Book review


Although it is common in economics to compare institutions on the basis of single-dimensional measures of concepts such as efficiency, fairness or freedom, Allan Schmid’s Conflict and Cooperation: Institutional and Behavioral Economics rejects that approach with a sharply contrasting vision of what institutional economics is all about. In Schmid’s view, institutional change inevitably creates winners and losers. People correctly anticipate that compensation of losers by re-distribution according to the Kaldor–Hicks principle rarely occurs in the real world. Sometimes, the incommensurability of distinct categories of benefits precludes the very possibility of compensation. Thus, policy options are virtually never Pareto comparable, because it is almost never the case that all agents (even weakly) prefer the same institution. Conflict is normal and, according to Schmid, its detail and dynamics must therefore occupy center stage in any social science aspiring to real-world relevancy.

The goal of Schmid’s book is to provide a conceptual framework for understanding the connections between institutions and their corresponding distributions of costs and benefits. Schmid writes (p. xvii), “I understand the angst that drives scholars and citizens to demand aggregate welfare measures by which to scientifically judge the desirability of alternative institutions. But I am not moved to supply their psychic balm... [E]fficiency is not a single thing... [T]he choice is what to be efficient about.”

The body of Conflict and Cooperation begins with two theoretical chapters that introduce Schmid’s situation–structure–performance (SSP) model. For Schmid, performance is a description or measure of how net benefits are distributed (i.e., who gets what) and serves as the dependent variable throughout much of his analysis. Schmid’s multi-layered framework allows for considerable breadth, including formal and informal institutions, equilibrium and dis-equilibrium, psychological and anthropological variables, and both mainstream and heterodox techniques of analysis. Although remarkably open, Schmid is no relativist, and his framework is not open to everything. His proposed framework eschews particular a priori axioms such as more is better and the self-regarding norms of homo economicus because, for Schmid, these are among the fundamental questions that economic research must attempt to answer. More of what? More for whom? Opportunistic or cooperative to what extent?

Social interdependencies, power, hierarchy, non-marginal change, learning, evolution, and multiple and non-existent equilibria are recurring themes. A chapter devoted to behavioral economics connects these group-level processes to individual-level traits of human
cognition and the behavioral regularities they produce. Schmid catalogues relevant discoveries in behavioral economics, including unstable reservation prices, mental accounts, lexicographic choice rules, satisficing, multiple selves, emotions, reciprocity and trust, underscoring the fragility of choice with respect to variation in context and the decision-making environment. Schmid argues that discoveries in behavioral economics imply new ways in which institutions matter, implying an expanded role for institutions in determining how real-world economies evolve.

Schmid brings together previously disparate bodies of work in institutional and behavioral economics demonstrating their strong complementarity, both in the substance of their findings and in their commitment to assumptive realism and empirical validity. Bounded rationality proves to be a fruitful bridging concept that ties a variety of informal institutions to simple heuristics and behavioral rules of thumb. True to Simon’s notion, Schmid argues that heuristics and rules of thumb should not be regarded as second-best, that they are instead strategic tools for dealing with uncertainty, complexity, and the social interdependencies implied by both.

Conflict and Cooperation repeatedly emphasizes the economic significance of human imagination and the difficulty of using probabilistic reasoning to analyze unknown future events. In cases where the universe of future events cannot be specified (because it has yet to be imagined and therefore does not exist), probabilities cannot be assigned and decision rules other than those based on expected utility must be employed. With echoes of Hegel, Schmid writes that the future itself is made out of imagined futures and that imagination, creativity, and the institutions which facilitate and constrain them, are thus determinative economic variables. Schmid offers lucid descriptions of how expectations and mutually reinforcing beliefs are the fundament of a socially constructed reality that economic analysis must take seriously in order to appreciate the full range of policies and feasible institutional arrangements. The range of real-world possibilities, Schmid argues, is much larger than is commonly appreciated because ideology and, in particular, strict adherence to constraining notions of ubiquitous opportunism (homo economicus) constrict the range of options that economists allow themselves to imagine. At the same time, Schmid is open to self-interested maximization when circumscribed within appropriate bounds: on maximization, he writes, “We do it when we think the situation calls for it.”

Among the strongest links Schmid makes between institutional and behavioral economics is the malleability of preferences. From high stakes constitutional questions to the mundane detail of local business norms, the scope for institutions to matter is broadened insofar as preference change is normal. Aware of the high stakes implications of malleable preferences in Veblen and Galbraith, Schmid enlivens his case with engaging examples illustrating the surprising influence institutional variation has over consumer choice. For example, Schmid cites work suggesting that the institution of frequency of payments (in this case, 12 monthly payments versus one annual payment) had significant effects on choices that exercise club members made about how much to exercise. Those paying monthly used club facilities at a relatively constant level of intensity, whereas those who made a single annual payment tended to use the club’s services intensely at the beginning and significantly less toward the end of the payment year.

Schmid’s chapter on the sources of human interdependence explains the concepts of incompatible use, externalities, sustainability, exclusion costs, common pool resources,
rival/non-rival goods, decreasing and zero marginal cost, economies of scale, asset specificity, rent seeking and socio-emotional goods, with a constant focus on the goal of policy relevancy (p. 137): “If you do not know where the interdependencies are coming from, you can’t design institutions to direct them.” With this assertion, Schmid cautions that he is not advocating planning versus laissez faire, or any other ideological agenda. His assertion is simply that every institution implies a particular distribution of benefits and that it is an important role of economic analysis to tabulate the distributions corresponding to different institutions. Schmid wants those who undertake economic analysis to realize that taking moral positions and making normative claims are unavoidable and, therefore, should be done in the open, as explicitly as possible. Real-world policy instruments and tools are never distribution neutral. Thus, efficiency cannot be considered separately from the distribution of resources.

After introducing the theoretical material, Conflict and Cooperation includes a chapter on methods, which covers experiments, case studies, econometrics and simulation. The remainder of the book is devoted to applications. Applications are grouped into chapters on markets, macroeconomics, technology, labor, political institutions and institutional change. Schmid’s coverage is vast, with applications on Russian and Chinese privatization initiatives in the 1990s, the role of property rights in the economic development of Spain and England in the 16th and 17th centuries, the shoemaking industry in early America, the development of time zones and railroads, functional explanations of the sacred cow in India, development of rules governing open fields and containment of grazing lands in England, and the concept of limited liability.

Ultimately, Schmid’s ecumenicalism regarding the question of whose work should be included under the institutional and behavioral labels succeeds in yielding insight. Names without obvious connections to either label, such as Stiglitz, Spence, Arrow, Myrdal, Solow, Sen, Krugman, Greif, Milgrom and Roberts, feature prominently alongside behavioral economists (e.g., Simon, Elster, Frank, Rabin, Scitovsky, Thaler) and established figures from both mainstream and heterodox camps of institutional economics (e.g., Coase, North, Williamson, Buchanan and Vernon Smith, alongside Ayers, Commons, Galbraith, Polanyi and Veblen). Inclusion of psychologists such as Robin Dawes and Gerd Gigerenzer, social economists such as Mark Granovetter and Rön Stanfield, and anthropologists such as Boas and Boyd lend convincing weight to Schmid’s case for a large complex of channels through which institutions exert causal force in shaping irreducible conflict inherent in economic life. Students of institutional economics, behavioral economics and others with an interest in systematic analysis of social interdependency will find much of interest in Conflict and Cooperation.

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