“It’s almost as if people couldn’t decide whether we had cancer, or maybe a fungal infection. We decided to treat them both, and the problem went away, but maybe that had nothing to do with the treatment.”
In the book *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Chicago Booth’s Richard H. Thaler and Harvard’s Cass R. Sunstein discuss how it’s possible to structure policies and programs in ways that encourage people to make particular choices, and how governments and organizations can use nudges to help people make better decisions. For example, when new hires are presented with a company retirement-savings plan, they may receive a form indicating that they will be automatically enrolled unless they take steps to opt out, so that the default option is to participate.

Thaler’s observations (they extend well beyond nudging) have transformed behavioral economics, which explores how human psychology and other nonmathematic factors affect economic decisions. When Thaler was awarded the 2017 Nobel Memorial Prize in Economic Sciences in October, Peter Gärdenfors, a member of the prize committee, said that Thaler has “made economics more human.”

Thaler is the eighth Booth faculty member to win the Nobel Memorial Prize in Economic Sciences. The prize celebrates distinguished work that has been completed. But Thaler’s research is ongoing—which is why you’ll see a write-up of recent research he coauthored, on the cost-benefit analysis of nudges, explored in this issue (page 7).

At *CBR*, we try to bring you the best and latest insights in business research, from our faculty and faculty at other institutions. We do that in the magazine, as well as online, where we have articles and videos about research by people who have won—or could yet win—distinguished prizes such as the Nobel. In this issue, you’ll also find comments from Chicago Booth’s Eugene F. Fama, a 2013 Nobel laureate, on topics ranging from corporate governance to algorithmic trading (page 45).

Online, we have a video of Thaler giving NFL draft advice, and one of Fama explaining the role of the government in the subprime-mortgage meltdown. We also have both researchers together, in an absorbing episode of *The Big Question*, our monthly video series, in which the two Nobel laureates discuss whether markets are efficient. Fama developed the efficient-markets hypothesis, which says asset prices fully reflect all available information. Thaler’s work has challenged this notion. Part of our mission at *CBR* is to facilitate such conversations between big economic thinkers.

If you’re not already receiving our email newsletters, sign up on our website, and follow us on social media. Through research summaries, articles, videos, essays, and briefings, we hope to bring you information that can help you make decisions that are thoughtful, informed, and ultimately, better.

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Summers: Why you should avoid chasing the crowd
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Trump supporters say they’re optimistic—but they’re not spending

Why we should teach people how to lie
In some situations, it’s better to be dishonest
By Chana R. Schoenberger

The rise of corporate saving
Household saving has declined relative to GDP, but companies have picked up the slack
By Boggy

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Holier than thou? No, just less evil
Money might influence people less than believed
Do corporate whistle-blower laws actually deter fraud?
Why people mismanage credit-card debt

Editors’ letter
Feedback
The Equation

CONTENTS
DEPARTMENTS
1 Editors’ letter
4 Feedback
80 The Equation

DATAPoints
7 Why policy makers should nudge more
8 Summers: Why you should avoid chasing the crowd
9 Credit shocks boost economies, but beware the fall
10 How health-insurance subsidies can help patients and hospitals
12 What Tweets and Yelp reviews are revealing
14 To reduce food waste, build more stores
15 Douglas W. Diamond says the next crisis will be different
16 How to save struggling banks: Get tough with high-risk borrowers
18 Whoops! China’s stimulus plan boosted shadow banking
18 Companies don’t wait for legislation to react to politics
19 Meaningless numbers can boost people’s performance
20 Holier than thou? No, just less evil
20 Money might influence people less than believed
21 Do corporate whistle-blower laws actually deter fraud?
22 Why people mismanage credit-card debt

COVER STORY
24 NEVER MIND THE 1 PERCENT
Let’s talk about the 0.01 percent
By Howard R. Gold

FEATURES
34 Why we should teach people how to lie
In some situations, it’s better to be dishonest
By Chana R. Schoenberger
40 The rise of corporate saving
Household saving has declined relative to GDP, but companies have picked up the slack
By Boggy

Richard H. Thaler, Charles R. Walgreen Distinguished Service Professor of Behavioral Science and Economics, won the 2017 Nobel Memorial Prize in Economic Sciences. His research is being used to inform public policies worldwide. The day he won the Nobel, Thaler taught his regularly scheduled Chicago Booth class on choice architecture, a term originally coined by Thaler and Harvard’s Cass Sunstein. (Page 7)

Eric Zwick, assistant professor of finance and James S. Kemper Foundation Faculty Scholar, studies the interaction between public policy and corporate behavior, with a focus on fiscal stimulus, taxation, and housing policy. He is particularly interested in the problems faced by new ventures and small- and medium-sized private companies. (Page 24)
Embrace passive management already
By Eugene F. Fama

What venture capitalists can learn from ‘racist’ rats
By Waverly Deutsch

With Whole Foods, can Amazon fill your every need?
By Pradeep K. Chintagunta

The real questions the Fed should ask itself
By John H. Cochrane

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By John Paul Rollert

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The market power of ‘superstar’ companies is growing
By Ram Shivakumar

Watergate and presidential power in America
By Philip B. Kurland

What contributed most to the financial crisis?
The IGM Panel

How can we improve social mobility?
The Big Question

FOOTNOTES

45 Embrace passive management already
   By Eugene F. Fama

48 What venture capitalists can learn from ‘racist’ rats
   By Waverly Deutsch

52 With Whole Foods, can Amazon fill your every need?
   By Pradeep K. Chintagunta

57 The real questions the Fed should ask itself
   By John H. Cochrane

60 What’s the matter with handouts?
   By John Paul Rollert

64 It’s time to rethink Milton Friedman’s ‘shareholder value’ argument
   By Asher Schechter, Oliver Hart, and Luigi Zingales

66 The market power of ‘superstar’ companies is growing
   By Ram Shivakumar

70 Watergate and presidential power in America
   By Philip B. Kurland

74 What contributed most to the financial crisis?
The IGM Panel

76 How can we improve social mobility?
The Big Question
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CORRECTION: The original version of the video “Why are stock returns lower under Republicans?” indicated that the annualized return for the S&P 500 during Barack Obama’s administration was 16.4 percent, while during Ronald Reagan’s administration it was 4.23 percent. These figures are inaccurate. The video has been updated to reflect average market returns in excess of the three-month Treasury bill rate, which were 14.35 percent under Obama and 4.23 percent under Reagan. Chicago Booth Review apologizes for the error.

ANOTHER LOOK AT PARTISAN PERFORMANCE

In response to ‘Why are stock returns lower under Republicans?’ (July 2017)

I enjoyed the video based on Chicago Booth’s Lubos Pastor and Pietro Veronesi’s research. Their analysis looks specifically at the US president and his political party. That begs a question about the other partisan branch of government, Congress.

It’s a different story if you include Congress. Stock markets during Republican-controlled Congresses outperform Democrat-controlled Congresses by about 8 percent annually. If you look at stock markets when a Republican president serves with a Republican Congress, that combination outperforms a Democrat president–Democrat Congress by about 2 percent annually.

Interestingly, the data show that the Democrat president–Republican Congress combination has stock markets that do better than any other combination, at a whopping 16 percent per year (think Clinton administration).

This makes Pastor’s statement in the video, that “stock returns under Democrats have been about 11 percent higher, on average, than stock returns under Republicans,” a bit too broad in my opinion. Sure, if you include the word “president” that might be a true statement, but that is leaving out a pretty important branch of government.

The US stock market has done amazingly well for the past 100 years, but I don’t think that’s enough data to make attributions to political parties. Bear in mind, Pastor and Veronesi’s research looked at 15 presidents and only nine party changes, and that doesn’t seem like a very large sample.

Rather, I think we have two parties that have shared somewhat equally in the success of this amazing macro bull market. Putting partisan bickering aside, Washington is, and has always been, filled with genuinely good people who want what’s best for the country, although they go about it differently.

It’s a true testament to our amazingly robust capital markets. Either party can’t help but oversee a strong stock market (if you’re optimistic) or screw it up (if you’re pessimistic).

—Andrew Van Fossen

ON COMBATING CORRUPTION

In response to ‘Should we stop the “revolving door”?’ (Fall 2017)

Research on the effects of the ‘revolving door’ is pointless if we ignore the similar effect of pay-to-play, i.e. bribery of our government officials in the form of campaign financing, collateral benefits accrued by their relatives and friends, etc.

Transparency (i.e. the opposite of opacity) is overrated when there is an almost complete absence of enforcement of current laws and regulations and, in cases where there is any enforcement, criminals get away with a slap on the wrist and taxpayers bear a big portion of the burden of the consequences.

—Usha Meghani Abramovitz

THE EFFECTS OF ECONOMIC BOOMS

In response to ‘How China’s stimulus plan inadvertently boosted shadow banking’ (Published online, August 2017, and on page 18 of this issue)

The parallels between the proliferation of CDOs [collateral debt obligations] in the late stage of the US housing boom and the rise of “wealth management products” following the Chinese infrastructure boom are remarkable and rather frightening.

—Matthew Miller

WHAT’S OLD IS NEW

In response to ‘When making a profit was immoral’ (Summer 2017)

Puritans’ moral attitude toward community/profits: in some ways not all that different from the views of millennial progressives today.

—Ian Salisbury
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Why policy makers should nudge more

It can be a cost-effective approach to encouraging specific behaviors

When policy makers around the world want to influence their constituents’ behavior, they have a few options. They can offer a carrot, such as a tax incentive, stipend, or other reward. They can use the legislative stick by passing a mandate or a ban.

But research suggests they should turn more often to a third tool, a “nudge,” which in many cases is the most cost-effective option.

Nudging is the word used in behavioral science to describe the structuring of policies and programs in ways that encourage, but don’t compel, particular choices. For instance, requiring people to opt out of rather than into a program, such as a retirement-savings plan, might nudge them toward participating. So might reducing the paperwork necessary to enroll.

Policy makers have seen opportunity in nudging, which is why the United States under President Barack Obama had a White House Social and Behavioral Sciences Team devoted to it, and other governments have analogous teams. To assess whether nudges are an effective use of public resources, a group of researchers—University of California at Los Angeles’s Shlomo Benartzi, Harvard’s John Beshears and Cass R. Sunstein, University of Pennsylvania’s Katherine L. Milkman, Chicago Booth’s
SUMMERS: WHY YOU SHOULD AVOID CHASING THE CROWD

“In general, the right career advice for people is the advice that made [Richard H. Thaler’s] career in many ways. Which is, don’t be like a little kid’s soccer game. In a little kid’s soccer game, everybody runs to where the ball is, and is in the crowd where the ball is. If you look at the most successful research careers, mostly they’re people who stayed where the ball wasn’t. Then, eventually, the ball came to their corner and they were there all alone, ready for their moment of glory.”

—Former US Secretary of the Treasury Lawrence H. Summers, speaking at a roundtable discussion hosted by the Becker Friedman Institute in October.

Cost–effective solution

Reviewing a range of incentives employed to get people to put more money toward their retirement plan, research finds that a nudge approach is the most cost–effective.

<table>
<thead>
<tr>
<th>Impact</th>
<th>Effectiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average increase in people’s own contributions</td>
<td>Average increase per $1 spent on the incentive</td>
</tr>
<tr>
<td>US dollars</td>
<td></td>
</tr>
</tbody>
</table>

**Nudge:** Requiring new employees to specify a contribution rate

- +$200 → +$100

**Incentive:** Offering money to attend an employee benefits fair

- +$59 → +$15

**Incentive:** Matching 20 percent of contributions

- +$94 → +$6

**Incentive:** Matching 50 percent of contributions

- +$245 → +$3

**Incentive:** Changing the tax deduction for Danish taxpayers’ contributions to a particular type of pension plan

- +$540 → +$3

**Incentive:** Higher tax credit for some US taxpayers’ first $2,000 of retirement savings

- +$12 → +$1
Credit shocks boost economies, but beware the fall

U.S. President Donald Trump and a Republican majority in Congress are moving to roll back some of the banking regulations put in place after the Great Recession. Proponents maintain that deregulation would boost the economy by freeing banks to offer credit to more people and businesses.

It could work, at least for a while, but there is some recent history that lawmakers might take into account. One of the last major efforts to deregulate banking proved quite successful for some states in the short run, but these same states were later hurt by the effects of the regulatory easing.

Princeton’s Atif Mian, Princeton PhD candidate Emil Verner, and Chicago Booth’s Amir Sufi studied the rollback of banking regulations in the 1980s, when states had the latitude to control the speed of deregulation. Those that moved quickly experienced the greatest benefits as wages and employment rose, GDP expanded, and house prices climbed. But they also later saw the steepest declines in those same metrics when the United States fell into recession in 1990–91.

States that rapidly deregulated banking sharply expanded credit availability. More money available to borrow led to increased demand for goods and services, particularly from individuals who bought nontradable goods such as real estate and services. Wages and employment grew in areas such as construction, the service industries, and public services.

But the regulatory easing magnified the effects of the 1990–91 recession in early-deregulation states, the researchers find. With household debt high, consumers had to cut back, and they did so in the nontradable sectors that had seen growth. “Credit supply shocks that operate primarily on the demand side of the economy may lead to an amplified business cycle, boosting demand during the expansion but leading to a more severe subsequent contraction,” write the researchers, who also find a link between the rise in a state’s household debt prior to the recession and the severity of the recession in that state.—Brian Wallheimer

Where recession hit harder

When the US fell into recession in 1990–91, many of the states that were quicker to roll back banking regulations during the ‘80s fared worse by these economic measures:

Changes in US states’ economies, 1989–92

<table>
<thead>
<tr>
<th>Unemployment rate change</th>
<th>Change in real GDP per capita</th>
<th>Change in housing prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage points</td>
<td>-10%</td>
<td>-5%</td>
</tr>
</tbody>
</table>

Note: Research includes Washington, DC, but excludes Delaware and South Dakota, which enacted special laws to lure banks’ credit-card business. Real GDP chart excludes Alaska.

HOW HEALTH-INSURANCE SUBSIDIES CAN HELP PATIENTS AND HOSPITALS

THERE HAS BEEN much debate in the United States about the costs and benefits of publicly subsidized health insurance. A survey of research on this issue suggests that both recipients and nonrecipients, including doctors and hospitals, benefit from expanding such insurance—but also highlights the complicated dynamics involved.

The impetus for this discussion is the 2010 Affordable Care Act (ACA). Popularly known as Obamacare, the ACA greatly expanded health-insurance coverage for low-income adults by making heavily subsidized plans available through federal and state-run marketplaces and by expanding Medicaid.

According to MIT’s Amy Finkelstein, Chicago Booth’s Neale Mahoney, and Northwestern’s Matthew J. Notowidigdo, who conducted a review of existing literature, subsidized health-insurance coverage can substantially reduce the risk that poorer patients will have large out-of-pocket expenses.

The subsidized coverage also has financial benefits for health-care providers, because additional coverage leads to more medical spending, and therefore revenue, the researchers find. Plus the coverage reduces the implicit costs of what otherwise amounts to uncompensated care. The uninsured “pay only a small fraction of their health-care costs, on the order of one-fifth to one-third of their medical expenditures,” write Finkelstein, Mahoney, and Notowidigdo. Providers and other parties pay the rest.

However, with the ACA in place, people who were previously uninsured said they felt healthier, and they reported a lower level of depression—but there is a lack of data showing actual health benefits. Some randomized studies have produced clinical health measurements, including for blood pressure, blood sugar, and cholesterol levels, but none of these showed significant improvements.

The researchers also review evidence suggesting that even modest premiums can deter many low-income adults from enrolling in health-insurance programs. If premiums were subsidized to 90 percent of insurers’ average costs, at least 20 percent of eligible individuals would elect to stay uninsured even if they faced penalties for doing so.

