the same innate preferences, might invest in different levels of *appreciation capital* for baseball, football and cricket, respectively. Taking a snapshot of them arguing over the remote control at age forty, it might seem that they all have innate and irreconcilable sporting tastes. However, interpreted using Becker and Stigler’s formulation, their cultural differences emerge from their earlier forward-looking investment decisions rather than simply from an innate preference. Thus an American teenager, who is thinking about developing a taste for sports, might foresee himself with few other friends come the crucial fifth day of the cricket test match, and choose to invest in appreciating baseball instead. If he envisions moving to India in the future, however, he might want to invest the time to understand the gentleman’s game.

The accumulation of capital, Becker and Stigler argued, is the main reason that older people are less likely to adapt to globalisation or other macroeconomic changes compared to the young. Given their lifetime investments in local languages, modes of dress and skills, they can produce the commodities they desire- e.g. camaraderie, status, consumption - more cheaply using their existing capital than by investing in new languages and accoutrements.⁷

Generalising his work on discrimination, Becker [17] wrote down a model in which an individual’s utility derived in part from a commodity, he called *social interaction*, a catch-all term that essentially represented the social environment within which the individual existed. Instead of simply expanding preferences, however, Becker envisioned a production function for the social interactions commodity. Thus, one could invest effort to change the social environment.⁸

⁶Formally, denote different commodities by $Z_1 \dots Z_m$. An individual maximises utility $U(Z_1 \dots Z_m)$, where each Z_i is generated by the production function:

$$Z_i = f_i(X_{1i}, \dots, X_{ki}, t_{1i}, \dots, t_{li}, S_1 \dots S_l, Y_i), i \in 1 \dots m \quad (1)$$

where X_{ji} is the amount of the j -th market good or services necessary to produce the i -th commodity (each with an associated price p_j), t_{ji} indexes the time required by the consumer to produce the good (with an associated wage w_j), S_j is the consumer’s *capital*, while Y_i are other inputs (Michael and Becker [60].)

⁷More ambitiously, Becker and Stigler’s argument could be taken to be an alternative explanation of the “sclerosis” of static societies envisioned by Mancur Olson [62]. Instead of redistribution, high degrees of appreciation capital, both invested individually, and stored in repositories of collective memory (e.g. monuments, religious institutions, libraries etc.) may limit the willingness of individuals in a society to adopt new practices, and make them less receptive to new ideas. As we shall see, Olson’s version of redistributive collective action can itself be interpreted in the light of the more “social” concept of capital.

⁸In symbols, the utility function is $U = Z(x, R)$, where x is a composite good, and R is the social environment. In Becker’s view, R could be interpreted as the preferences, identity or actions of others that impinge on each consumer’s well-being. Becker suggested a simple social production function:

$$R = D_i + h \quad (2)$$

where D_i is the value of the environmental variable without the individual’s effort, and h is the individual’s choice of effort. Finally, the individual’s budget is limited by his “social income” S , consisting of money income

Becker used this mechanism to analyse provision of charity, merit goods, and the family.⁹

Becker’s work on social interactions foreshadowed a further entry in the lexicon of capital, added by Glenn Loury in his 1977 dissertation [56]. Again, racial differences in labour market in the United States provided the setting. Contending that actual investments in human capital alone did not explain the gap between blacks and whites, Loury claimed that socially-determined circumstances raised or lowered the costs to such human capital investments. The segregation of American society meant that these social determinants- parents, teachers, neighbourhoods and peers- differed strongly by race. Loury called these determinants *social capital*, a term later adopted, reconsidered and made popular by James Coleman [35],[36] and Robert Putnam [66],[65].

The sixties and seventies were a period where *homo oeconomicus* gained tastes for culture and the ability to invest in culture-specific capital. Even with these innovations, economists were finding that the influence of culture and identity on economic outcomes could not be satisfactorily analysed within the traditional framework of impersonal market exchange moderated by prices (Arrow [10].) In particular, the degree of coordination within societies and communities were difficult to reconcile solely with decentralised decision making. Attention now focused upon the interactions between individual decisionmaking and social norms. Four extended families of culture models emerged: social interaction models, preference-based models of status, transactions costs models and models of community enforcement.

