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Book Review

Culture and Prosperity: The Truth about Markets—Why Some Nations Are Rich but Most Remain Poor

By John Kay.

New York: HarperBusiness, 2004. *Pp. xii, 420. $25.95.*

John Kay's latest book offers an absorbing romp through the history of economic thought in the 20th century. Kay attempts to explain the complex reality of a modern market system rather than resorting to simplistic theorizing about it. Gone are perfectly rational traders, perfectly competitive markets, incentive compatibilities, low transaction costs, informational symmetries, and no externalities. Kay highlights problems and problem solving as the ubiquitous and historical strata through which markets in the West evolved.

Business and society respond adaptively (rather than rationally) to deal with impediments, according to Kay. "Path dependency" then generates a set of institutions, policies, and cultural norms that become "embedded" with markets to manage problems, but—and this is the critical point—these institutions, policies, and cultural norms cannot easily be replicated or imposed elsewhere. Hence, if we wish to understand why Norway is rich and Nigeria is poor, the bottom line is "Rich states are the product of—literally—centuries of coevolution of civil society, politics, and economic institutions. [This is] a coevolution that we only partially understand and cannot transplant" (p. 355).

A survey of rich societies today reveals a wide range of regulations, policies, institutions, and social conventions that work adequately to solve information, rationality, externality, public good, and trust problems. In the United States these mechanisms take different forms than in other highly productive economies like Norway or Switzerland. In Kay's view there is no simple "grand narrative" that can explain the diversity of successful models of capitalism. Because of adaptive behaviors and path dependencies, there is no "one" correct way. Attempting to construct an ahistorical and acultural account of economic development in which the only institution that matters is "private property" is more than foolish—it is hazardous to the success of markets. Not surprisingly, this book is dedicated to those for whom "a partial understanding of complex reality is better than the reassurance of false universal explanations" (p. 355).

The standard neoclassical model—purely rational, materialistic, atomistic actors maximizing utility and profit within free markets—is in Kay's view a simplistic doctrine rife with inconsistencies and dangerous omissions. It is not terribly helpful even in explaining the success of American business, he argues. The blind application of the neoclassical model to novel settings around the world promises more disaster than desserts.

The breadth of the book is enlivening. Kay cuts a wide swath through economic history and the history of economic thought. The downside is that he jumps around without always tying the pieces together. The upside is an erudite exposition of modern economic concepts applied to business. The author notes with amusement how few microeconomists are actually hired by businesses, which he suggests is partly because simplistic microeconomic theory does not capture the evolutionary path-dependent nature of a business enterprise. Nor does the standard model portray the complex incentive structures that motivate managers and workers in business. However, while all models must simplify, models should not be dangerously simplistic.

Kay's long and distinguished career gives him some authority in making these charges. After a productive "conventional" academic career at Oxford (under the future Nobel Prize winner James Mirrlees), Kay left to work on applied economic problems at a think tank headed by Nobel Laureate James Meade. Kay quickly rose to become director. He was eventually drawn to explore the application of economic theory to problems in business policy. Pursuing that interest he accepted a chair in business strategy at the London School of Economics and started an international consulting company, which after 10 years had spread to three continents. In 1996 he was chosen to head the new business school at Oxford, and in 1997 he became the first professor of management selected as a fellow in the British Academy. After 1999 he "retired" to write books and a biweekly column for the *Financial Times.*

Culture and Prosperity at times becomes a somewhat rambling discourse of Econ 101 topics: risk, financial markets, money, adverse selection, moral hazard, general equilibrium, efficiency, game theory, and so on. Kay's observations are often amusing, as in this passage in which he discusses the risk-sharing characteristics of traditional marriage: "Only in the twentieth century did marriage become a put option, in which either party could exit the contract at a pre-arranged price" (p. 24).