If an uninsured patient were to rack up medical bills, she might walk away from the debt, especially if she already has a low credit score. The costs would ultimately be paid, mostly or entirely, by taxpayers and health-care providers.

“Because the uninsured do not face the full social cost of being uninsured when uncompensated care exists, they have less incentive to take up formal insurance coverage,” the researchers write. This situation helps explain why the ACA levied tax-related penalties on people choosing to remain uninsured.

There is an estimated $75 billion in overdue US medical debt, according to data compiled by the researchers. Many people assume that hospitals pass on unpaid debts from uninsured patients to charity-based organizations, other family members, and the government, as well as to insured patients by inflating hospital charges. But the researchers find limited evidence of a hospital’s ability to “cost-shift.”

—David J. Phillips

What Tweets and Yelp reviews are revealing

Economists and other social-science researchers are using large bodies of text—from Twitter messages, Google searches, Yelp reviews, and other sources—to predict asset price movements, estimate racial prejudice, and study what’s driving consumer decisions.

As text analysis becomes more popular, Stanford’s Matthew Gentzkow and Chicago Booth’s Bryan T. Kelly and Matt Taddy survey the research, and identify and explain some of the most common ways to transform strings of words into usable data.

In its simplest form, text analysis involves counting the frequency with which words and phrases appear in documents, internet search queries, or online databases, and using these counts to answer research questions. (For more, see “Why words are the new numbers,” Spring 2015.) As the field develops, researchers are using patterns uncovered by earlier studies to test for potential biases in their own findings.

Researchers are also making a host of observations—from finding political slant in news coverage to measuring how much political uncertainty affects economic growth. MIT’s Albert Saiz and Wharton’s Uri Simonsohn use web search results to estimate the extent of corruption in US cities. Seth Stephens-Davidowitz, a former Google data scientist, uses the frequency of racially charged terms in searches to measure prejudice in areas of the United States. And University of Bonn’s Benjamin Born and the European Central Bank’s Michael Ehrmann and Marcel Fratzscher analyze the effects of financial stability reports issued by central banks. Their research suggests optimistic reports move stock markets at least 1 percent in the month following their release, while pessimistic reports have less influence.

Such analyses involve large volumes of data. “A sample of 30-word Twitter messages that use only the 1,000 most common words in the English language has roughly as many dimensions as there are atoms in the universe,” write Gentzkow, Kelly, and Taddy. —Amy Merrick

Go to Review.ChicagoBooth.edu to see citations for research in this article.

Subsidized coverage reduces the cost of what otherwise amounts to uncompensated care.
A process of deconstruction

While researchers have been processing text into numeric data for decades, new technologies are enabling them to analyze these data in inventive ways. This Shakespearean sample gives an overview of what researchers are doing on a large scale, preparing text for different kinds of analysis.

**Dictionary-based methods:** After making a bag of words, researchers classify them according to a predefined dictionary such as Harvard’s General Inquirer program, which groups them by sentiments such as “positive” or “optimistic.” “This is by far the most common method in the social science literature using text to date,” the researchers note.

**Text regression model:** This type of model uses statistical methods to predict some attribute, such as real-estate prices, from counts of words. The most common text regression model, known as a penalized linear model, imposes constraints that minimize irrelevant estimates. This approach does not try to model the structure of the language.

**Generative model:** Here researchers explicitly simulate the process by which language is produced. For example, when more people lose their jobs, unemployment-related terms will rise in web searches. One common generative model is a topic model, which discovers the themes in a collection of documents and then clusters the documents accordingly.

**Deep-learning techniques:** Artificial neural networks simulate interconnected brain cells inside a computer. They recognize nonlinear relationships in complex data sets extremely well. New “deep” versions of neural networks work faster with less tuning required by users. Already powering Google Translate, these methods are catching on quickly in research.

Gentzkow et al., 2017
To reduce food waste, build more stores

More than one-third of all food produced in the world is wasted, according to the United Nations. In industrialized countries, retailers and consumers throw out 300 million metric tons of perfectly fine food per year—enough to feed the estimated 900 million people who are going hungry. The UN, United States, and European Union have set a goal to halve food waste by 2030, and to meet that, some countries including the US are running public-service or education campaigns to encourage people to waste less food.

Much of the guidance is targeted at consumers. The UN, for example, advises people to plan meals, eat the food already in their fridges before buying more, and compost food scraps. But research by Chicago Booth’s Elena Belavina suggests policy makers should focus less on consumer advice and more on urban planning. Her research finds that many cities could significantly reduce food waste by increasing grocery store density.

Belavina looked at the number of stores in a given market area and built a model that weighs the effects of store density on consumers and retailers. On the consumer side, higher store density leads to lower consumer food waste, she finds. When stores are closer to each other, they’re also closer and more accessible to shoppers, which means people go shopping more often and buy less on each visit.

When the store is convenient, a shopper is less likely to stock up—and less likely to let food spoil. “Households have to travel less to visit a store in denser markets, which incents more frequent trips to grocery stores and smaller basket sizes or household inventory levels,” Belavina writes. “Smaller inventory levels imply less food waste as it is less likely that the inventory will expire before it is consumed.”

However, higher store density also leads to more retail food waste. When customers waste less, they buy less. Meanwhile, each store serves a smaller area and carries inventory, which is less efficient than a system that involves more centralized inventory. Demand is also more irregular and variable, Belavina says, as shoppers who stock up return to stores on a more predictable basis than shoppers with less in their baskets. The end result: stores end up with leftover inventory, which becomes waste.

Belavina created a model that weighs the competing effects and countereffects.

Ideal balance of grocery stores and food waste
Research suggests how many stores could be added in five US locations to generate the lowest level of waste.

Optimal density of grocery stores
Annual per capita carbon emissions associated with food waste, by number of stores

<table>
<thead>
<tr>
<th>Location</th>
<th>Actual stores per 10 sq km</th>
<th>Optimal number of stores</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denver</td>
<td>5 stores</td>
<td>102.5</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>11.25 stores</td>
<td>147.5</td>
</tr>
<tr>
<td>Chicago</td>
<td>15 stores</td>
<td>195</td>
</tr>
</tbody>
</table>

**Measure of carbon emissions**

<table>
<thead>
<tr>
<th>City</th>
<th>Stores per 10 sq km</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denver</td>
<td>400</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>400</td>
</tr>
<tr>
<td>Chicago</td>
<td>400</td>
</tr>
</tbody>
</table>
Consider, for example, that when there are more stores in an area, there’s more competition, which leads to lower prices. “This increases consumer waste as consumers waste more of the cheaper groceries,” she writes. “This higher consumer waste translates into higher market demand, which decreases retail waste on account of the smaller safety stocks.” Belavina’s analysis reveals that despite this, and despite generally increased retail waste, higher store density does generally reduce food waste.

She looked at Chicago, Denver, Los Angeles, the borough of Manhattan, and Ithaca, New York. In Chicago, having just three to four more stores per 10 sq km would lead to 6–9 percent less food waste. “Recall that the carbon footprint of food waste is comparable to that of all road transportation,” she writes, “thus these gains are very substantial.” The effects were less pronounced for Manhattan, where the stores are already closer together.

But more density reduces waste only up to a point. When stores reach a threshold density, there’s more food waste. None of the cities she looked at have yet reached that point, although Manhattan is closest. The optimal density of stores there would be 495 stores per 10 sq km, she calculates, whereas the actual density is 458. “Adding significantly more stores here might even lead to an increase in waste.”—Ed Robinson

It has been 10 years since the 2007–10 financial crisis started. What have we learned about what happened?

There are several narratives, but no consensus on the “reason” for the crisis. One narrative is that the system was too interconnected—too many people relied on other people who bought insurance, credit default swaps, and so on. Another narrative says people panicked, and there was a run on the financial system that had to do with short-term debt. A third narrative is too big to fail (TBTF).

TBTF is a problem, but it wasn’t the reason the crisis occurred. Who caused the most trouble? Investment banks such as Lehman Brothers. I don’t think anyone thought Lehman was too big to fail. The things at the center were not the traditional TBTF institutions.

I gave a speech before 2007 saying financial crises are everywhere and always caused by problems related to short-term debt. It looks to me like what happened was a run.

What do you think of the postcrisis regulations? There’s no great evidence yet about whether Dodd-Frank has been good or bad. Probably more than 40
percent of the bill is good, and nothing is a disaster. But we haven’t had another big financial crisis, so we can’t say which of the hundreds of requirements in it were good, unnecessary, or bad.

The big banks don’t like the capital requirements or the Volcker Rule, which says you can’t do this (proprietary trading) and that (lending). I like capital requirements better than the Volcker Rule, because a lot of things look like proprietary trading, including market making. The Volcker Rule seems to have cut the amount of bonds that market makers hold, and there’s controversy about whether the bond market has become less liquid.

When you don’t know what caused the crisis, it’s hard to write a law to treat it. It’s almost as if people couldn’t decide whether we had cancer, or maybe a fungal infection. We tried to treat them both, and the problem went away, but maybe that going away had nothing to do with the treatment. Maybe it went away on its own.

Are we any safer than we were in 2007? Yes, I think Dodd-Frank did make things safer, although we’d be safer even if we hadn’t passed any laws at all. We don’t tend to have two crises in a row. Memories are still fresh. People say, “I made that mistake yesterday. I’ll make a different one today.”

Dodd-Frank didn’t outlaw every risky practice that could cause a crisis. No law could or should. Something’s going to happen, and at that point, we’ll see how well it works.

But one stated intent, I think, in writing the law was to make sure there would be no bailouts ever again. And if that’s how the law were to ever actually be interpreted, that would be a huge problem. The ability to prop up the financial system in a crisis is essential. That’s what central banks and governments are about. We don’t want to rely on their help too much, but we don’t want to make that help impossible.

You’ve studied banking for more than 40 years. Will we have another crisis? We will have another crisis. We’re not going to get rid of them, but we can certainly cut down on the severity of them. But you’re not going to get crises down to zero.

We’re not going to get rid of them, but we can certainly cut down on the severity of them. But you’re not going to get crises down to zero.

Have another crisis. We’re not going to get rid of them, but we can certainly cut down on the severity of them. But you’re not going to get crises down to zero.

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Are we any safer than we were in 2007? Yes, I think Dodd-Frank did make things safer, although we’d be safer even if we hadn’t passed any laws at all. We don’t tend to have two crises in a row. Memories are still fresh. People say, “I made that mistake yesterday. I’ll make a different one today.”

Dodd-Frank didn’t outlaw every risky practice that could cause a crisis. No law could or should. Something’s going to happen, and at that point, we’ll see how well it works.

But one stated intent, I think, in writing the law was to make sure there would be no bailouts ever again. And if that’s how the law were to ever actually be interpreted, that would be a huge problem. The ability to prop up the financial system in a crisis is essential. That’s what central banks and governments are about. We don’t want to rely on their help too much, but we don’t want to make that help impossible.
 Trump supporters say they’re optimistic—but they’re not spending

Donald Trump supporters became significantly more optimistic about the economy after he was elected president, playing out a partisan split over economic perceptions that has become commonplace among the US electorate. As decades of political-science research have demonstrated, supporters of the party in the White House typically think the economy is in better shape than supporters of the opposition party do.

But though each presidential election is accompanied by a jolt of economic optimism from voters in the victorious party, Trump supporters have not let their newfound confidence affect their spending habits, and neither did the supporters of winners in the four previous US presidential elections, according to research by Princeton’s Atif Mian, Chicago Booth’s Amir Sufi, and Nasim Khoshkhou of Argus Information and Advisory Services. Although economists generally predict that consumers with optimistic economic expectations will boost their spending, Trump voters didn’t display such behavior in the aftermath of the election, according to the findings.

The research is an extension of work Mian, Sufi, and Khoshkhou started before Trump’s election, in which they uncover that optimism inspired by political elections doesn’t necessarily translate into spending. (For more, see “Relax, US elections don’t drive consumer spending,” Winter 2015.) Analyzing county-by-county results for presidential elections between 2000 and 2012, they find that election-driven consumer sentiment and spending didn’t necessarily match up. After Barack Obama’s 2008 election, voters in areas that generally opposed him said they planned to purchase less, but their actual spending didn’t change.

After Trump’s election, the researchers looked again at the opinions and consumer habits of voters, analyzing optimism and spending patterns on a countywide level. They looked at data sources including surveys and polls of individual voters, as well as county-level data reflective of sales such as new-car registrations and credit-card spending. They find little evidence of a spending bump.
The state of the economy is partisan

While Republicans' and Democrats' optimism about the US economy shifts depending on whether they hold the presidency, the gap between the parties' opinions has been widening.

Difference between Republicans' and Democrats' sentiments about the US economy

<table>
<thead>
<tr>
<th>Party</th>
<th>Sentiment Difference</th>
<th>Standard Deviations</th>
</tr>
</thead>
<tbody>
<tr>
<td>George W. Bush</td>
<td>0.37</td>
<td>1</td>
</tr>
<tr>
<td>Barack Obama</td>
<td>0.71</td>
<td>1</td>
</tr>
<tr>
<td>Barack Obama</td>
<td>0.89</td>
<td>1</td>
</tr>
<tr>
<td>Donald Trump</td>
<td>1.11</td>
<td>1</td>
</tr>
</tbody>
</table>

Republican counties' spending when their candidate won...

Change in auto sales for every 1 percentage point advantage in county vote

- Bush 2000–01
- Bush 2004–05
- Trump 2016–17

The cumulative results indicate that over the past 20 years, the partisan effect has grown increasingly strong, widening the gap in economic expectations between the winning and losing camps. Trump's election led to an unprecedented relative increase in optimism, eight to nine times larger than the election of George W. Bush in 2000, and three to four times larger than the effect following Obama's elections in 2008 and 2012.

The researchers find support for the notion that the expectations gap created by electoral results is the product of partisanship rather than other factors, such as policies that benefit one party's voters more than the other's. Looking at state- and county-level data, the authors find there's little to suggest that "economic circumstances change to the benefit of areas supporting the new president after elections." In fact, even Democrats and Republicans within the same zip code have profoundly different outlooks on the future of the economy.

Despite Trump supporters' upbeat expectations, as was the case following earlier elections, optimism doesn't appear to have translated into spending. Though Republican respondents to a Gallup survey question did report a 6 percent increase in spending after the election, Republicans polled by the University of Michigan didn't feel it's a better time to buy durable goods, such as appliances, electronics, or furniture. Data on actual (as opposed to reported) spending also don't reflect an increase: as of June 2017, the counties that voted heavily in favor of Trump had seen no increase in car buying. This extends the pattern the researchers identified before the election, but "the evidence for the 2016 election is most striking," they write.

For economists, the findings call into question the practical interpretations of economic expectations. When researchers ask a consumer how healthy she expects the economy to be five years out, they typically treat the answer as a reflection of the individual's expectations about her own potential income, and therefore spending power. But this study suggests postelection optimism doesn't necessarily lead to economy-boosting spending.

—Dee Gill

Whoops! China’s stimulus plan boosted shadow banking

Dominique Strauss-Kahn struck an optimistic note in response to the State Council of China’s 2009 announcement of an unprecedented 4 trillion RMB fiscal-stimulus package, in the wake of global financial recession. Strauss-Kahn, managing director of the International Monetary Fund at the time, said the stimulus would “have an influence not only on the world economy in supporting demand but also a lot of influence on the Chinese economy itself, and I think it is good news for correcting imbalances.”

But less than a decade later, China’s local governments are struggling under massive debt caused by the stimulus, research suggests. Tsinghua University’s Zhiguo He and Chun Liu along with Chicago Booth’s Zhiguo He document how the stimulus led to rising debt and a surge across China in shadow-banking activities—lending and financial activities conducted by institutions not regulated as banks.