2.2 Social norms and cultural evolution

Thomas Schelling’s [69] seminal work on residential segregation in 1971 set the tone for subsequent work on social interactions and neighbourhood effects. Schelling’s approach used *cellular automata*- agents with simple decision rules interacting with one another. Schelling showed that if individuals had even mild preferences for living beside members of the same race, their individual choices could result in the creation of extremely segregated neighbourhoods. Schelling also discovered that multiple equilibria were possible, depending on the starting position of each agent. Schelling’s approach- simplifying individual decisionmaking in order to examine steady states and local stability of each equilibrium- characterises much of the current research on social norms and cultural evolution.

Recent followers of the social interactions tradition have attempted to apply models from statistical mechanics and physics to explain polarisation and conformity.¹⁰ Blume [25] and Brock and Durlauf [30],[31] use field models to incorporate the spillover effects that the choices of neighbours have on the welfare of each resident. By applying a number of distributional assumptions, it becomes possible to estimate the neighbourhood effects using simple logistical and multinomial regressions. According to Brock and Durlauf’s [30] basic model, individuals make a choice- e.g. to learn a language, to engage in crime etc.- based upon their conditional expectations of the choice level in the population. Brock and Durlauf find three equilibrium choice levels. Assuming myopic learning, they are able to appeal to local stability to restrict their set of equilibria.¹¹

I_i and the value of his existing social environment $D_i p_R$:

$$p_x x + p_R(D_i + h) = I_i + D_i p_R = S \tag{3}$$

⁹His insights into interactions within the family appear in a more detailed form in Becker’s [19] famous treatise.

¹⁰Durlauf and Young [39] provide a recent summary of the *new social economics*. Bolton [26],[27] provides a useful regional scientist’s view of social capital.

¹¹Formally, Brock and Durlauf [30] propose the following utility specification for agents, each faced with a

Similar in flavour to social interactions models of culture are those of bounded rationality and evolutionary games. Bounded rationality views culture as a framing device, as source of readily available heuristics and rules-of-thumb that shape the very mechanisms by which decisions are made (e.g. Boyd and Richerson [28], Vega-Redondo [80]). Along with modelling how culture influences behavior, bounded rationality theorists have also interested themselves in the emergence of cultural norms and their propagation through a society. A new cultural norm may emerge through the “mutation” of the status quo-e.g. an invasion by a small number of individuals that follow a different heuristic (Maynard Smith and Price [74].) The norm then spreads through society by out-competing others through a process of selection. The actual method of transmission or “learning” may be genetic, through the imitation of significant or successful agents within a social group (Weibull [82]), derived solely from past experiences (Arthur [11]) or may be “inherited” from a combination of these (Boyd and Richerson [28],[29].) Work by Kandori, Mailath and Rob [52] and Peyton Young [85],[86] has moved away from the clockwork determinism of earlier evolutionary models, adding a probabilistic flavour to the study of long-run outcomes generated by a process of persistent cultural mutation.¹²

While useful for studying population aggregates and the robustness of equilibria, social interactions models suffer from the general problem that their premise—agents roam around a localised area seeking randomly-determined partners—can often be less than convincing when applied to actual settings. Strong assumptions on the agents’ matching process eliminates the possibility of repeated interactions.¹³ Memory is non-existent, or extremely limited (Young [86].) In addition, agents lack the ability to communicate and coordinate on behaviours and sanctions. Without allowing for even the possibility of memory and coordination, any story about the emergence of cultural norms omits much that seems crucial.

binary decision $\omega \in \{-1, 1\}$:

$$V(\omega_i) = u(\omega_i) + S(\omega_i, \mu_i^e(\omega_{-i})) + \epsilon(\omega_i) \quad (4)$$

The first term is the private utility of making a choice and the second, the *social utility* deriving from choices made by all agents (where μ_i^e is the conditional probability that other agents will make a particular selection.) $\epsilon(\omega_i)$ is the idiosyncratic utility to the individual from making their choice- assumed to be independent and extreme-valued (hence the differences in the errors are distributed logistically, allowing for a simple specification.) Brock and Durlauf impose two further assumptions on social behaviour:

$$J = \frac{\partial^2 S(\omega_i, m_i^e)}{\partial \omega \partial m_i^e} > 0 \quad (5)$$

$$S = -\frac{J}{2}(\omega - m_i^e)^2 \quad (6)$$

(5) assumes strategic complements in social utility- e.g. if I learn a language, it is more valuable for you to do so too- while, following Bernheim’s [22] model discussed below, (6) assumes penalties for deviations from social norms.

¹²Jha [51] provides a technical overview of the evolutionary and stochastic games approach.