Central to Kay's analysis is the role of adaptation. He notes: "While the Darwinian evolution of the species is driven by chance—genetic mutations emerge accidentally—the evolution of social, political, and cultural institutions is the result of many different selection mechanisms. These include learning, imitation, and reward" (p. 217). Society advances using the mechanism of "disciplined pluralism"—"experiment, failure, fresh experiment" are what drive the market to spontaneous order (p. 127). However, while markets solve some problems of coordination, they cannot solve them all. Social conventions, norms, laws, and institutions all play a part in creating order and discipline. Kay explores the evolutionary biology argument for explaining cooperative instincts, along with behavioral economic findings.

According to Kay, the actual behavior of many market participants—managers, workers, and shareholders—is adaptive, but not necessarily rational. How could this be? The answer is that businesses are complex organizations. It would take a superhuman to be fully rational about all choices and opportunities, especially when uncertainty looms large as it does in most business settings. It is expensive, time consuming, and self-defeating to examine all alternatives. Hence, rules of thumb, instincts, and conventions often rule behavior. Successful instincts can defeat the plodding mechanism of rational judgment in many evolutionary settings. Hence, adaptation "is not necessarily efficient, or optimal, in any ordinary sense" (p. 216).

If great entrepreneurs are not purely rational, neither are they purely materialistic. Nonfinancial incentives play the major role in developing the key technological breakthroughs of the 20th century: relativity, computing, DNA, and television. Moreover, Kay argues that attempts to optimize profits or efficiency within organizations will often produce paradoxical countereffects. The neoclassical model is thus not self-sustaining: As firms strive to become profit maximizing using ultrarational models, they actually lay the seeds for worse performance because they undermine the cooperative human networks and adaptive creativity that have worked historically. Kay writes that "Cooperative value systems are key to the development of successful businesses" (p. 256). Social relationships are the context for transactions within and between firms. Positive synergies in group behavior are almost impossible to quantify and reward, but they can be stifled by excessive attention to single quantifiable goals. Mutual suspicion can become a dominant value in organizations that focus on instrumental values.

This concept is developed more fully elsewhere in Kay's writings. The term "obliquity" is used to describe the method by which goals are often best achieved through indirect means. Obliquity is the preferred approach when systems are "complex, imperfectly understood, and change their nature as

we engage with them."[1] According to Kay, attempts in corporations to focus on the simple, well-defined objectives of "profit maximization" or "shareholder value" have not been successful. Optimizers often make the same mistake of underestimating the complexity of the system with which they dealt and the value of the traditional knowledge they inherited. And the answer to their problem is not better analysis and more sophisticated modeling but more humility.[2]

The implications of this approach for developing economics should be clear. The chief problems with the neoclassical model are its neglect of the role of social, political, and economic institutions and its simplistic account of motivation. If we ask why a worker in Sweden has a high standard of living it is because she is a member of many overlapping teams and organizations. These have evolved over the years through positive adaptation "to manage information, pool risks, achieve cooperation and coordination, generate knowledge, and to do so within an extensive and elaborately developed set of conventions and rules" (p. 301). By contrast, people who live in poor countries likely work outside a team or as members of smaller, inefficient teams. Their local institutions have evolved over the years through negative adaptations. These institutions are ineffective or directed toward nonrelevant social and economic objectives (e.g., rent seeking). Because of idiosyncratic path dependencies, it is difficult to later simply say to Nigeria, "Go and imitate what Norway did with its oil wealth." Kay's formula for economic success is eclectic, interdisciplinary, and path specific. One does not have to be as pessimistic as Kay is about transfers of economic theory and institutions to appreciate the depth and application of these insights.

To summarize, Kay attempts to construct a more plausible and self-reinforcing account of how capitalism really functions. This book will be of interest to far more than development economists. In fact, it is mainly geared to microeconomists who can profit from the breadth of new economic ideas repackaged to support a provocative thesis. The first part of the book is slow to develop, and the informal writing style is bothersome at times. One is not given a very clear roadmap of where things are heading. The last half of the book is pure joy as the pieces fit together. This book is highly recommended.

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[1] John Kay. 2004. Obliquity. *Financial Times.* 17 January. Accessed at www.johnkay.com/strategy/317.
[2] Ibid.