Basing their analysis on various public and nonpublic data sources, Chen, He, and Liu estimate that the stimulus took the form of around 5 trillion RMB in bank loans that were pushed to the Chinese economy in 2009 alone. Meanwhile, the total debt balance of Chinese local governments ballooned from 6 trillion RMB in 2008 to 27 trillion RMB in 2016, with most of that debt coming from nonbank loans.

According to the researchers, this dramatic growth in nonbank, local-government debt is a manifestation of the 2009 stimulus plan’s overhang effect. Local governments took out bank loans in 2009, but they had to repay all those loans around three to five years later, at which point the governments resorted to nonbank financing to either continue their long-term infrastructure projects or roll over their maturing bank loans.

To track shadow-banking activity, Chen, He, and Liu looked at municipal corporate bonds (or cheng tou zhai in Chinese), one form of nonbank financing that many local governments took on. Local governments issue these bonds to finance infrastructure projects whose benefits and revenue streams materialize several decades later. As most such bonds are invested by households via wealth management products, the shift toward nonbank debt across China strongly paralleled a rise in China’s shadow-banking sector. In provinces where local governments took out more-stimulus-related loans in 2009, there was, from 2012 to 2016, more growth in municipal corporate bonds and shadow-banking activities.

Local-government nonbank debt, as a fraction of China’s shadow-banking balance, grew from a negligible 1.5 percent in 2008 to 22 percent in 2014 and 48 percent in 2016, write Chen, He, and Liu. Local governments especially turned to this type of financing after 2012, when bank debt came due. As many economists believe that Chinese governments will continue to finance their debts through shadow banking, it’s clear that stimulating China’s economy has come with a significant cost.

—Alex Verkhovskiy

The rise of nonbank loans

China’s 2009 stimulus allowed local governments to take out bank loans, but when it came time to repay them, the country saw a rise in nonbank financing.

<table>
<thead>
<tr>
<th>Local governments’ debt balance</th>
<th>Municipal corporate bonds issued, as a percentage of China’s GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other debts</td>
<td>Other purposes</td>
</tr>
<tr>
<td>Bank loans</td>
<td>Investments</td>
</tr>
<tr>
<td>Municipal corporate bonds</td>
<td>Bank loan repayments</td>
</tr>
</tbody>
</table>

Trillions of RMB | Trillions of USD (2017) |
---|---|
¥30 | $4.5 |
¥25 | $3.75 |
¥20 | $3 |
¥15 | $2.25 |
¥10 | $1.5 |
¥5  | $0.75 |
¥0  | $0   |

Note: 2013–16 bank loan data are approximate. Chen et al., 2017; XE Currency Converter

COMPANIES DON’T WAIT FOR LEGISLATION TO REACT TO POLITICS

When legislators debate tax policy, corporate managers listen, according to research from Stanford’s Lisa De Simone and Joseph D. Piotroski and Chicago Booth’s Rimmy Tomy. Between 2009 and 2011, when US policy makers considered numerous bills offering a repatriation tax holiday to companies holding cash abroad, the companies most likely to repatriate “accumulated $376 billion to $488 billion in excess cash in anticipation of a reduction in repatriation taxes,” the researchers find.

NUDGES, behavioral-finance parlance for little cues that urge us to do things at certain times, have been embraced by governments and organizations to influence behavior. For example, when you pay a restaurant bill with a credit card, a list of suggested tip amounts can nudge you into tipping at least 15 percent. When you sign up for a retirement plan, the company may precheck a box to nudge you into participating.

Now research suggests people may respond as well to “numerical nudges,” which are dynamic and changing but inherently meaningless numbers that can nevertheless be used to strategically alter behaviors.

Luxi Shen of the Chinese University of Hong Kong (a recent graduate of Chicago Booth’s PhD Program) and Booth’s Christopher K. Hsee ran several experiments designed to test numerical nudges. In one, the researchers had people complete online surveys rating advertisements, telling participants that the three people who finished the most surveys would receive a cash prize. For every survey completed, participants received a score, which did not indicate anything about a person’s performance and could not be exchanged for any reward. But participants responded to the scores anyway. People who saw their point total accelerate quickly filled out significantly more surveys.

Another experiment tested men who were doing two-minute rounds on a step machine. Such machines typically track the number of steps a person takes while exercising, but the researchers adjusted some machines to display an extra number that increased according to a preprogrammed algorithm. “Notably, this number carries no independent information,” the researchers write—and they told the men as much. Yet once again, participants who saw their “X number” scores accelerate more quickly climbed more steps than others.

A variety of organizations could use numerical nudging to influence behavior, the researchers say. For example, retailers could give shoppers a score for repeatedly buying the same product. If a person sees the score climb quickly after he purchases a specific brand of soap, for example, he may buy even more of it on his next shopping trip. An accelerating number, says Shen, could be used to motivate people to pay bills on time, save energy, and more.—John Wasik

Holier than thou?
No, just less evil

S
ocial psychologists have documented that people believe they’re more likely than others to do charitable actions, such as donating money, volunteering time, or participating in political campaigns. But research from University of Chicago postdoctoral researcher Nadav Klein and Chicago Booth’s Nicholas Epley suggests that people don’t necessarily believe they are holier than others. Instead, people simply believe they are less evil than others. Understanding the fine distinction between the two ideas could be used to help guide behavior.

The researchers conducted a series of experiments to explore how people think of their own and others’ virtue. In one, Klein and Epley called people into a lab and told some participants (“targets”) that they would be paired up with other participants (“actors”). Each pair had a chance of winning $10 at the end of the experiment, but the actors got to decide how this $10 would be split between themselves and the targets.

Klein and Epley instructed some actors either to keep $9 out of the $10 for themselves (a selfish action) or to keep only $1 (a generous action). The researchers then asked all participants whether the actors would have done the same thing had they been free to do so.

The actors who were told to selfishly keep $9 were less likely than the targets to believe that this selfish action represented their true character. However, the actors told to keep only $1 were no more likely than targets to believe that this generous action represented their true character. Actors saw themselves as less evil than targets thought them to be—but they didn’t see themselves as more ethical.

Other experiments revealed the same “asymmetric self-righteousness,” as the researchers call it: people consistently reported they were less evil but no more moral than others. In one case, participants predicted that they’d feel worse after carrying out a selfish act (giving away just $1 of $6), but not any better than others after carrying out an unselfish act (giving away 5 of $6). In another case, participants believed they’d give more money to another person than others would in their most selfish moment—but no more than others in their most generous moment.

And people felt they were less likely than others to engage in immoral behaviors, such as stealing a $20 tip left for a waiter—but neither more nor less likely to engage in moral behaviors such as returning a lost wallet.

When it comes to ethical behaviors, people judge themselves based on their own positive intentions, but they judge others based on their actions, the researchers write. And when it comes to unethical behaviors, people justify their own actions but are less understanding of others’.

The findings could benefit people writing policies to encourage particular behaviors. Take, for example, a company that wants to initiate policies that promote ethical practices, such as avoiding gender bias in job applications. If people believe they are unlikely to engage in unethical behaviors, saying these policies are aimed at preventing unethical behavior might be ineffective “since in that case people might think, ‘Oh, that doesn’t apply to me!’” says Klein. “So the better way to frame these policies may be as ones aiming to promote ethical—rather than discourage unethical—behavior.”—Alice G. Walton


MONEY MIGHT INFLUENCE PEOPLE LESS THAN BELIEVED

THINKING OF MONEY can change how people think, feel, and behave—or, at least, this has been generally accepted among behavioral scientists for the past decade. But research by Chicago Booth’s Eugene M. Caruso, Stony Brook University’s Oren Shapira, and Booth postdoctoral scholar Justin Landy raises questions, and suggests that these systematic effects on thinking and behavior may be overstated, if they exist at all.

Numerous published studies have found that thinking about money makes people feel more self-sufficient. The first such one, from 2006, involved things that remind people of money, or “money primes.” More than 165 experiments generally supporting the theory were published in the subsequent decade. But when Caruso, Shapira, and Landy were conducting their own, related experiments, they found that demographic characteristics sometimes appeared to influence the results, and they realized that other research had also produced similar inconsistencies.

To probe these inconsistencies, the researchers systematically evaluated the effects of previously used money primes, testing a number of the prompts across a diverse sample of people. They first had 2,200 online participants view one of several prompts. One group saw the instructions for the study over a faded image of a stack of bills. Others were asked to imagine being wealthy or impoverished in the future, or to unscramble money-related phrases.

Almost all of the manipulations did get participants thinking about money. But the primes had weak and inconsistent effects on whether these thoughts led participants to feel wealthy or self-sufficient. And demographics including gender, socioeconomic status, and political ideology produced no clear patterns.

The results raise questions about priming. Beyond that, they produce a method that could be used to test other findings in psychological research.—Alice G. Walton

Go to Review.ChicagoBooth.edu to see citations for research mentioned and to read a longer version of this article.
Do corporate whistle-blower laws actually deter fraud?

High-profile financial frauds in recent years spurred state and federal authorities to implement or strengthen “whistle-blower” incentives, which offer tipsters financial rewards (and a shield from employer retaliation) for blowing the lid on corporate fraud.

These initiatives can help deter fraud, according to the dissertation of Heemin Lee, a recent graduate of Chicago Booth’s PhD Program, now at CUNY-Baruch College.

Lee examined two classes of companies. One was made up of those subject to state-level False Claims Acts (FCAs) that have a qui tam provision, which allows a private citizen to file a lawsuit on behalf of the government and obtain a portion of any money recovered. The other was composed of companies that are subject to the Securities and Exchange Commission (SEC) whistle-blower program—implemented in 2011 as a part of the Dodd-Frank Act—which allows individuals to provide tips directly to the SEC and offers enhanced protection from retaliation along with financial rewards if the information leads to successful enforcement actions. (Lee did not consider effects of the Sarbanes-Oxley Act of 2002 because the act does not provide financial bounties to whistle-blowers.)

Her data suggest that exposure to the threat of whistle-blowing under state FCAs reduced a company’s probability of accounting fraud by 7 percent. The SEC whistle-blower program reduced the probability of fraud by a similar amount, Lee reports. (To gauge the effectiveness of federal programs, she analyzed companies, during a sample period of 2008–14, that had not been subject to state-level FCAs but were subsequently exposed to the SEC’s whistle-blower program.)

To determine the change in probability of accounting fraud, Lee used two prediction models that identify unusually high accruals, inflated sales, overstated inventory, and other conditions often associated with fraud.

The deterrent effect could have been noted by audit firms: their fees tended to fall by 5 percent after clients were exposed to state FCAs, Lee finds. When there’s a lower probability of fraud, there’s also reduced potential auditor liability.

Lee constructed her first sample using US public-equity holdings of state pension funds in jurisdictions that had enacted an FCA with a qui tam provision. Whistle-blowers in these states could obtain financial rewards by reporting financial fraud of any company, regardless of its location, whose shares were owned by the state’s pension fund. Lee then used within-company variations in state-pension-fund ownership as well as variations in state FCAs, such as the year of passage and the scope of coverage, to identify companies that were subject to whistle-blowing laws to some degree.

The second sample consisted of companies subject to the SEC whistle-blower program. Here, Lee’s control group consisted of companies that were previously exposed to state FCA provisions. Companies that had not previously been exposed to state FCAs tended to have a more marked response to the new federal whistle-blower provision.—Marty Daks

Why people mismanage credit-card debt

Consumer-finance experts usually advise people with balances on multiple credit cards to make the minimum payments on all of their cards and then put any remaining payments on the card with the highest interest rate. However, relatively few people do that, and research suggests why. According to University of Nottingham’s John Gathergood and Jörg Weber, Chicago Booth’s Neale Mahoney, and University of Warwick’s Neil Stewart, consumers try to manage multiple debts at once rather than pay off the most expensive one. That flawed approach can be costly. The researchers consider a number of explanations, including that people could be repaying the credit card with the highest capacity, the highest balance, or the lowest balance. Looking at a data set based on records from five major credit-card issuers in the United Kingdom, they pit these explanations against their own theory, “balance matching,” in which payments are proportionate to overall amounts owed.

People didn’t follow the most cost-effective path

The researchers assessed the credit-card records in their data set and confirmed that the experts’ advice was on point. After taking care of monthly minimum payments:

- The share of people’s remaining payment money that optimally should have gone to the card with the highest interest rate: 97.1%
- The share that actually went to people’s highest-rate cards: 51.5%

The research reveals that consumers’ actual-payment activity put too little toward their highest-rate cards compared to what the optimal payment would have been.

They focused mostly on their cards’ balances rather than the interest rates

Looking at consumers with balances on multiple credit cards, the researchers compared people’s actual-payment behavior to a calculation of what the monthly payments would have been had the payment money been divided in proportion to the balances owed on each card. By focusing on balances—which are prominently displayed on credit-card statements, the researchers note—people underpaid their highest-rate cards by more than 20 percentage points.

The researchers explored five scenarios:

- **Avoiding max-out**: Prioritizing the card that’s closest to hitting its credit limit, to avoid penalty fee.
- **Making room**: Prioritizing the card that has the most credit room, to enable a large purchase.
- **Biggest balances**: Prioritizing the card with the highest balance, to maintain equal balances across cards.
- **Small victory**: Prioritizing the card with the lowest balance, motivated to have one that’s paid off.
- **Balance matching**: Making payments proportional to the balances owed on each card.

The researchers compared people’s actual-payment behavior to the balance-matching model developed by the researchers—significantly more so than the other four scenarios they tested.
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The share of people’s remaining payment money that optimally should have gone to the card with the highest interest rate

- 97.1%
- 51.5%

People didn’t follow the most cost-effective path

The researchers assessed the credit-card records in their data set and confirmed that the experts’ advice was on point. After taking care of monthly minimum payments:

**PAYMENT BEHAVIOR ON THREE CARDS**

<table>
<thead>
<tr>
<th>Card</th>
<th>Lowest Balance</th>
<th>Highest Balance</th>
<th>Lowest APR</th>
<th>Highest APR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Card 1</td>
<td>45%</td>
<td>36%</td>
<td>51%</td>
<td>27%</td>
</tr>
<tr>
<td>Card 2</td>
<td>40%</td>
<td>60%</td>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>Card 3</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**PAYMENT BEHAVIOR ON FOUR CARDS**

<table>
<thead>
<tr>
<th>Card 1</th>
<th>Card 2</th>
<th>Card 3</th>
<th>Card 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>40%</td>
<td>60%</td>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>51%</td>
<td>27%</td>
<td>51%</td>
<td>27%</td>
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</tbody>
</table>

**PAYMENT BEHAVIOR ON FIVE CARDS**

<table>
<thead>
<tr>
<th>Card 1</th>
<th>Card 2</th>
<th>Card 3</th>
<th>Card 4</th>
<th>Card 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>44%</td>
<td>30%</td>
<td>44%</td>
<td>30%</td>
<td>44%</td>
</tr>
<tr>
<td>76%</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
<td>76%</td>
</tr>
</tbody>
</table>

Looking at consumers with balances on multiple credit cards, the researchers compared people’s actual-payment behavior to a calculation of what the monthly payments would have been had the payment money been divided in proportion to the balances owed on each card. By focusing on balances—which are prominently displayed on credit-card statements, the researchers note—people underpaid their highest-rate cards by more than 20 percentage points.

The research reveals that consumers’ actual-payment activity put too little toward their highest-rate cards compared to what the optimal payment would have been.