¹³A recurrent question that emerges is how much choice models of social interaction should give their agents in choosing their partners for exchange. This will of course depend on the type of question that is being asked. If a study is purely interested in large populations with many homogeneous agents, then random matching may be an appropriate assumption to make. Another possible scenario where random matching may be useful exists when agents have independently distributed characteristics that influence their probability meeting each other but are unobserved by the econometrician. In these cases, an element of randomness, conditional upon observables, might be an appropriate approach to modelling. Yet, if a study purports to study social dynamics, then random matching models that ignore the possibility of repeated interactions between individuals, and the possible formation of sub-coalitions, or “communities” if you will- omits key elements of human interaction.

2.3 Preference-based models of status and social sanctions

Akerlof’s [2] theory of social customs was designed explicitly to deal with the challenges faced by Becker [13] and Arrow [8] in their models of discrimination. In particular, Akerlof sought to show that social norms that might have deleterious effects on every individual in a community- such as insisting upon “fair wage” even if it implies unemployment- might still be upheld for fear of sanctions. To do this, Akerlof introduced a “code of beliefs” and “social reputation” into each individual’s utility function.¹⁴ Individuals are able to choose to abide by the code or disobey it. He finds two possible equilibria- either the custom is stable, with a constant proportion μ believing in it, or the custom disappears, with no adherents.

Bernheim [22] builds on Akerlof’s model, applying the machinery of information economics to develop a “signalling” model of conformity. In Bernheim’s model, individuals have heterogeneous tastes for conforming to a social norm. These tastes are known only to the individuals themselves, but they develop “social reputations” by their choices of actions. Status derives from the inferences of others in society.¹⁵ In Bernheim’s model, the equilibrium probabilities people in society use to assign social esteem to the actions of individuals reveal a discontinuity. This leads to the existence of both a pooling equilibrium- every member of society chooses to abide by the norm- and a separating equilibrium. Depending on the importance a person ascribes to social status, the equilibrium may be fully separating- each type of person chooses a different action- or partially separating- some people choose to conform, while those with extremely iconoclastic tastes choose to deviate.

In their work on “identity”, Akerlof and Kranton [4],[5] explicitly interest themselves in social sanctions. They consider the setting in which individuals assign themselves and others to “categories” - social labels, each of which contains an implicit code of behaviour. In their formulation, an individual’s utility is affected both by her own adherence to the ideals of their own category and the adherence of others.¹⁶ In fact, Akerlof and Kranton solve a simpler

¹⁴In particular, Akerlof proposes the following utility specification:

$$U = U(x, R(A, \mu), A, d^c, \epsilon) \quad (7)$$

where x are material goods, $R(A, \mu)$ is the individual’s “social reputation”, produced by the individual’s obedience to the social code of beliefs A , and the proportion in the population who adopt a similar norm μ . The individual has a personal belief or disbelief in the social code d^c , and idiosyncratic tastes ϵ . Akerlof also assumes a simple dynamic structure - that the proportion following the code in the next period is a function of those that believe in it and those that actually obey it: $\dot{\mu} = g(\mu, G)$.

¹⁵Bernheim’s status-conscious consumer maximises:

$$\max_{x \in X} -(x - t)^2 + \lambda \int_T h(b)\phi(b, x)db \quad (8)$$

where t denotes the individual’s intrinsic taste (his type), λ is a weight on social status, $h(b)$ is the “social esteem” individuals receive from being of some type b . $\phi(b, x)$ represents the probability density function used by others to accord him social esteem, given his actions x . This pdf is endogenously determined in the model, with its discontinuities resulting in pooling and separating equilibria.

¹⁶An identity-endowed consumer j faces the following problem:

$$\max_{a_j} U_j(a_j, a_{-j}, I_j) \quad (9)$$

where a_j is the consumer’s actions, a_{-j} are the actions of others in society, and I_j represents the individual’s identity. Identity in turn is determined by actions, the category of the individual c_j , the code of behaviour \mathbf{P} appropriate to that category, and idiosyncratic tastes.

$$I_i = I(a_j, a_{-j}, c_j, \mathbf{P}, \epsilon_j) \quad (10)$$

problem- a two stage game in which two individuals choose actions that either follow their identity prescriptions or violate them. Violation by one individual has an external effect on the other. In order to deter such deviations, the second individual threatens to sanction and punish the first.

