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We Happy Few

Not many people seem to realize what an optimistic, life-affirming bunch we economists are. And by relying on economists' happy worldview, we might just be able to improve corporate governance.

Across the political spectrum, people in charge (or people-in-charge-wannabes) treat you like children, but not us economists – we trust you. Whether it's left-leaning types who tell you that malevolent multinationals are brainwashing you to convince you to eat more refined sugar and destroy the environment, or their rivals who warn you about Hollywood and its attempts to sabotage the nuclear family by glamorizing sex and adultery (I may be oversimplifying a bit), the message is loud and clear – regular people are a bunch of gullible losers who can't be trusted to make up their own minds.

That seems like a fairly depressing outlook on life – do we really need our betters to guide us through the thickets of modern life? Mainstream economics answers that question with a resolute No. Economists routinely recommend the use of markets, and reliance on markets is based on the assumption that we're grownups who can be trusted to know what we want. Look at any standard microeconomic textbook. Markets are efficient when individual consumers "maximize utility" (subject, of course, to a "budget constraint"). A consumer's utility depends on his or her "preferences," whatever they happen to be: A portrait of Elvis on velvet? Tickets to the opera? It's your choice.

To an economist, your preferences are just as good as anyone else's. If lots of people want to see *Police Academy* movies, for example, then the marketplace responds with *Police Academy* movies and people are better off. To an economist, it doesn't matter what the critics think.

Economists' views on advertising are instructive. Why does a firm advertise? Economists have at least two explanations. First, advertising provides consumers with information. If consumers don't know about your product, they won't buy it; advertising gets the word out, and, the advertiser hopes, increases sales. But what about products that everyone already knows about? One explanation is that advertising shows potential consumers that you're serious. If you spend a fortune on advertising, but you have a lousy product, the advertising expense will be wasted. Consumers may try your product, but once they've determined it isn't any good, they won't come back. So it only makes sense to advertise if you have a good product. But then consumers know that advertised products are worth buying, and so advertising is still a form of information.

"You look like the kind of man who maximizes utility on a regular basis"

In general, it's difficult to distinguish the "tricking people" explanation for advertising from the standard textbook stories – consumers' preferences aren't readily observable. Economists solve this problem by assuming it away – by and large, we simply assert that advertising doesn't change preferences/trick consumers.

But what basis is there for assuming that consumers can be trusted? Basically, it's ideology. But that's the point – mainstream economics is based on the optimistic ideology that consumers know what they want and should be trusted. (There are exceptions, of course: some products that some consumers want are illegal, and we're discouraged from buying other products by special taxes.)

Because we're trusted, we expect to be able to buy whatever we want, so long as we have the money. Think what would happen if you weren't trusted. Suppose you showed up at the local luxury car dealership with a wad of cash to buy that spiffy convertible you've had your eye on. The sales person, although eager to make a sale, informs you that before selling you the car, he'll have to determine whether that particular car is suitable for your needs, taking into account, for example, your financial status and your automotive objectives. You'd be outraged, right? It's your money, you can buy whatever you want! And that applies to the car you want, the house you want, not to mention those botox injections.

And of course you're right. As long as you

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have the money, no car dealer will refuse to sell you a convertible, if that's what you want. But suppose that after a visit to the showroom floor, you reconsider – on second thought, your old car still has a few good years left; you don't really need a new car. So, instead, you decide to head down to your broker's office and invest the money instead. It's still your money, you can invest in whatever you want. Well, yes and no. It turns out that, unlike the sales person at the car dealership, sellers of securities (at least in the US) have an obligation to determine whether what you want to buy is a "suitable" investment.

Here's Rule 2310 of the National Association of Securities Dealers Manual & Notices to Members, for example (the New York Stock Exchange has a similar rule):

2310. Recommendation to Customers (Suitability)

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(1) the customer's financial status;

(2) the customer's tax status;

(3) the customer's investment objectives; and

(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

You may think that's a bunch of boilerplate that no one pays any attention to, but brokers are routinely accused of selling "unsuitable" securities to their customers, and those disputes keep various lawyers and financial economists gainfully employed.

This lack of trust when it comes to financial matters isn't limited to buying securities. Throughout the industrialized world, the apparent unwillingness or inability of people to save enough for their retirement is a concern, and "forced savings" plans are common. In the US, for example, Social Security – and its proposed privatization – remains a contentious political issue (I know, Social Security isn't really a form of savings, but you get the idea).

It seems odd that, by and large, we're trusted to make decisions about what to do with our money on most things, but not on important financial matters. You'd think that if there's anything we'd study with a rational, cold-eyed detachment, it would be investment and retirement decisions. What possible basis can there be for assuming people systematically make irrational decisions about financial matters?

Um, well, bad news here. There's a growing camp of economists who think people routinely are, in effect, fooled. In his acceptance speech for the Nobel Prize, George Akerlof discussed a variety of topics addressed by the new "behavioral economics." One favorite area is the "prevalence of undersaving for retirement." As Akerlof explains:

"A key theoretical innovation permitting systematic analysis of time-inconsistent behavior is the recognition that individuals may maximize a utility function that is divorced from that representing 'true welfare.' Once this distinction is accepted, 'saving too little' becomes a meaningful concept. . . . Determining whether people save too much or too little involves asking whether people . . . have one (intertemporal) utility function which describes their welfare, but maximize another."

Cut through the technical lingo, and what you get is: people are regularly fooled about how much they need to save.

With so many people apparently getting fooled (or fooling themselves) about savings decision, surely government intervention is called for? Well, maybe. Markets routinely fail to generate "optimal" results, but to call for government intervention whenever a market fails to comport with the textbook ideal involves an often unwarranted assumption – namely, that intervention makes imperfectly functioning markets work better. But intervention in markets is costly (you need to pay bureaucrats, just for starters), and routinely generates unintended consequences.

Take the current Enron/WorldCom/Tyco/Adelphia/whoever's next mess. In the US, the response has been a mad dash to pass new laws and regulations. Will all this additional intervention improve corporate governance? I suppose it might. But before we get too carried away with lots of new rules, I have a modest proposal. Why not reach into the economist's bag of tricks and try trusting people to know what's best for themselves? In particular, the owners of publicly traded firms – shareholders.

Current US rules and regulations, as administered by the Securities and Exchange Commission, restrict the ability of shareholders to control a company's Board of Directors. (Just one example – company ballots for corporate elections include only candidates nominated by the Board; shareholders aren't trusted to nominate their own candidates.) As the recent scandals show, not all Boards have been looking out for shareholders' interests. Why not invite shareholders to the party? (In the interest of full disclosure: I'm a regular contributor to eRaider.com, a site dedicated to shareholder activism.) Trusting shareholders to look after their investments may not work well, of course – people do get fooled. But I'm optimistic.

REFERENCE

George A. Akerlof, "Behavioral Macroeconomics and Macroeconomic Behavior," American Economic Review, June 2002, Vol. 92, No. 3, pp. 411-433.