So what were they thinking? The researchers explored five scenarios:

**Balance Matching**
Making payments proportional to the balances owed on each card

**Avoiding Max-Out**
Prioritizing the card that’s closest to hitting its credit limit, to avoid penalty fee

**Making Room**
Prioritizing the card that has the most credit room, to enable a large purchase

**Biggest Balances**
Prioritizing the card with the highest balance, to maintain equal balances across cards

**Small Victory**
Prioritizing the card with the lowest balance, motivated to have one that’s paid off

NEVER MIND THE 1%
LET’S TALK ABOUT THE 0.01%

BY HOWARD R. GOLD
Some research argues that while 1% of US families hold 41.8% of the country’s wealth . . .

. . . the top 0.01% hold more than a quarter of the “1 percent’s” wealth, and 11.2% of the country’s total.

Saez and Zucman, 2016
Since the Great Recession, America’s wealthiest 1 percent have been demonized as fat cats who have grown ever richer while the middle class has stagnated. While protesters have called for the 1 percent to be taxed more heavily, economists have been digging into data to develop a better understanding of who the top earners are.

These economists have been seeking to measure income inequality and wealth inequality, and to understand the nature of the 1 percent’s income and assets. And views differ. Some say the 1 percent are predominantly entrepreneurs and the “working rich,” people who made their money by starting and running successful businesses. Other economists note that a significant proportion of the 1 percent are the heirs of wealth accumulated over time.

But the data also reveal disparities within the 1 percent. The 1 percent, it turns out, have their own 1 percent.

“Since the 1970s, average incomes have grown, but the growth has not been uniform across the income distribution. The incomes at the top, especially in the top 1 percent, have grown much faster than average,” wrote Harvard’s N. Gregory Mankiw, in a 2013 paper entitled “Defending the One Percent.” “These high earners have made significant economic contributions, but they have also reaped large gains. The question for public policy is what, if anything, to do about it. This development is one of the largest challenges facing the body politic."

Mankiw noted that the 1 percent’s share of total income, excluding capital gains, rose from about 8 percent in 1973 to 17 percent in 2010, the latest figures available at the time. “Even more striking is the share earned by the top 0.01 percent. . . . This group’s share of total income rose from 0.5 percent in 1973 to 3.3 percent in 2010. These numbers are not easily ignored. Indeed, they in no small part motivated the Occupy movement, and they have led to calls from policymakers on the left to make the tax code more progressive.”

In the nearly five years since Mankiw’s paper, economists have assembled more data with which to analyze the 0.01 percent. In the 35 years ending in 2015, the share of total income has accrued faster to the 0.01 percent than it has to the rest of the 1 percent. The share of total income has risen, according to 2015 data, to 5 percent for the 0.01 percent and 22 percent for the 1 percent. The 0.01 percent’s share of total US wealth quadrupled in the 35 years ending in 2012 to 11 percent, argue University of California at Berkeley’s Emmanuel Saez and Gabriel Zucman, who have made wealth calculations through 2012.

Not all economists agree that the 0.01 percent are the most significant slice of the distribution. New York University’s Edward N. Wolff, using different data, notes that the wealth of the top 5 percent has grown faster than that of the 1 percent over the past 30 years. Chicago Booth’s Steve Kaplan says that income share for the 1 percent stagnated between 2000 and 2015.

But the disparities within the 1 percent have intrigued other economists. Who are the 0.01 percent? How well are they really doing? How are they making their money? And how, if at all, should policymakers respond?
The 0.01 percent, by the numbers

The United States has 325 million people—in 160 million households, as viewed by the Internal Revenue Service. That means 1.6 million households fall into the 1 percent category.

The threshold for membership in the 1 percent in 2014 was an annual household income of $386,000, excluding any capital gains, according to Chicago Booth’s Eric Zwick. That’s more than seven times the median household income that year of $54,000. The 0.1 percent, 160,000 families, in 2014 made at least $1.5 million a year. The top 0.01 percent, 16,000 families, had annual income of $7 million.

Income share is another way to assess how the strata of the 1 percent are doing.

Between 1995 and 2015, the income share (including capital gains) of the top 1 percent rose from roughly 15 percent to 22 percent, according to Piketty and Saez’s data. The income share of the top 0.1 percent rose from 6 percent to 11 percent, and the income share of the top 0.01 percent rose from 2.5 percent to about 5 percent. In terms of percentage points, the top 1 percent’s rose the most. In terms of the rate of increase, the 0.01 percent’s did.

... and that same 1% divided into four groups:
After-tax income tells a similar story. For the top 1 percent, it nearly tripled between 1980 and 2014, according to research by Paris School of Economics’ Thomas Piketty and UC Berkeley’s Saez and Zucman. For the top 0.1 percent, it almost quadrupled in the same period. And posttax income for the 0.01 percent rose 423 percent. Posttax income for the entire US population rose by only 61 percent during this time, the study demonstrates.

The 0.01 percent also perform best in comparisons of wealth. Saez and Zucman, in an influential 2014 study, used income data from the IRS to “capitalize,” or derive, wealth based on the expected aggregate rate of return from every asset class or source of income reported on tax returns. They say the share of total wealth of the top 1 percent has increased steadily, from below 25 percent in 1978 to 42 percent in 2012. The share of total wealth of the top 0.1 percent has roughly tripled, and the share of the 0.01 percent has more than quintupled. The top 0.01 percent of US households had at least $111 million in net worth in 2012, compared to $4 million for the 1 percent.

Not everyone slices the data the same way, or draws the same conclusions. New York University’s Wolff, using data from the Federal Reserve Board’s Survey of Consumer Finances, finds...
that between 1983 and 2013, the top 5 percent of households saw their wealth grow faster than the top 1 percent did. This would challenge the notion that wealth is increasingly concentrating at the top. He also argues that the rise in overall wealth inequality in the US from 2007 to 2010 is due less to very wealthy people’s success than to the middle class’s failures, chief of all taking on debt only to lose value in their homes.

And Piketty and Saez’s income-share data show that long-term growth has stagnated since 2000 for the 1 percent, 0.1 percent, and 0.01 percent, argues Chicago Booth’s Kaplan. All three groups saw their income shares and inflation-adjusted incomes peak in 2007, and those shares have yet to recover to those pre-Great Recession levels, he points out.

University of Chicago’s Greg Kaplan says the main point of recent research he did with University of Minnesota’s Fatih Guvenen is to highlight that there’s variety in the group so many know as the 1 percent. “When I hear people talk about top income inequality, I hear words and phrases such as ‘top 1 percent,’ ‘top 0.1 percent,’ ‘top earners,’ ‘CEOs’ . . . thrown around all the time,” he says. “I think we need to keep in mind that these are very different people. They get their income from very different sources. They live in different parts of the country. . . . There is a huge amount of diversity, even within a group that we think is small but is actually very big, which is the top 1 percent.”

Who’s in the 0.01 percent? When discussing the super-rich, many bring up family dynasties such as the Waltons of Wal-Mart, or the Rockefellers and Koch brothers of energy fortunes. They may think, too, of highly paid corporate executives such as Apple CEO Tim Cook (who made $150 million in 2016, according to Bloomberg), celebrities such as Diddy (who took home $130 million pretax in the year through June 2017, per Forbes), and entrepreneurs such as Facebook founder Mark Zuckerberg (No. 5 on Forbes’ 2017 list of the world’s billionaires).

But who is actually in the 0.01 percent? Researchers are developing a better understanding of how people in various rungs of the 1 percent make their money. And some research suggests business income plays a big part.

Since the late 1990s, “nearly all of the recent rise in top incomes has come in the form of business income,” write Matthew Smith of the US Treasury Department, Danny Yagan of
UC Berkeley, and Chicago Booth’s Owen Zidar and Zwick, whose work focuses on the 1 percent and 0.1 percent. “The demand for top skill has outpaced its supply, with the returns to top skill increasingly taking the form of business income.”

This income is broad-based among the 1 percent. “What’s covered on CNBC or in the Wall Street Journal or New York Times might be overemphasizing the drivers of wealth in Wall Street and Silicon Valley, and the economy is much bigger and more diverse than that,” Zwick says. “There are a few Carnegies and Rockefellers, a Bill Gates and a Jeff Bezos here and there, but there are a lot more people earning between $300,000 and a few million dollars doing a lot of different things.”

Smith, Yagan, Zidar, and Zwick find that the 1 percent’s income is being driven by owner-managers, mostly of small and medium-sized companies—specifically S corporations, partnerships, and limited liability companies. These are talented managers: the researchers find that profits of companies run by these 1 percent-ers are far higher than those of businesses owned by people in the top 5-10 percent. In the researchers’ sample, when these businesses’ owners died prematurely, while still running their companies, profits plunged by more than half.

The average company in the top 1 percent of income has $7 million in sales and 57 employees, according to the research. “If that firm has, say, a 10 percent profit margin to split between two owners, it’s enough to put someone in the top 1 percent category,” says Zwick. The businesses earning the most profits in the bulk of the top 1 percent were physicians’ and dentists’ offices, professional and technical services, specialty trade contractors, and legal services.

To reach the top 0.1 percent of income, the average company has $30 million in sales and 150 employees. “If you’re an auto dealer and you have five or six dealerships and you’re doing $30 million in sales, you have a bunch of workers and you split...
Several studies indicate that finance is an important sector for the 0.01 percent. Members of the Forbes 400 represent the top 2 percent of the top 0.01 percent—the top 0.00025 percent of US households. For them, finance was the source of wealth for almost one in four.

$3 million in profits between one or two owners, that would put you in that top 0.1 percent group,” says Zwick. In the top 0.1 percent, physicians’ offices ranked only sixth in profits—behind managements of private companies, financial and investment activities, auto dealers, professional and technical services, and oil and gas extraction.

It’s harder to get at the source of income for the top 0.01 percent, but several studies indicate that finance could be an important sector for the group. Williams College’s Jon Bakija, the US Treasury Department’s Adam Cole, and Indiana University’s Bradley T. Heim find that one-fifth of the primary taxpayers in the top 0.1 percent of income (including capital gains) work in finance. The latest data used in this study are from 2005, before the 2007-10 financial crisis altered the landscape. But between 2008 and 2012, “finance and insurance is by far the most highly represented industry among the highest earners,” find Guvenen and Kaplan,

High-income US workers’ top industries

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<th>Top 0.1%</th>
<th>Rest of the 1%</th>
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<td>Finance and insurance</td>
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Guvenen et al., 2014
who looked at the 0.1 percent. In the rest of the 1 percent, health care is the most represented sector.

Beyond that, there’s more detailed information about only the very richest of the 0.01 percent, and it seems to suggest that the richest members of the group may own large, successful businesses. Kaplan and Stanford’s Joshua Rauh used Forbes’ “rich list” as a data set on the wealth of the richest Americans. Since 1982, Forbes has compiled an annual list of the 400 wealthiest Americans, using public information, private interviews, and valuations of comparable assets. As the rich list comprised 400 households, it represents the top 2.5 percent of the 0.01 percent—the top 0.00025 percent of US households.

But this small group could control more than a quarter of the income in the 0.01 percent. According to Saez and Zucman’s calculations, in 2012 the top 0.01 percent had an average wealth of $371 million, which would imply a collective total of $6 trillion. That same year, the estimated combined net worth of the individuals on the Forbes 400 list was $1.7 trillion.

Among the group who made the rich list, for almost one in four, finance—especially hedge funds and private equity—was the source of wealth, while 15 percent came from technology-based companies. Food and beverage companies accounted for 10 percent.

And these sectors were on the upswing. “The ‘finance and investments’ category grew in representation by around 16 percentage points, technology (both computer and medical) by 11 percentage points, and retail/restaurant by 10 percentage points,” Kaplan and Rauh write.

On the 2016 rich list, two-thirds were self-made and one-third had inherited at least part of their fortune. More than 10 percent were immigrants to the US.

How did they get so wealthy?

Piketty and Saez have theorized that investments grow faster than the economy, giving entrenched dynasties insuperable advantages. But Kaplan and Rauh argue that the super-rich are predominantly creating rather than inheriting wealth. Kaplan also says that wealth in this group has been fueled by a marriage of in-demand skills, globalization, and technology—the combination of which are allowing businesses to scale up as never before.

Skills, say many economists, are critical to the modern economy. As the US economy grows, jobs are going unfilled as companies scramble to find skilled people to hire. There’s a flip side to this: as certain skills have become scarce, this has raised the amount companies are willing to pay people who have them. The situation has similarly raised the amount of profits skilled company owners can make, and technology and globalization are further magnifying the value of in-demand skills.

If this is true, the 0.01 percent are most likely benefiting from what economists call “skill-biased technological change”—the increasing return on certain skills in an economy driven by technology and globalization. Under this well-established theory, a shortage of in-demand skills raises the value of those skills in rapidly expanding markets, and new technology helps some workers’ productivity grow much more than others’, exacerbating inequality.
In the Information Age, the change has been particularly pronounced. “In business, you can use technology to do things you couldn’t do 30 years ago,” says Steve Kaplan. “You can scale your business using technology, and you can use people in India and China and all over the world—you couldn’t do that as effectively 30 years ago.” This, he argues, has been spectacularly positive for poorer people in developing countries. In 1990, the World Bank estimated that roughly 35 percent of the world lived in extreme poverty. Today, less than 11 percent of the world’s population is so impoverished.

And it has been good for wealthy residents of developed countries. For them, the result has taken the form of the “superstar” or “winner-take-all” phenomenon, first identified in a landmark 1981 paper by the late Sherwin Rosen, who taught at the University of Chicago. “In certain kinds of economic activity there is concentration of output among a few individuals,” wrote Rosen. “Relatively small numbers of people earn enormous amounts of money and dominate the activities in which they engage.”

Technology, from the internet to media such as ESPN and Bloomberg terminals, has given elite athletes, entertainers, entrepreneurs, and financiers the ability to profit on a much larger, global scale, making the fruits of their labor more valuable than what previous superstars, such as, say, Pelé or Babe Ruth, brought in. Ruth’s peak salary of $80,000 would be worth about $1.1 million in 2016 dollars, one-thirtieth of the $33 million the highest-paid Major League Baseball player, pitcher Clayton Kershaw of the Los Angeles Dodgers, made in salary alone in 2016.

The world’s hundred highest-paid athletes, led by Cristiano Ronaldo and LeBron James, stars of soccer and basketball, respectively, “banked a cumulative $3.11 billion” over the past 12 months, Forbes calculated this past June. Among entertainers, rapper/entrepreneur Diddy and singer Beyoncé each raked in more than $100 million over the same period, Forbes estimated.

And hedge-fund managers make multiples more than top athletes and entertainers. James Simons of Renaissance Technologies and Ray Dalio of Bridgewater Associates each made more than $1 billion in 2016, even though, as Institutional Investor’s Alpha reported, the top-25 hedge-fund earners took in the least as a group since 2005, largely because of the industry’s overall poor investment performance.

“Technology allows a hedge fund to be able to manage $20 billion and invest it,” says Steve Kaplan. “I don’t think people had the systems and information to do that to 30 years ago. Now they have the systems and the information to do that. That technological change is here and is not going away. If anything, it’s getting stronger.”

What should policy makers do (if anything)?
The question of what, if anything, should be done in response to the spectacular rise of the 0.01 percent is a thorny one, as Mankiw acknowledged. “At the outset, it is worth noting that addressing the issue of rising inequality necessarily involves not just economics but a healthy dose of political philosophy,” he wrote.

When policy makers want to address the concentration of income and wealth, the first place some have looked is the top marginal tax rate, which slid in the US and other developed countries after the Reagan and Thatcher revolutions. The US and UK had tax rates as high as 80 percent, wrote Saez and Piketty in the Guardian in 2013. “The job of economists should be to make a top rate tax level of 80 percent at least ‘thinkable’ again.” But on this, Steve Kaplan disagrees. Raising the top marginal rate could send people and their money scurrying for tax havens, he says, pointing to France as an example.