The expansion of preferences to “explain” observed phenomena was and remains a popular device in economics, though its effectiveness has often derived chiefly from highlighting questions in need of further analysis. By expanding preferences, the economist’s implicit “explanation” for a particular choice by an agent is that they chose it because they liked it. Along with discrimination, preferences have been used to “rationalise” a variety of apparently “non-rational” behaviour, such as altruism, voting, and tipping in airports (McPherson [59].) Indeed, the “enchanted world of definitions”, as Sen calls it, permits the rationalising of all choices as the result of quirky preferences (Sen [73].) Since desires and preferences are the primitives of most economic analysis, this device seldom adds insight into choices being made at the individual level, though as the models above exemplify, it eases the analysis of how such choices interact within equilibrium.

2.4 Transaction costs and the new institutionalism

Preference-based and social interactions models of culture are implicitly bilateral in structure, with individuals imposing externalities on their neighbours. These models, while equipped to analyse conformity to social norms, lack the flexibility to discuss the coordinating and strategic aspects of cultural interaction and identity choice. Advances in the theory of the firm and the “new institutional economics” provide the machinery for doing just that. Ronald Coase [33],[34] mooted the possibility that “holes” in the mechanisms of contract enforcement in the market were responsible for the creation of firms (Pagano [63].) He proved that in the absence of “transaction costs,” market exchange will be efficient, no matter who is initially assigned property rights.¹⁷ The Coasian notions of transaction costs and the boundaries of the firm were taken in two different directions by the “New Institutional Economics” that emerged between the 1970s and 1990s. While the new institutionalists all concede that institutions emerge in response to the costs of transacting, they view them with different degrees of skepticism.

Oliver Williamson [83],[84] expands upon the Coasian theory of the firm, viewing them as “governance structures” that serve to reduce the costs of monitoring required to enforce contracts. Williamson [84] isolates three dimensions that characterise transactions and exchanges. These are the *specificity* of assets to the particular exchange, the *uncertainty* of outcomes and payoffs and the *frequency of repetition* expected. Each transaction can then be mated with the governance structure that is most efficient in reducing the uncertainty and other costs involved.

Non-specific assets are easily salvaged should the deal turn sour and can be easily redeployed to other bidders in a competitive marketplace. Because competition from an easily accessible “outside option” will set narrow parameters on the price-setting possible between the partners to an exchange, the danger of opportunism is limited, and thus short-term contracts are effective governance forms even if two traders eventually maintain a long-term relationship.

With a rise in specificity, an individual’s exposure to opportunism rises, and so too does the complexity of the governance structure. With moderate levels of specificity and the possibility of repeated interactions, the folk theorem results apply, and bilateral contracting based upon sanctions and punishment strategies become the governance structure of choice. If one indi-

¹⁷Modern usage of the term “transaction costs” has flipped Coase’s theorem on its head- transaction costs represent the difference between the outcome achievable by an omniscient social planner and that attainable in the presence of asymmetric information or limited contracting (Segal and Tadelis [72].)

vidual engages in this sort of exchange relatively more often than his or her counterpart, then the exchange may be conducted in a hierarchical manner, with the more experienced trading partner receiving more discretion (Williamson [84].)

Naturally, as the number of repeated interactions diminishes the possibility of opportunism in the bilateral structure increases. Rare one-off interactions between individuals—the arm’s length exchange assumed by social interactions models—raise the need for third party enforcement and institutions of justice.¹⁸

Finally, in the case of highly specific assets, Williamson [84] tells us that the great degrees of risk taken by both parties implies that a large degree of bilateral and third-party contracting is required. In this environment, the governance structure will depend on the relative efficiency of the legal ordering underlying the market and the efficiency gains from internal organisation. If the common law institutions are efficient in eliminating uncertainties, there may continue to be market-based interaction, while relative savings from the monitoring and bonding structures available within a single organisation may lead to a “unified” governance structure, in which one party assumes the role of residual claimant, and either hires the other party or buys them out completely (Williamson [84].)

Williamson’s ideas were highly influential in the theory of the firm, particularly in studies of the “hold-up problem”- the threat of reneging that trading partners face from one another when they make specific investments (e.g. Grossman and Hart [47].) Yet, though Williamson’s theory put a strong emphasis on third-party sanctions and verifiability, this line of research has not been fully applied to understanding the governance of cultural institutions. Arguably, communities act as “islands of conscious power” in much the same manner as do firms (Jha [50]).¹⁹

The transactions costs economics has made some inroads into theories of culture. For example, Edward Lazear [54] develops a simple social interaction model in which individuals with different starting languages (or culture) randomly meet one another, hoping to engage in exchange. Cross-cultural dealing imposes costs. He finds that minority groups that live in areas with a definite majority are more likely to *assimilate*— learn the language and practices of the majority. He examines the phenomenon of ghettos and shows that it is individually rational to live in one. Lazear [53] further examines the importance of cultural diversity. He argues that due to transaction costs from language and cultural barriers, culturally diverse teams will result only if there is sufficient complementarity in skills or knowledge available between cultural groups. Akerlof [3] examines the implications of *social distance*, arguing that transactions become more costly, the greater the social distance between parties to an exchange. Using the standard model of particles interacting with a gravitational field, he finds, perhaps not surprisingly, that individuals interact the most with those closest to them in social space.

Iannaccone [49] applies the notion of specific investments to religion and cults. He sees cults as providing club goods. The “quality” of the club increases with the amount of time and resources members invest in “participation.”²⁰ Naturally, there is an incentive for individuals

¹⁸However, as the Coase theorem assures us, these institutions do not necessarily have to be impartial for efficient outcomes, they just have to be consistent and predictable, so that individuals can engage in side-deals. The impartiality of the justice system is fundamentally an equity issue.

¹⁹Robertson [67], in his study of firms in the market, asked why we observe the “islands of conscious power in this ocean of unconscious cooperation like lumps of butter coagulating in a pail of buttermilk?”, cited in Coase [33], Pagano [63]

²⁰Iannaccone’s religious consumer has the following indirect utility:

$$V = \max_{R,S} \{U(S^i, R^i, Q^i) | \pi_s S + \pi_r R \leq I\} \quad (11)$$

where S^i is a vector of secular commodities, R^i is the individual’s own “participation” in the club, and Q^i is the “quality” of club, a function of the number and average participation levels of other club members. Notice the

to take advantage of others' participatory efforts by contributing little themselves. Iannaccone allows the institution of the club to respond efficiently. In order to limit participation to the truly committed, religious practices, such as stigma and self-sacrifice develop to act as screening devices.

Recent work by Roland Fryer [41] examines the economics of *cultural capital*. Fryer envisions a game in which agents of different abilities are endowed with a community membership. They choose to allocate time to investment either in community-specific attributes or in human capital. What follows is an infinitely repeated prisoner's dilemma game with randomly chosen members of the community, all of whom observe the individual's identity choice. Fryer assumes that community members perceive the probability of continued interaction with the agent to be a function of this choice. Naturally, there exists a cutoff discount rate— and thus a cutoff level of human capital— above which agents can sustain cooperation and below which the agent is sanctioned.

Among the valuable features in Fryer's analysis are that conformity (investments in cultural-specific capital) comes from individual's investments to maintain trust in the community, while the impetus for sanctions against violators occurs naturally as a result of a breakdown of trust. Given its Williamsonian provenance, Fryer's analysis should be seen as a special case of a more general theory, one that encompasses a broader range and type of specific investments.²¹

2.5 Institutions and community enforcement

In contrast to the functionalist perspective taken by transaction costs economics, is the contextual emphasis of the historical comparative institutional analysis (see Greif [46] for an overview. Also, see Greif [45],[44].) The strength of historical comparative institutional analysis lies in its explicit recognition that to properly craft a context-specific analysis, one must go back and forth between abstraction and thick knowledge of a cultural environment. The HCIA approach begins by identifying a transaction that will serve as the unit of the analysis. In Greif's [42],[43] seminal work this was the hidden action problem faced by Mediterranean merchants who had to rely on agents to look after their interests in distant cities. The second step involves isolating the relevant institutions and information sets available to a boundedly rational decisionmakers seeking to write an effective (self-enforcing) contract. The choice of which institutions can be considered exogenous and which emerge as a consequence of the model requires careful examination of the context itself. Game theory is called upon to identify which institutions are generated as possible equilibria from the interactions of agents. Once the details of the game have been defined, verification can be sought by seeing how agents act off the equilibrium path in the presence of changes in the underlying parameters. This can again be compared with the historical record.

In more contemporary analytical settings, mixed methods analyses, combining in-depth sociological studies that both aid in the design and interpretation phases of larger-scale surveys, are providing promising new avenues (Udry [76].) In both of these systems, the key is that at each step of the analytical process, the social scientist informs and evaluates her analysis using her knowledge of the cultural context.

similarities between this specification and that of Akerlof [2]

²¹Further work in this literature includes that by Athey and Jha [12]. They compare communities with seniority-based social hierarchies with those based upon investments in identity. They find that social hierarchies—where senior members act as intermediaries for exchange— tend to be more efficient than groups based upon identity investment. They also tend to be more robust to the expansion of the range of trading opportunities from globalisation.