Raising the top tax rates in the US could also send people to take advantage of more favorable tax rules within the code itself. And closing perceived loopholes can be controversial. For example, some people working in finance benefit from the code’s treatment of carried interest, where income flowing to the general partner of an investment fund is typically treated as capital gains and therefore taxed at a lower rate.

“This tax preference is viewed as an unfair, market-distorting loophole by some but consistent with the tax treatment of other entrepreneurial income by others,” writes the Tax Policy Center.

Then there’s the issue of whether raising the top marginal rate could discourage business activity. The marginal rate is intended to tax individuals on their earnings, and it rises with income. But a lot of business income is being taxed at that marginal rate rather than a corporate rate. Because the top US marginal personal tax rate was lower than the corporate rate for some time, business owners had an incentive to change their form of corporate organization from the traditional C corporation, which has profits taxed at the higher, corporate rate, to a partnership, limited liability corporation, or S corporation, taxed at the lower, individual rate. By 2011, these pass-through entities accounted for most of the business income earned in the US. (For more, see “The $100 billion tax dodge,” Summer 2016.)

Policy makers should design an income-tax system that takes into account the nature of the income, and design a system that harmonizes taxes to discourage people from shopping the code for the best tax rates, Zwick suggests—recognizing this is a tall order.

And despite his research interest, Greg Kaplan says we should be careful about populist reactions that lead us to focus too much on the super-rich: “We are better off concentrating on how to improve the lives of those in the bottom 50 percent.” In this group, many workers are in desperate need of a skills upgrade. As these workers fall behind, many economists say, policy makers need to focus on better preparing them for the workforce, perhaps by investing in education, working more closely with local companies to determine what skills their workers need, and removing barriers such as onerous regulations preventing people from entering certain professions. (For more, see “How to create middle-class jobs,” Summer 2017.)

In short, there’s a split among economists. Some argue that income needs to be distributed more equitably, while others say governments should focus less on taking actions that could inhibit top earners and more on addressing the reasons others aren’t as successful. Do we slow the 0.01 percent or lift the 99.99 percent, which could be a heavier and more complex assignment? As the debate continues, members of the 0.01 percent continue on their course.—CHE
Why we should teach people how to lie

In some situations, it’s better to be dishonest.

BY CHANA R. SCHOENBERGER  ILLUSTRATION BY MATT CHASE
Could you handle being honest—totally, brutally truthful, without even a well-intentioned falsehood to smooth over a social situation—for three days? Most people don’t think they could, at least not without ruining their family, social, and work lives. Fibs, white lies, and half-truths (along with, perhaps, more egregious whoppers) are such an important part of our interpersonal tool kit that going without them seems next to impossible.

But Chicago Booth’s Emma Levine, along with Carnegie Mellon’s Taya R. Cohen, asked exactly that of a group of research subjects and came away with a surprising conclusion: it’s not as bad as it sounds.

The researchers asked some participants to be completely honest in every interaction, with every person in their lives, for three days, while other participants were asked simply to be kind or conscious of their words. The participants predicted that being forced into honesty would make them unhappier than if they had to be kind or just aware of what they were saying to others. They anticipated frayed relationships as a result of abandoning the lies they typically use to cover up awkward or uncomfortable situations. But being honest didn’t torpedo subjects’ friendships, family connections, or jobs.

“The experience of being honest is far more pleasurable, leads to greater levels of social connection, and does less relational harm than individuals expect,” Levine and Cohen write.

The study is part of a movement within behavioral science to determine how important honesty is to human interactions. As researchers explore the spectrum of ethics from truth telling to lying, we come closer to understanding why we do, or don’t, tell one another the truth, and what this means for our society.

There are, after all, documented social benefits to being dishonest. People often lie in the service of being kind; when kindness and honesty are at odds, the former often wins, because “we trust people who are kind,” says University of Pennsylvania’s Maurice Schweitzer, who was Levine’s dissertation advisor. We have a tendency to be more forthcoming to kinder people, particularly friends and colleagues.

But purpose matters, of course: those who transparently lie simply to make themselves look good don’t enjoy the same social benefits. The truth is, we care more about others’ good intentions than their honesty.

**Lying in the workplace**

As in social contexts, lying can have positive or negative effects in the business world. When evaluating the acceptability of lying, people often consider two things: the immediate emotional harm that telling the truth could cause, and the potential long-term value it could create. In most cases, people believe you should tell the truth. But if the truth causes emotional harm and cannot create long-term value, many people endorse lying.
For instance, imagine that a colleague is about to make a big presentation and asks for your opinion on his suit, which you believe is quite ugly. People are much more likely to believe it is acceptable to lie to the colleague and tell him he looks fine if he is already wearing the suit and has nothing else to change into. But if the colleague asks your opinion the day before the presentation, when there’s time for him to wear a different outfit, most people would say you should tell him how you really feel about his clothes. What matters is “the extent to which feedback or any truthful statement actually provides instrumental value,” Levine says.

Schweitzer says that to keep honest feedback from overwhelming staff, managers should focus on specific business-related issues that need work and skip issues that the person can’t control.

Though it’s possible to be honest without being fully transparent, the same principle of practicality can be applied to decisions about transparency: in some cases, transparency for its own sake could be counterproductive. For instance, calls for full transparency on pay within an organization are “nonsense; it will make people miserable,” Schweitzer says. Sharing salary figures could rattle a company’s social dynamics. Some employees are solid performers, but “when they learn that others are being paid more, they become miserable, sulky, and less productive,” he says. Though pay transparency may be motivational for some people, and can help combat discrimination, it could also be disruptive for many teams.

Is silence golden?
In another study, Levine looks at whether it’s better to say nothing or to lie in a situation where lying provides comfort and hope, and the truth would be hurtful. Her research finds that while the communicator—the person making the choice about lying—often thinks the best thing to do is to say nothing, thus sparing oneself the guilt of lying, the target prefers to hear the lie.

“In certain cases, such as the ill-fitting attire, [the target] might walk around feeling anxious if he realizes that you are not commenting on the suit,” she says.

It’s a complicated question. In health-care situations, for instance, both doctors and patients think honesty is best. If you have cancer, most people agree that your doctor should tell you this scary news gently but frankly. But because hope is important to their mental state as they fight the disease, patients sometimes prefer that their doctor gives them hope, rather than giving them no information at all. For example, a patient might find comfort in her doctor telling her that she has a chance to beat the cancer, even if, medically speaking, she doesn’t. Avoiding the topic doesn’t work in this situation, because a lack of a prognosis is disconcerting to the patient.

“False hope at least provides hope, while omission doesn’t provide any emotional benefit,” Levine says. Though an uncompromising policy of truth may be less problematic than it sounds for most people, such as those in Levine’s three-days-of-honesty experiment, well-intentioned deception still has its value.

Frankly speaking
The tension between kindness and honesty can be seen in the language patterns that we use. English speakers regularly preface cutting remarks with “frankly” or the more slangy “not gonna lie”; the concept has even been abbreviated, for social media purposes, to “tbh,” short for “to be honest.”

“It’s just a linguistic marker people use to say, ‘Don’t blame me for what I’m about to say,’” says Levine. Such a phrase is meant to absolve the speaker, giving her a moral out.

In a 2014 paper, a trio of researchers—Emory’s Ryan Hamilton, University of Minnesota’s Kathleen D. Vohs, and Chicago Booth’s Ann L. McGill—looked at the language of honesty in online customer reviews. In a series of five experiments, they find that reviews with “dispreferred markers”—phrases such as “I’ll be honest,” “God bless it,” “Don’t get me wrong,” or “Bless its heart,” which indicate reviewers’ desire to offset negative information—were considered more believable. Participants felt that reviewers who included these phrases in their comments were more likable than those who didn’t. When a review used this language, participants were also more likely to pay more for the product being reviewed and to be more satisfied with it, the researchers find.

“More than homey sayings, dispreferred markers act as a social lubricant, allowing an otherwise sticky interaction (the communication of negative, and therefore potentially threatening, information) to operate smoothly,” they write.

Cultural norms can complicate this picture. In Japan, for instance,
lying is common, Schweitzer says, because the culture places a premium on avoiding conflict, particularly avoiding saying “no.” Japanese language patterns contain ritual phrases that are polite to repeat in conversation whether or not they are true, Schweitzer says.

Everybody lies
What research cumulatively shows is a disconnect between our official moral view of honesty and what people actually do and how it makes them feel. And needless to say, this ambiguity doesn’t just manifest itself when people are motivated by good intentions.

In the corporate world, it takes the form of widespread ethics scandals, such as 2016’s Wells Fargo imbroglio, which resulted in the US Consumer Financial Protection Bureau fining the bank $100 million for “the widespread illegal practice of secretly opening unauthorized deposit and credit card accounts.” A year earlier, the US Environmental Protection Agency accused German automaker Volkswagen of installing software on clean-diesel cars to help them cheat on emissions tests. Cases of ethical misconduct span industries and decades.

But why? The conventional explanation is that dishonesty and its attendant problems, such as corruption, can be traced to individual bad actors, and that companies have little sway: the best they can do is to root out these people by careful screening, hiring, monitoring, and firing.

A body of experimental work on dishonesty and ethics demonstrates that this narrative is incomplete. Some people lack morals entirely, but small acts of immorality form a more pervasive problem.

“What the research my colleagues and I conducted shows is that all of us, no matter how much we care about honesty, tend to behave unethically when faced with an opportunity to cheat,” Harvard’s Francesca Gino says. Pretty much everyone cheats, as long as they can justify or rationalize their behavior at the time.

That’s why studying dishonesty quickly turns into a question of how to remind people that their morals are important to them.

“It is more about making sure that we are aware of the forces that lead us astray when it comes to ethics and figuring out ways we can remind ourselves that morality is something we care about,” Gino says.

In a 2012 study, Gino and her collaborators worked with an auto-insurance company to see how honest customers were in reporting the mileage from their car’s odometer, a standard part of the insurance process that helps determine premiums. Higher reported mileage means a customer’s premium is more likely to rise. Half of the customers were given the company’s usual form, which asked them to sign the following statement that appeared at the bottom: “I promise that the information I am providing is true.” The other half filled out a revised version of the form, in which this statement was located at the top.

Among those who signed the pledge at the top of the page—before filling out their odometer readings—the average reported mileage was more than 2,400 miles higher.

“Our follow-up research demonstrated that signing at the top of the form (before reporting information that could be inflated) increased the salience of ethical standards by highlighting people’s self-identity and improving their ethicality, so the disparity in average mileage suggests a difference in reporting ethics rather than in driving habits,” Gino says. The behavioral “nudge” of asking participants to make an initial promise to be honest seemed to work by reminding them of their own morals.

Some situations do allow for dishonest actions to be seen as “less morally problematic,” Gino says. For instance, research has shown that crossing ethical lines to help others is often viewed in more of a neutral light, as is cheating that involves creativity, she says.

How pervasive is dishonesty? Duke’s Dan Ariely examined that question in his 2013 book, The Honest Truth about Dishonesty: How We Lie to Everyone—Especially Ourselves. Ariely, a behavioral economist, also set up a video booth, the “Truthbox,” to capture ordinary people talking about their...
own dishonesty, from fibs to whoppers. Posted on YouTube, the videos reveal people who use lies as excuses, or to make things easier in social situations. One woman explains that she is chronically late and always blames her tardiness on train trouble or other transparent fictions. She muses that she assumes her friends know she’s lying, because everyone knows that she’s always late.

Another woman explains how she tells people her father died when she was young, but omits that he was abusive. “It doesn’t feel safe for me to tell people that level of truth about something that tragic, so I filter it,” she says.

Her story is an illustration of our complicated relationship with lying. Our moral code tells us that lying is wrong, yet we intuitively act in ways that demonstrate how lying is often the right thing to do. “My broad claim would be that as managers, as teachers, as parents, we should teach our employees, students, and children when and how to lie,” Schweitzer says. Instead, we send a mixed message, insisting that one should never lie and at the same time rewarding some lies. Children are admonished for dishonesty in one breath and, in the next, encouraged to tell Grandma how much they like the new sweater she bought them. Rather than condemning lying altogether, Schweitzer suggests, we should move to a set of ethics based on what we understand about behavioral science.

“Let’s give people guidance, because we can identify broader rules here,” he says.

Go to Review.ChicagoBooth.edu to see citations for research in this article.
THE RISE OF CORPORATE SAVING

THE UNIVERSITY OF CHICAGO IN FALL ...

STUDENTS STUDY ...

THE PIGEONS COO ...

... AND THE SQUIRRELS WORRY!

ARE WE SAVING ENOUGH ACORNS FOR WINTER?!

DOES EVERY SQUIRREL HAVE ENOUGH ACORNS FOR RETIREMENT?!!

WHO IS SAVING ACORNS? HOW MANY ARE THEY SAVING?!
I can help! I'm an expert on saving!

As you can see, household saving rates have been declining since 1980. My question is . . .

Chicago Booth's Brent Neiman

Are we all going to starve?!

No one will starve! Household saving has declined relative to GDP, but companies have picked up the slack.

A company can store and invest the acorns on our behalf instead of giving them back to us right now as dividends. So we will still eat when we retire.
PHEW! WE'RE SAFE!

BUT SINCE THERE ARE INVESTMENT BANKING FEES AND TAXES TO PAY ANYTIME WE WANT TO TRANSFER ACORNS TO OR FROM COMPANIES, THE CHANGE CAN MATTER. MY THEORY ON WHAT CAUSED THE SWITCH IS—

I KNOW WHAT CAUSED IT!!!

MULTINATIONAL TAX EVASION! HE'S BEEN SENDING ALL OF HIS EXCESS ACORNS TO AN IRISH BANK!

I CONSIDERED THAT, BUT THE COMPANIES THAT HAVE BEEN SAVING MORE HAVEN'T BEEN PAYING LESS IN TAXES.

IT'S PROBABLY DUE TO THE MODERN NEED TO ACQUIRE COMPANIES AND INTEGRATE THEM.

NICE IDEA, BUT THE PATTERN HOLDS TRUE ACROSS ALL COMPANIES, NOT JUST MODERN TECH COMPANIES.

COMPANIES MUST BE SAVING FOR THEIR STOCKHOLDERS TO AVOID CORPORATE TAXES ON DIVIDENDS!!

THAT'S NOT IT EITHER; THE COMPANIES THAT CHOOSE TO PAY LESS IN DIVIDENDS AREN'T ALWAYS THE ONES SAVING MORE!
Over the past 30 years, wages have dropped as a share of corporate income and the shares of interest and dividend payments have remained stable. So profits have ballooned!

That's a lot of acorns! Why do companies save instead of giving them back to us as dividends?

Great question! We're looking into it! But dividends typically adjust less than profits, so I think the squirrels of Chicago have bigger things to worry about!

Dog!

Run!!!
There are many roads to growing and protecting business and financial capital while reinforcing personal values that support a flourishing family. In the Chicago Booth Private Wealth Management program for high-net-worth individuals and families, you can explore the options and then decide which ones are right for you and your family.
Embrace passive management already

Some advice from the father of efficient markets

Chicago Booth’s Eugene F. Fama weighs in on market efficiency, active management, and corporate governance, among other topics, and explains why investors shouldn’t buy hedge funds.

On efficient markets
People say, “Information is much more available. We have the internet. We have much faster computers. Are markets more or less efficient than they were in the past?” I can’t tell. They’ve always looked very efficient. I don’t see any improvement or degradation.

On active versus passive investing
There is no debate whether active management is better; it can’t be. That’s a matter of arithmetic, not a hypothesis. A simple way to think about it is: active managers can’t win at the expense of passive managers, because passive managers hold cap-weight portfolios of the entire market or of subsets of the market—which means, they don’t really respond to the actions of active managers.

On factor investing
Forget timing factors. That’s ridiculous. A company that I’m involved with [Dimensional Fund Advisors] does it passively. They just buy the whole value segment of the market, or the whole small segment of the market. They’re not trying to pick winners or losers. Timing is even more subject to error than picking individual securities.
On financial products
In academic finance, there are three to five ideas that survive every 20 years. In marketing and applied finance, there are 10 new products a week. But the key to all of it is robustness. People are too ready to come out with products based on things that are flimsy statistically. When academics do stuff, we always look for other time periods and go to other markets to see if we see similar things. If we don’t, we don’t trust them. If they have absolutely no relation to theory anywhere, we don’t trust them.

On corporate governance
It’s better than it was because of the professionalization of investment and the fact that we have investment managers who take it seriously. Passive funds have gotten big enough that they realize they have responsibility to their investors. They want to deliver value. They don’t want the value to be stolen by the insiders, so they’re into corporate governance. I mean, at Dimensional, we have 20 people that just do corporate governance. I think it’s probably similar at other places. We have rules such as: if a board member of a company votes in favor of a poison pill, we’ll follow that director for the rest of his life and vote against him no matter where he goes.

On active managers
Being good at active management, that’s a human-capital skill. That person is going to charge high enough fees to absorb the rents that she’s creating. Investors are always going to be just as well-off buying passive, even if they can identify who the good active managers are.

On financial advisers
When Dimensional started dealing with financial advisers, I said to them, “Your business model has to change because just doing portfolio management is not worth 1 percent a year. You’re going to have to get into other aspects of the business. You’re going to have to do general wealth management and, maybe, life insurance, accounting, all kinds of other things.”

The adviser business has definitely moved in this direction. The fees for financial advisers are getting negotiated downward. I don’t think there’s much 1 percent any more, except at the low wealth end.

On portfolio construction
When I talk to institutional investors, I like to chide them that they change their portfolio allocations based on three to five years of past returns, and that’s basically noise. There’s no information from that about expected returns.

On robo-advisers
In the end, these are going to be a boon to professional advisers. They’re going to be a way advisers can show their clients what distributions of outcomes possibly look like with different investment strategies.

I play a lot of golf with a lot of rich people. When I talk to them about their portfolios, they don’t want to bother with them, basically. They want an adviser, and they do not want to be involved in investing on a day-to-day basis, because their value added is somewhere else. I don’t think that’s going to change. These robo-things are just a technology tool that will help advisers in the end, not hurt them.

On algorithmic trading
It could make the market more efficient, or it could lead to problems. Lots of it does seem wasteful. All of this investment and capital to just be a microsecond in front of everybody else seems a bit wasteful.

On proposals for transaction taxes
I hate them. The more you interfere with markets, the worse off you’re going to be.

On market structure
We have competition among markets now. That’s the way you want to see it. Let’s see what survives out of all of that. Governments are never in a good position to regulate things like that. I mean, insider trading, maybe. But actually regulating the mechanisms of the market is tricky because they change so fast.

On market regulation
When the NASDAQ market came online, there was a quiet period, and then in the late 1970s, early ’80s, they loosened the listing requirements.
Now, they didn’t do that on their own. There was a demand for it. They figured out that people were willing to hold companies that weren’t profitable when they went public. There was an explosion in listed companies—and listings grew until about 1996. Since then, the number of listed companies has fallen dramatically. I think it’s 30 percent lower at this point than it was then.

You say, “Maybe there were too many listed companies.” But the really frightening part of it is that it’s also happened for nonlisted companies. If you look at business formation, it’s tanked in the same period. And that’s where the dynamics of the economy really sit. This has a lot to do with regulation. It’s just so hard to start a business. It’s so expensive. You can’t go into the financial business now without having compliance from day one, which means you have to have a certain amount of capital that you didn’t need 30 years ago. So it’s much more difficult to start a financial business, and I think that’s true across the board.

Unwinding all of that, my preference would be that every regulation has to be renewed every three to five years, otherwise it lapses. Of course, nobody listens to me!

**On private equity**
The private-equity market has expanded into somewhat bigger stuff, but that’s different from market efficiency, in the sense that people can have good ideas and not be able to manage a company, or have the capital to implement their ideas. A private-equity company can provide both these things, management and capital. I have no problem at all seeing higher returns to private equity. The problem is, you can’t measure the returns to private equity because they’re all self-reported. You don’t get to see the bad ones.

Again, there’s a warning because this is a human-capital activity. When it works well, the returns should go to the private-equity managers, not the investors.

**On hedge funds**
If you want to get poor quickly, you should go into them. If you believe the arithmetic of active management, why would you pay anybody 2-and-20 (2 percent of total asset value, 20 percent of any profits)?

I’ve never been able to explain why these things exist. They demonstrate, absolutely, the phenomenon of money moving quickly based on noise. . . . You expect extreme returns, one way or the other. After you take off the 2-and-20 you expected, on average, you’re going to be down. Because hedge funds are subject to the arithmetic of active management, they’re part of that game.

**On changes in academic finance**
In the 1960s, there were two places doing serious research, Chicago and MIT, as well as Carnegie to some extent. But now, every university has a pretty good finance group with really good people in it and they’re all doing similar sorts of things. The challenge is to figure out what is the result of data dredging and what is the result of something real. But that’s a good challenge to have in the sense that you’ve got a lot of talented people out there doing really good things.

**On building a financial business today**
I would focus on providing a full range of products, not simply investment products but financial management or wealth management products. Estate services, maybe even tax services—all of that—and portfolio management, I think, can be done as a part-time activity.

What an adviser has to do in rebalancing portfolios, that’s not really a full-time job if you have a pretty clear picture of where you want to be and how to get there. But the rest of it is, or can be, a full-time job. So that’s what I would do if I were in that end of the business.

If I were in the institutional end of the business, hiring people, what I’d say is, “Cut the staff and go passive.” I’ve been saying that to the university’s endowment for 50 years. They’ve never followed my advice, and it would be a much bigger endowment now if they had.

Eugene F. Fama is Robert R. McCormick Distinguished Service Professor of Finance at Chicago Booth. This was adapted from a dialogue at the CFA Society Chicago, where Fama was interviewed by Kepos Capital’s Bob Litterman.
What venture capitalists can learn from ‘racist’ rats

Science sheds light on the importance of familiarity

Peggy Mason, a renowned professor of neurobiology at the University of Chicago, set out to discover the biological basis of empathy. To do this, Mason and her team created a unique test for her lab rats, which started by placing two rats in a large box. The first rat was free to move about, and the other was placed in the middle of the box in a trap that could only be opened from the outside. Rats, in general, do not like to be out in open spaces, where they can be spotted by predators—but, astonishingly, the free rat risked its own exposure to rescue the rat in the trap. Mason had discovered empathy in rats.

Every discovery leads to more questions, and in this case, Mason wondered, how deep did the empathy go? She reasoned that her lab rats were familiar with each other—bunking and often learning new skills together. But would they rescue rats they had never met? Mason put newcomers into the traps. Lo and behold, her rats rescued the strangers.

Was the empathy linked to genetics? Scientific labs use white rats for their experiments, and most of these rats have been crossbred for generations. Mason brought in some genetically distant black rats, and when one of these was put into the trap, the result was dramatically different. The free white rat did not go to the black rat’s rescue.

Mason wondered if the white rats were racist, responding to a genetic call, or if the issue was familiarity. She had the white and black rats room together for a while and repeated the test. This time white rats
rescued black rats—those with which they had bonded, and even black rats they’d never met.

As one further test to understand the role of genetic pull versus familiarity, Mason took newborn white rats, separated them, and raised each one in a litter of black rats. These little rats never saw other white rats; they only knew their black litter mates and packs. When one of these rats was placed in the box with a trapped white rat, it did not come to the rescue. The trapped white rat was as unfamiliar to the free one raised by black rats as the original black rat had been to the white rats who had never seen black rats before.

I have oversimplified the research, which is told in all of its scientific detail in the journals Science, eLife, and Frontiers in Psychology. But it sheds light on the importance of familiarity—and by extension the problem that familiarity bias creates for human beings. We make assumptions about who is like us and who is different from us, and these assumptions affect behavior, and can be costly.

Female founders are getting overlooked

This issue of familiarity is an important one in venture capital, where one of the biggest stories right now is how little of VC funding goes to female founders. Fortune’s Valentina Zarya, drawing on data from PitchBook, a leading venture-finance research platform, reports that while nearly 5 percent of deals in 2016 went to companies with female founders—up from just under 3 percent a decade ago—the dollar amount going to these companies represented a paltry 2 percent of total investment, despite the fact that women represent a third of private-company owners in the United States. This 2 percent was the third lowest percentage in the last 10 years, behind 2008 and 2012. Not only do a tiny handful of women receive venture funding, the amount they are able to raise has fallen. The average amount of money invested in women-led deals fell from $6 million in 2015 to $4.5 million in 2016—compared to the average deal size for male entrepreneurs of $10 million in 2016.

Logic dictates that deploying only 2 percent of investment capital with female entrepreneurs means venture capitalists are missing opportunities. Six percent of the current crop of unicorns—private companies valued at over $1 billion—were founded by women. VC firm First Round Capital looked at its portfolio of 300-plus companies and 600 founders and discovered that investments with at least one woman on the founding team performed 63 percent better than all-male teams.

Many possible explanations have been proffered for the VC funding gender gap. One is that women don’t ask for VC money at the same rate men do, which is the case, but women ask for VC money far more than 2 percent of the time. One recent study by Malin Malmstrom, Jeaneth Johansson, and Joakim Wincent of Luleå University of Technology looked at 125 applications for venture money and found that 21 percent were led by women. Yet 53 percent of female-led start-ups were denied funding, compared to 38 percent for male entrepreneurs. Not only were female-led start-ups funded less often; the ones that were funded secured less money. The women received 25 percent of what they asked for, while the men got more than half of their requested amounts.

In another study, by Columbia’s Dana Kanze, Mark A. Conley, and E. Tory Higgins and University of Pennsylvania’s Laura Huang, 189 entrepreneurs pitched at the TechCrunch Disrupt event in New York. Their start-ups had been fully vetted and were of comparable quality, and 12 percent had been founded by women. Male-led start-ups raised five times the amount of capital the female-led ones did.

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Another explanation for the gap: women tend to create businesses that do not fit the normal VC profile. That’s not completely true either. PitchBook data from 2010 to 2016 suggest that women entrepreneurs are somewhat underrepresented in software—the biggest category for overall investment, with 39 percent of all venture dollars—and overrepresented in consumer products and recreation, which represent a meager 4 percent of venture deals. But women entrepreneurs are well represented in the five other most popular segments for venture investment, including STEM-heavy fields. (See “Out of proportion, but not everywhere,” page 50.)

Hire more women venture capitalists!

Actually, it’s not that simple

Looking at the effect of homogeneity in the investment process—investors favoring those who are “like” themselves—is a fruitful line of research. A 2014 study by the late Ola Bengtsson and David Hsu of the University of Pennsylvania indicates that having a shared ethnicity nearly doubles the chances of getting an investment from a particular investor (even though the same research finds that shared ethnicity is associated with worse investment outcomes). This research has led many to call for the VC industry to hire more diverse employees, including women, who would presumably invest in women.

However, in a small industry such as venture capital, which employed 2,105 active investors in 2016, it is no easy task to radically change the number of women hired. Data from Crunchbase, a comprehensive database of venture deals, indicate that the pipeline of qualified candidates in the industry is relatively narrow, with only 22 percent of female VC employees on the investment side at the associate, vice president, and principal levels. And venture capitalists are slow to hire new partner-level employees.

There’s also no guarantee that women, once hired, will seek out female entrepreneurs to invest in. Research by University of Colorado’s Stephanie K. Johnson and David R. Hekman suggests that in the corporate world, there is a penalty for women and minority managers and executives who promote and advocate for people “like” themselves. The study used two techniques to isolate this risk: the
researchers compared responses to surveys of 350 executives (with questions on topics that included diversity in hiring) with results of the same executives’ 360-degree-feedback reviews, and they ran an experiment in which businesspeople were asked to rate the competence of a hypothetical hiring manager. The research finds that female and minority managers who hired women and minorities were given substantially lower performance ratings, penalized by bosses and experiment participants, even though white men weren’t penalized for hiring white men. Might new female investment partners feel they risk similar penalties if they actively support women entrepreneurs?

Out of proportion, but not everywhere
PitchBook data show that women entrepreneurs are somewhat underrepresented in software—the biggest category for overall investment—and overrepresented in the consumer products sector. But they are well represented in other popular categories.

The evidence suggests that the presence of a female investment partner at a VC firm does not dramatically alter that firm’s propensity to fund women entrepreneurs. A 2014 study by Harvard’s Alison Wood Brooks, Penn’s Huang, Sarah Wood Kearney of PRIME (a charity that directs investment to fight climate change), and MIT’s Fiona E. Murray finds that women and men were twice as likely to invest in males over females, and that the gender of the investor did not significantly affect this ratio. This held true even when men and women were pitching the same business.

More recently, Crunchbase’s Gené Teare and TechCrunch’s Ned Desmond find that 7 percent of female investment partners in top VC firms were women. Among the top 100 VC firms, 62 had no female investment partners at all, 28 had one, seven had two, and only three had more than that. The presence of female investors didn’t seem to significantly affect whether a firm had more than the average number of female founders in its portfolio. Similarly, Kanze, Huang, Conley, and Higgins find that 40 percent of investors at the TechCrunch Disrupt event were female, and the women entrepreneurs still raised less money than the men.

Venture capitalists, women and men, apply different standards and language to male and female entrepreneurs. Men are often promoted on their perceived potential, while women are promoted on their past performance, a 2011 McKinsey report on corporate promotions indicates. The study by Malmstrom, Johansson, and Wincent finds this effect exists in venture investing as well. By recording the sessions where two female and five male venture capitalists discussed potential investments, the researchers discover that the venture capitalists used different language to describe entrepreneurs who were, aside from gender, fairly similar. They described men as “young and promising,” “experienced and knowledgeable,” and “cautious, sensible and levelheaded,” while they described women as “young but inexperienced,” “experienced but worried,” or “too cautious and does not dare.”

Kanze, Huang, Conley, and Higgins’s study mirrors these findings, in a way: the researchers identify that two-thirds of the questions posed by investors to male entrepreneurs were promotion oriented, asking about the potential of the business and the entrepreneurs’ hopes. Meanwhile, two-thirds of the questions for the female entrepreneurs were prevention oriented, focusing on risk reduction and security. Questioners asked men about customer acquisition, but they asked women about retention; men about revenue growth and milestones, but women about time to breakeven; men about market-size potential, and women about defending market share. Entrepreneurs who fielded promotion-oriented questions were awarded $16.8 million on average, while those asked mainly prevention-oriented questions received an average of $2.3 million in funding. Investors want companies that have large exit potential, not those most likely to preserve capital, and the way the questions are phrased can push entrepreneurs into answering in a way that reinforces perceptions.
Venture capitalists used different language to describe entrepreneurs who were, aside from gender, fairly similar.

Familiarity: The problem and the solution
It may take some time to meaningfully increase the number of female investment partners in the VC industry, and for those women to feel empowered to champion female entrepreneurs, but research suggests that just having women on the investment team improves the performance of the women-led portfolio companies. University of Alberta’s Sahil Raina discovered that only 17 percent of female-led venture-backed start-ups had successful acquisitions or initial public offerings, versus 27 percent of the male-led companies. But when Raina controlled for the presence of a female investor on the funding team, the gap completely disappeared, which suggests that the relationship between the founder and her investors, who also serve as coaching and governance partners, makes a difference.