3 The economics of cultural economics

To understand why economics has, time and again, embraced and then spurned cultural inquiry, it is useful to study the economics of economics itself. Most social scientists implicitly take as self-evident that, if presented with the same circumstances, identical agents will act the same way. Yet the secret that allows economists to predict and explain rather than merely describe, has been their willingness to make a leap of faith, from requiring that agents and circumstances be *identical* for prediction, to allowing them to be *similar*.

“Similar” here means identical in all relevant observable measures. In making predictions, differences are allowed only if they are idiosyncratic—for example an individual’s tastes or abilities. Systematic differences that could affect agents’ behaviour have to be accounted for explicitly in the analysis. Not doing so would result in mis-attribution of an effect to one cause when it could be the result of quite another.

Thus adding the many systematic differences between people to a predictive framework also adds analytical complexity and expands the empirical challenges. Not all can be addressed satisfactorily. Not surprisingly then, Occam’s Razor is kept well-honed by economists. The attributes and circumstances considered *relevant* for making a prediction or explanation are whittled down to the minimum, not because of a complete disregard for understanding the cultural underpinnings of human behaviour, as members of other disciplines quip, but because ultimately decisions must be made based upon the information available and constraints faced.²²

The pragmatism that has enabled the discipline to progress thusfar, has necessarily been at the expense of the scope of what economists have deemed to be “relevant” for a particular decision. The actual test of relevance of a cultural process is not one based solely on in-depth case studies that reveal its importance for certain social outcomes, but instead is based upon a comparison of the costs and benefits of introducing it into the analysis of the issue at hand. For the costs of collecting cultural data, how much additional insight will we gain?

Here the cards are stacked against the inclusion of cultural processes versus other areas of analytical expansion. While, they may be of key importance in a particular setting, the benefits from introducing specific cultural elements into an economic analysis are reduced by the loss in the researcher’s ability to generalise to other cultural contexts. For example, any study of politics in India would be incomplete without addressing the caste system, while any study of yearly consumer spending patterns in the United States would be deficient without accounting for the Christmas shopping season. Yet it is unlikely that the culturally- conditioned results emerging from the American consumer study would be apply to Indian consumers, nor that the Indian politics study would be the most appropriate for studying American politics. In contrast, these topics, when shorn of their cultural specificity, might provide new insight into both: a study of investments in celebrations and ritual, or of the effect of identity affiliations on voting might shed light at key elements underlying consumer behaviour and politics in India and in the United States. Not surprisingly then, we find that the relative absence of culture-specific studies stands in gross contrast with theories of social networks and psychology that economists have been more readily reconciled to incorporating into their frameworks (Loury [56].) Such studies, that generalise across peoples and settings, continue to provide a bigger bang for the buck.

²²See for example, Arjun Appadurai in this volume: “It is customary for anthropologists to pin the blame on economists and their unwillingness to broaden their views of economic action and motivation and to take culture into account. And economics is hardly blameless, in its growing preoccupation with models of such abstraction and parsimony that they can hardly take most real-world economies on board, much less the matter of culture, which simply becomes the biggest tenant in the black box of aggregate rationality[7]”

The lack of generalisability of culturally-conditioned studies will continue to push economists towards studying more general social phenomena. On the costs side, however, the situation is more hopeful. As in many other processes, a cultural lag exists both in economics and its supporting environment of data. The Living Standards Measurement Surveys (LSMS), NSO or other large-scale surveys rarely ask the questions required to properly address cultural issues, largely because it was never thought important to do so before. At present, empirical economists examining cultural issues generally have to collect the data themselves (e.g. Bloch and Rao [24], Udry [76].) Yet, once we know what to ask, the incorporation of new questions into the large-scale surveys of particular regions can be achieved relatively inexpensively in the future.

Economic theorists have struggled to grasp the essential elements of cultural processes off and on for more than a hundred and fifty years. A major concern of economists before the first world war, culture returned to the spotlight in the fifties with an awakened consciousness of racial discrimination in the United States. Since then, *homo oeconomicus* has evolved tastes for religion, conformity, status, endogamy, constructed communities and repositories of memory, invested in appreciation for music and the arts, even while economic models developed their own aesthetics. Yet, a wealth of questions bear further analysis. I guess it is time to start.

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