To build a pipeline of female employees, venture capitalists should implement a form of the Rooney Rule, which the National Football League uses to increase diversity in its hiring practices for head coaches. Proposed in 2002 by Dan Rooney, the late owner of the Pittsburgh Steelers, after two teams fired minority coaches who had winning records, the rule mandates that teams interview at least one minority candidate for their head-coaching vacancies. No requirements are placed on hiring, merely on increasing exposure to the minority applicant pool. By 2006, the percentage of minority head coaches in the league had jumped from 6 percent to 22 percent. Today, eight of 32 teams have minority head coaches. Northwestern PhD candidate CC DuBois finds that a minority candidate has a 20 percent better chance of being hired as a head coach in the NFL than at the college level or as an NFL coordinator, neither of which is subject to the same requirement.

Tech giants including Amazon, Facebook, and Intel, as well as several government agencies, have voluntarily implemented their own forms of the Rooney Rule. A similar effort could force venture capitalists to expand their networks and broaden their searches for talent, and could make women aware of these jobs.

What, besides hiring female investment partners, can venture capitalists do in the short run to find and fund more of the best female entrepreneurs? Looking back at our rats provides some clues. White rats only needed a short time living with the black rats to see them as fellow rats. Familiarity is a subtle thing. VC firms need to increase their level of exposure to women investors and entrepreneurs.

For starters, firms could hire men with teenaged daughters. Research from Harvard’s Paul Gompers and Harvard PhD candidate Sophie Q. Wang suggests that when venture capitalists hire male partners who have teenaged daughters, those firms hire more women and perform better—increasing deal success and internal rate-of-return metrics by 3 percent.

VC firms could also add women to their advisory boards. I work with OCA Ventures, a leading tech investor in Chicago, and the partners there will attest that I bring them investment candidates that feature female founders, and I make sure the issue of team composition and diversity is discussed. Seeking out and networking with the most-successful female entrepreneurs in your region can only expand the accessible pool of female talent in hiring, deal sourcing, due diligence, and portfolio support, and help identify promising female entrepreneurs.

Finally, being aware of internal bias can help investors better coach and mentor female entrepreneurs. These investors can avoid the promotion-versus-prevention-oriented bias effect, by consciously scripting their due diligence interviews, plus they can encourage female entrepreneurs to reframe interview questions themselves. One of the most interesting discoveries in Kanze, Huang, Conley, and Higgins’s study is that when the entrepreneurs who were presented with predominantly prevention-oriented questions chose to give promotion-oriented answers, effectively changing the question orientation, they mitigated the negative effects of the bias. This allowed them to raise about $8 million, while entrepreneurs who answered with prevention-oriented responses received $563,000.

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Go to Review.ChicagoBooth.edu to see citations for research in this article.
With Whole Foods, can Amazon fill your every need?

It’s trying, by embracing scope, scale, and speed

Amazon’s recent acquisition of Whole Foods has triggered a lot of discussion about the motives behind the purchase. But many of these explanations can be rationalized by looking at Amazon’s primary mission, which says, “At Amazon, we are committed to being the most customer-centric company on earth.” That is not only a rather audacious statement; indeed, it is a tall order. And while some people may in the past have perceived the mission statement as purely aspirational, over time, with moves such as this acquisition, it is increasingly clear that Amazon is trying to make what seemed aspiration into a reality.

One way in which marketers often approach customer analysis is by studying what has been referred to as the customer’s “journey,” or the “consumption chain.” Essentially, studying this journey includes mapping the steps that a customer goes through when fulfilling a specific need, then trying to make sure that your company’s product can fulfill that need.

For example, let’s say a customer needs to wash clothes. With the consumption chain in mind, one can trace a number of innovations that detergent manufacturers have incorporated into their products over time. One step in the customer’s journey is knowing when it is time to buy more detergent. Accordingly, manufacturers introduced transparent “windows” in containers of liquid detergent so consumers could gauge when they were running low. Another step is the act of pouring the detergent. To help customers avoid making a mess on the side of the container or dripping detergent on the floor, manufacturers added spouts designed to ease pouring, as well as channels to allow excess detergent to drip back into the bottle. (Manufacturers are more reluctant to add clearer markings than they currently do on the insides of caps that would help customers measure detergent according to the size of their loads, since they would rather customers use more detergent than required.)

Amazon has taken the idea of mapping the customer’s journey beyond merely fulfilling a specific need to trying to address all the needs a customer might have over the course of a day. In many instances, this goal involves providing services that complete the need-fulfillment journey for specific categories. In the detergent example, after a customer recognizes that he needs to buy detergent, he still needs to go to the store, pick the product from the shelf, pay for it, come home, and use it. Amazon is able to help a customer complete nearly all of these steps through Amazon Prime Now, a single service that delivers products within two hours of an order.

But Amazon has gone beyond even this by creating ways to make the process simpler. The first is the Amazon Dash Button, a physical button that customers press when they need a specific product. If you’re running low on Tide detergent, press the Tide Dash Button that you’ve affixed to your washing machine to order more. However, while Dash buttons solved a specific problem, Amazon also created the Echo speaker, which takes voice commands. Echo obviates the need for multiple Dash buttons while also offering other, unrelated services, including the ability to control devices such as alarms and radios.

A customer’s daily activities include more than washing clothes, of course—
they also include waking up, eating breakfast, taking a shower, getting dressed, going to work, returning from work, relaxing in front of the television, preparing dinner, and going to bed. It is not hard to see how, over time, Amazon has increasingly crept into these activities—by delivering groceries for breakfast, toiletries to use in the bathroom, clothes to wear, television and content to enjoy while relaxing, and more groceries as well as other food delivery for dinner. The inexorable moves to map and fill a customer’s daily needs mean that Amazon is becoming increasingly central to the consumer’s experience, as much as it is becoming more customer-centric in everything it does. This idea of occupying “adjacencies”—meeting customer needs proximal to those that you currently fulfill—has been a pillar of marketing practice for a long time. Amazon, for its part, has done this aggressively and expansively, by meeting a core or “primitive” need first, and then layering on top of this need to meet additional needs over time.

**Scope, scale, and speed**

To be more customer-centric, Amazon has clearly recognized the power of the three s’s: scope, scale, and speed. In order to become the one-stop destination for the consumer, what Amazon really needs is scope. The more products and services that consumers can find under one roof, and the more easily consumers can access these services, the more benefits consumers will see and accrue by engaging with Amazon. But customers will not be attracted to Amazon if they find prices too high, which is where scale and efficiency come in. Having access to a very large customer base allows Amazon to obtain favorable terms from suppliers, while having efficient operations keeps a further lid on costs.

And then there is speed. One-stop, low-cost shopping is certainly attractive, but if a customer’s need is not immediately met, the shopping experience will not be fulfilling. This is where speed comes in: having more locations conveniently located close to the customer will enable Amazon to fill a variety of orders inexpensively and quickly. Delivering what the customer wants, when she wants it, at a price she is willing to pay is the ultimate value proposition.

But there are three things that Amazon needs in order to deliver the three s’s. First and foremost, it needs data, both external and internal. External data include information from Amazon’s own customer base and the customer bases that come in via acquired companies. It can mean data from the marketplace, which includes...
competitors and companies with other business models and innovations. Amazon also needs internal data. How are the internal processes doing? Where can they be improved? Are there bottlenecks that can be eliminated?

Amazon also needs innovation to retain and enhance its customer-centricity. This could be innovation in product (such as Alexa, the voice service that powers the Amazon Echo), process (such as delivery by drone), or content (such as the Amazon original TV series Fortitude). With Amazon facing ever-changing customer needs, the ability to marry data with innovation will be a key driver of the company’s future success.

Lastly, as the company increasingly moves from the online world to the offline, it needs to think of ways of replicating its platform strategy offline. The ability to offer a wide range of products online was made possible by bringing third-party sellers onto Amazon’s platform. These sellers provide mainstream products, plus they extend the breadth of product offerings by giving consumers access to more obscure products (those in the “long tail” of customer needs). This reinforces the consumer benefit from visiting and shopping on the Amazon site. Initial moves at Whole Foods seem to be going against this notion, however, as the acquired company announced a reduced emphasis on local suppliers. But Amazon needs to nevertheless explore ways in which it can better leverage physical locations as local platforms.

The idea behind the three s’s, and what is needed to support it, bears a strong resemblance to what Amazon refers to internally as the “flywheel.” In the
traditional strategy literature, organizational “fault lines,” where one activity may require skills that are not consistent with those required for other activities, are associated with the organization’s need to manage the three s’s. What Amazon has been able to do thus far, and needs to continue to do, is manage effectively across these fault lines.

**Putting the three s’s into action**

Now let’s get back to the original question of why Amazon acquired Whole Foods and, in light of the above analysis, examine various reasons Amazon provided.

- One argument is that as grocery purchasing increasingly migrates online, Amazon will be able to use its access to Whole Foods to fulfill this need.
- Another is that Whole Foods can act as a distribution hub since it has urban and suburban locations. Because the locations have attractive demographic profiles, with high-earning residents, Amazon can physically reach its customer base in these areas. In addition, the stores can become showrooms for Amazon products, such as Alexa, that have been optimized to allow consumers to shop more easily on the Amazon website.
- Third, and related, is that as Amazon gets access to the Whole Foods customer base, Whole Foods shoppers who are not big Amazon buyers may be tempted to sign on with a Prime bundle designed specifically to appeal to them.
- Fourth, the company will get more out of customer data. By combining offline data from Whole Foods with online shopping data, Amazon may be able to further refine the scope of its product offerings.
- Fifth, with its experience in running its own operations efficiently, Amazon may help improve the efficiency of Whole Foods operations. From sourcing and dynamic replenishment to dynamic pricing and streamlined store operations, there are many ways in which the companies may be able to lower costs while enhancing the overall customer experience.

Other reasons: the retail locations can become sites where customers who find store returns convenient can return products purchased on Amazon, rather than go to the post office or UPS store. Also, the acquisition gives Amazon access to a set of retail employees considered some of the most customer-centric in the business, and who may help Amazon better understand ways of enhancing employee satisfaction at Amazon itself. Ultimately, as many marketers have pointed out, the profit chain runs through both employees and customers.

**Amazon cannot discount the possibility of upsetting customers as it engages more deeply in their lives.**

The acquisition also gives Amazon access to Whole Foods’ private-label product line 365. Recall the customer’s journey for detergent. The one factor that Amazon still has no control over is the detergent itself, since detergents are manufactured by outside companies. Because this limits Amazon’s profit margins, the company has increasingly been launching its own products—AmazonBasics batteries and cords, for example. This own-brand push will be significantly enhanced by the 365 line from Whole Foods.

Many more reasons for the acquisition have been advanced, but as should now be clear, most of them fit into the broad rubric of enhancing Amazon’s scope, scale, and speed. Indeed, the acquisition also has a direct impact on some of the enablers: data, innovation, and platform.

While growing size, product, and service variety are clear advantages for now, Amazon cannot discount the possibility of upsetting customers as it engages more deeply in their lives. When I was recently on the site, trying to buy some cranberries, I was met with a dizzying array of products and processes including AmazonFresh, Amazon Prime Pantry, Amazon Prime, and a host of third-party sellers. These options, plus even more unique possible combinations, made me decide to buy the product elsewhere.

In the end, I was unable to locate the right combination of product (organic cranberries in a 3 lb package), process (Prime), and price—even though I knew that the right combination existed somewhere in the multitude of search results.

I find there’s typically a movie quote for every situation—and in this case, a perfect one comes to mind. Toward the end of The Lincoln Lawyer, the title character, Mick Haller (played with gusto by Matthew McConaughey), offers his services for free to a potential client. His chauffeur, Earl (played by Laurence Mason), overhears this generous offer and asks, “Are you all right?” To this Haller replies, “Repeat customers, Earl. We’ll stick it to ‘em next time.” As Amazon scoops up customers who become more reliant on it, these customers should hope that the company does not behave like Haller and stick it to them down the line.-

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The real questions the Fed should ask itself

Don’t mistake relative calm in the financial system as a sign that the central bank’s work is done

When Federal Reserve Chair Janet Yellen spoke at the Fed’s annual monetary policy symposium in Jackson Hole, Wyoming, this August, her topic—financial stability and the Fed’s role in financial regulation and supervision—said a lot. Financial regulation, supervision, and direction is much more centrally a part of what the Fed is and does these days than is standard monetary policy. Whether overnight interest rates go up or down a quarter of a percentage point may be the subject with the greatest ratio of talk to action, and of commentary to actual effect, in all of economics. (Bottom line: interest rates in the United States are likely to stay around 1 percent for the foreseeable future. Get used to it.) But the Fed is deeply involved in running the financial system, and all the talk points to it becoming more so.

Rather unsurprisingly, Ms. Yellen did not give a speech bemoaning the current state of affairs. She’s been in charge, after all. If she viewed the Dodd-Frank Act as a grossly complex Rube Goldberg contraption, and the Fed as only following silly rule-making dictates to comply with the law, she would have said so loudly, and long before August. Nonetheless, I was left a bit disappointed after reading it. She devoted just three paragraphs to a section entitled “Remaining Challenges,” and yet there are far more questions to be asked, paths to choose, and fundamental choices to be made than could be covered so briefly. With President Donald Trump having nominated Jerome H. Powell to replace Ms. Yellen as chair when her term expires in February, this is an opportune time to consider them.

Which deregulation?
The call from many policy makers, including some within the Trump administration, to roll back our regulatory structure can be read two ways: 1) reduce the insanely complex rules, and the even more intrusive discretionary supervisory regime, designed in a futile attempt to make sure banks never lose money, and replace them with higher capital standards so that banks’ losses pass smoothly to shareholders without threatening the economy; or 2) reduce capital and leverage ratios, keep the complex, anticompetitive rules on the books, let banks continue to slowly capture the discretionary regulators, and keep the wink-wink bailout regime in place. Let profits roll in to the big banks. Until the next crisis.

You can guess which one I favor. I sense Ms. Yellen is mostly pushing back on the second, especially the desire by big banks for less capital and more trading freedom. But aside from acknowledging that “there may be benefits to simplifying aspects of the Volcker Rule . . . and to reviewing the interaction of the enhanced supplementary leverage ratio with risk-based capital requirements,” she concludes in her speech that “any adjustments to the regulatory framework should be modest.” Really? Is every provision of the Dodd-Frank Act wise? Is there no room, after 10 years and a lot of experience, for a thoughtful evaluation and revision of the tens of thousands of pages of rules?

We don’t need 10,000 pages of regulations, or annual stress tests, just to demand more capital.
Practically nobody stops to ask: Just because a central bank can affect the economy through its regulatory or asset purchase powers, should it do so?

we can use to gauge safety, and conceded that each has its flaws. But perhaps their biggest flaw is that they have to be interpreted and acted upon—just the right time and in just the right way—by policy makers, who have proven spectacularly unequal to this challenge in the past. How much better is Ms. Yellen’s feeling that the banking system is safe than was former Fed Chair Ben Bernanke’s similar feeling in 2007, and on what basis? More deeply, what justifies her faith that this time, policy makers monitoring “a range of supervisory and market-based indicators of financial system resilience” will see the crisis coming, and do something about it? Ms. Yellen herself acknowledged that those who assembled at Jackson Hole 10 years ago were fairly sanguine about the stability of the financial system.

The screaming lesson of the last crisis ought to be that we need a resilient system, not purportedly clairvoyant policy makers monitoring—and, by implication, guiding—the system. Crises are, by definition, unpredictable. Any regime that relies on regulators to see it coming is doomed to failure. Again.

Regulation or supervision?
An analogy: the highway patrol, the Department of Motor Vehicles, and the Department of Transportation are in charge of highway safety. By and large they set rules: drive 55 mph here and 35 mph there; stop at red lights; stay within lane lines. They do not tell us, “Submit your plan to drive to Los Angeles for approval”; nor do they put an employee in the back seat to tell you when it’s time to pull over and rest. We tend to call all of the above activities “regulation,” but “supervision” is a polite word for the latter endeavors. There are many impolite words.

So is the Fed’s job to set up stable rules of the game, standards such as capital requirements, so that the system is resilient on its own? Is it in charge of writing the fire code, and determining how many sprinklers and extinguishers should be in each house? Or is the Fed’s job to be the fire department, spotting fires as they break out, rushing to the rescue? Or, should it send its
employees to watch over how we cook dinner, as its embedded employees watch the big banks?

Central banks are giant discretionary financial regulators, making little distinction between the sit-back-and-make-rules versus decree-actions-and-outcomes approaches. It’s no surprise, then, that their regulatory, supervisory, and policy activities are merging. When a little stimulus is needed, they can just tell banks to lend, or they can use quantitative easing to push up asset prices. If a bubble is diagnosed, they can tell banks to cut back, or they can tighten regulations, or they can sell some assets.

Hundreds of academic papers find that central banks can affect this or that by buying securities, changing bank regulations, changing financial regulations, and so on. Then they segue into policy conclusions on how central banks should use these dandy new tools. Practically nobody stops to ask: Just because a central bank can affect the economy through its regulatory or asset purchase powers, should it do so? The question, “Do we really want an independent central bank routinely dialing up and down levers of cash-out refinancing, with an eye to raising or lowering stimulus?” just never occurs to anyone.

That constitutional question is the big one we all should be asking as central banks move to financial regulation and discretionary supervision.

What’s systemic anyway?
Just what do we mean by a “systemic” crisis? That would seem to be a foundational question that a Fed chair should weigh in on, yet the answer is decidedly muddy.

It bears on policy. For example, right now there is a movement around the world to declare that asset managers are systemic dangers. How is that possible? The manager buys and sells your stocks. If he or she invests in a stock and it goes down, you can’t demand your money back, you can’t run, and you can’t force the manager into bankruptcy. Shouldn’t asset managers get a nonsystemic gold star, for not issuing run-prone securities? Well—the story goes—they might “herd” or be prone to behavioral biases, and, heaven forbid, sell stocks, which might, heaven forbid, go down. “Financial stability” now seems to mean nobody should ever sell anything, and stocks should never go down.

If the explanation for the crisis is all “madness of crowds,” there is absolutely nothing in the new regulatory regime to stop a crisis from happening again.

Are insurance companies systemic? Are retirement plans systemic? Just who gets saved when?

Or to take the other half of the phrase: What is a crisis? Is it just a bunch of bankruptcies? What is the nature of contagion? Is it a domino effect—Bank A fails, Bank B owes Bank B money, so Bank B fails? Is it a run—Bank A fails, so people question Bank B and pull out run-prone assets?

The system seems to handle even big bankruptcies fine at some times but not at others. What makes those times different? How do you “resolve” a bank during a crisis?

Ms. Yellen points to liquidity being a problem in a crisis, and her Fed now encourages institutions to have lots of liquid assets to sell in the event of losses. But sell to whom? Isn’t there something deeply wrong about a system in which everyone’s risk-management plan is to sell assets in the event of price declines?

Ms. Yellen’s account of the 2007–10 financial crisis, as presented in her Jackson Hole speech, is largely a familiar story of behavioral excess (by market participants and regulators), with no mention of mechanics. Yet the Fed chair’s job is to fix the machine, not to wish for smarter people. If the explanation for the crisis is all “madness of crowds,” there is absolutely nothing in the new regulatory regime to stop a crisis from happening again.

I have a view on this. The crisis was a run—and not one of the other stories. Runs are by definition unpredictable. The essence of a run is not the riskiness or illiquidity of bank assets; it is the run-prone nature of bank liabilities. We can set up our financial system so that it will never again have a crisis by insisting banks fund themselves with run-proof liabilities, predominantly common equity, and isolate any needed leverage outside the banking system. Such a system requires an order of magnitude less regulation, and two orders less supervision. Well, I don’t run the Fed. But those who do desperately need clear answers to these questions, and a clear vision of the Fed’s role in managing the financial system.

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What’s the matter with handouts?

How charitable giving became about endowments and museum wings, not spare change

The topic of redistributing wealth has a tendency to short-circuit dates, spoil Thanksgiving dinners, and occasionally sever friendships—unless the redistribution in question is charitable giving. When the haves give freely to the have-nots, most people see it as an example of enlightened self-interest and therefore a cause for celebration, not complaint.

Still, not all benefactions are created equal, and, for many, the least among them may be giving money directly to the poor. Indeed, handouts have fallen into such disrepute that Pope Francis himself felt the need to defend them. “Help is always right,” he told a Milanese street magazine, Scarp de’ tenis, in February. But what if I give a beggar a few bucks, and he spends it on a glass of wine? “If a glass of wine is the only happiness he has in life,” the pontiff mused, “that is fine.”

Throughout the interview, Francis seems less concerned about vindicating a particular kind of gift than vitiating the reticence to give, but as a counter to conventional wisdom about charitable giving, his reply is remarkable nonetheless. Maintaining a scrupulous inhibition about handing out money to panhandlers isn’t the exclusive domain of prigs and penny-pinchers. Even my father, whose politics and leonine hairline can occasionally make him seem like a Catholic Che Guevara, discouraged my sisters and me from dispensing spare change on the street corner for precisely the wine-related reason Francis dismisses. Such gifts were liable to do more harm than good, he told us, and we were better advised to fill the collection plate or favor some charity.

The notion that handouts could be counterproductive to charitable ends is hardly a peculiar opinion today, but the logic supporting it has a fairly recent vintage. In the West, until just a few hundred years ago, helping the less fortunate was a fairly straightforward process. Consider how the King James Bible describes evidence of the “blessed”:

For I was an hungred, and ye gave me meat: I was thirsty, and ye gave me drink: I was a stranger, and ye took me in: Naked, and ye clothed me: I was sick, and ye visited me: I was in prison, and ye came unto me.

Beyond the comforts afforded by human contact, the help that might be provided the “least” among us is almsgiving, offering money or other aid directly to the poor. Such assistance is the most ancient of philanthropic exercises. That it is no longer the most venerable as well says a lot about how the ethics of charity have changed over time.

Cotton Mather’s view of charity

This evolution was anticipated by Cotton Mather, the Puritan minister of colonial Boston who articulated an approach to charity that was so unorthodox in spirit as to seem slightly heretical. Reflecting on what prevented us from undertaking charitable endeavors, Mather regarded a failure of will as the chief impediment. The tendency to be idle, even in the face of great need, was “the most concealed, and yet the most violent of all our passions,” Mather wrote in Bonifacius, or Essays to Do Good. Such “baneful Thoughts” needed to “be chased out of our Minds” to make room for the “Subject, ‘What Good may I do?’”

The concern that laziness might undermine our charitable instincts is largely unobjectionable, but Mather made the more radical and contentious move to apply the same logic to charitable acts themselves. Benefactors should always
As much as anyone else in the early American experience, Benjamin Franklin shifted the organizing logic of charitable activities from “help” to “self-help.”

Ben Franklin weighs in
That the withholding of charity might itself be a charitable act proved an unlikely but enduring contribution to philanthropic theory, yet it wasn’t the only legacy of Mather’s Essays to Do Good. In his autobiography, Benjamin Franklin highlighted the influence of Mather’s book, together with Daniel Defoe’s An Essay upon Projects, for championing the support of significant public initiatives that improved the moral and social welfare of a community. “[W]hat is done for Schools, and for Colleges, and for Hospitals, is done for the general good,” Mather had written. “The endowment or maintenance of these is at once to do good unto many.”

As Franklin made his way from penniless apprentice to the most famous man in America, he took great pride in cultivating what he called the “projecting public spirit” that saw him lend his intellectual, organizational, and financial assistance to a host of programs in and around his adopted city of Philadelphia. Franklin chronicled these efforts at length in his autobiography—everything from the formation of what would become the University of Pennsylvania, to the establishment of the city’s first lending library and public hospital, to the organization of a subscription program to employ street sweepers. “Some may think these trifling Matters not worth minding or relating,” he writes, acknowledging that he’s testing the patience of his readers. And yet, he continues, “Human Felicity is produced not so much by great Pieces of good Fortune that seldom happen, as by little Advantages that occur every Day.”

The implied lesson was that the good person did not wait around for grand opportunities to make his philanthropic mark. He seized every chance, large and small, to improve his community, showing himself less concerned about bragging rights than common benefit. Franklin’s life and work make it clear why he and Mather are credited with helping to inspire the volunteeristic spirit that so decidedly shaped the colonial experience, and yet “the First American” (as Franklin was nicknamed) went far beyond his illustrious forerunner by omitting the ameliorative role of almsgiving from his charitable regimen. Whenever he discusses doing good, Franklin’s focus is always organizational in nature, his philanthropy programmatic. He didn’t emphasize the necessitous individual, but the needs of what one admirer called “a rising people.”

These two sets of commitments are certainly not at odds. They aren’t even inconsistent. One can endow soup kitchens and philosophical societies without any cognitive dissonance. But like Mather before him, Franklin viewed traditional almsgiving with skepticism, worried that efforts to remedy the immediate pangs of poverty might interfere with the “cure” for idleness. Franklin’s solution was a variation on his lesson of “Human Felicity” and the “little Advantages” that support it. “If you teach a poor young man to shave himself and keep his Razor in order,” he wrote, “you may contribute more to the Happiness of his Life than in giving him 1000 Guineas. The Money may be soon spent, the Regret only remaining of having foolishly consum’d it.”

More from John Paul Rollert
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Andrew Carnegie’s tougher stance
As much as anyone else in the early American experience, Franklin shifted the organizing logic of charitable activities from “help” to “self-help.”
At the same time, he contributed to the growing suspicion that a handout and a hand-up were mutually exclusive. The philanthropically inclined had to choose, and Andrew Carnegie, nearly a century later, had no difficulty making his decision.

“It were better for mankind that the millions of the rich were thrown into the sea than so spent as to encourage the slothful, the drunken, the unworthy,” the steel magnate wrote. “Of every thousand dollars spent in so-called charity to-day, it is probable that $950 is unwisely spent; so spent, indeed, as to produce the very evils which it proposes to mitigate or cure.”

Carnegie’s broadside against “indiscriminate charity” came in “The Gospel of Wealth,” an 1889 essay in which he addressed the precarious social conditions his own success had helped exacerbate. Describing the “concentration of business” in “the hands of the few” as a hallmark of advanced capitalism, Carnegie admitted that this development had fostered antagonism and mutual distrust. “The problem of our age is the proper administration of wealth,” he wrote, “so that the ties of brotherhood may still bind together the rich and poor in harmonious relationship.”

Among other things, such an assertion assumes that free markets won’t mend this relationship, and that the redistribution of wealth is necessary. Searching for a solution that would preserve individual prerogative, Carnegie took his cue from Franklin’s “projecting public spirit,” widening its scope to accommodate the philanthropic abilities of the wealthiest men in America. To them, Carnegie extolled “benefactions from which the masses of their fellows will derive lasting advantage,” a universe of charitable largesse that included the endowment of colleges, libraries, and concert halls, “the ladders upon which the aspiring can rise.” At the same time, he did not so much eschew as shunt aside the traditional form of charitable assistance. “Neither the individual nor the race is improved by alms-giving,” Carnegie maintained. “Those worthy of assistance, except in rare cases, seldom require assistance.”

As such declarations attest, the ultimate aim of philanthropy, in Carnegie’s view, was not to assist the poor by binding up their wounds and offering some small measure of human comfort. It was to grease the gears of meritocracy and make ample room among the elite for the “really valuable men of the race.” As Carnegie interpreted his own life, such efforts had been made on his behalf. He arrived in America when he was only 12 years old and immediately went to work in a Pittsburgh cotton factory for $1.20 a week. Having almost no formal education, he forever regarded as his first patron Colonel James Anderson, a local gentleman who made his personal library available to “working boys” on the weekends. “Only he who has longed as I did for Saturdays to come can understand what Colonel Anderson did for me and the boys of Allegheny,” Carnegie later said. “Is it any wonder that I resolved if ever surplus wealth came to me, I would use it imitating my benefactor?”

It is a wonderful sentiment but worthy of the disclaimer that not everyone can imitate Andrew Carnegie, certainly not in all of the ways that made him one of the most remarkable men of his era. Carnegie understood this. You cannot be the unapologetic social Darwinist he was unless you acknowledge that the strong and weak will inevitably be among us. The aim of his philanthropic “Gospel” was simply to ensure that this distinction was not synonymous with the rich and the poor—that, unlike the aristocratic realm he left behind in Scotland, merit, rather than inherited money, made all the difference in who succeeded.

**Lessons for modern philanthropy**

But what should be done for those who fall? For the meritocrat with charitable intentions, this is a thornier matter. Consider the boot-strapping maxim, “If you give a man a fish, you feed him for a day. If you teach a man to fish, you feed him for a lifetime.” Like most platitudes, this one is comforting but also incomplete. You can’t teach someone to fish who doesn’t already have a fishing pole, and if you go ahead and hand out 10 poles to 10 men, for every one who lands a leviathan, another will lose his pole, one will break it, and three will still come home empty-handed.

What to make of these misadventures, to say nothing of the man who sleeps in and doesn’t fish at all, is not a problem for the older vision of charity, which simply demands evidence of need. But the disposition toward the poor that was anticipated by Mather and Franklin and acclaimed by Carnegie is more ambivalent. At its best, it indulges the temptation to look upon the less capable with a spirit of benign paternalism—a tendency that can manifest itself in a reticence to offer alms but also, in what might seem like a worthier form of redistribution, to pay the poorest workers higher wages. (Carnegie himself issued the unctuous warning that if great wealth were “distributed in small sums” to laborers, it would largely be “wasted in the indulgence of appetite.”) At worst, however, this spirit of contemporary charity favors a tone that can seem almost pitiless, at times, exchanging the sentiment “there but for the grace of God” in the face of the poor for a healthy, even righteous, disdain of failure.

Pope Francis seemed to have this sentiment in mind in his February interview. “It is possible to see a homeless person and look at him as a person, or as if he were a dog,” he said. For those in need, a helping hand, in any form, is preferable to a tight fist, but the deed loses something of its luster if, instead of a gesture of solidarity and warm encouragement, it more closely resembles the way we redistribute scraps to dogs under the dinner table.

You can’t teach someone to fish who doesn’t already have a fishing pole, and if you go ahead and hand out 10 poles to 10 men, for every one who lands a leviathan, another will lose his pole, one will break it, and three will still come home empty-handed.

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It’s time to rethink Milton Friedman’s ‘shareholder value’ argument

Where Friedman was wrong

In 1970, the late Milton Friedman of the University of Chicago famously argued that corporate managers should “conduct the business in accordance with [shareholders’] desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.”

Since then, Friedman’s view that the sole social responsibility of the firm is to maximize profits—leaving ethical questions to individuals and governments—has become dominant in both finance and law. It also laid the intellectual foundations for the “shareholder value” revolution of the 1980s.

Friedman’s position has been attacked by many critics on the grounds that corporate boards should consider other stakeholders in their decisions. Yet, if the owner of a privately held firm is under no obligation to care about anybody’s interest but her own, why should it be different for a publicly traded company?

While agreeing with Friedman’s premise that managers should care only about shareholders’ interests, Nobel Laureate Oliver Hart of Harvard and Chicago Booth’s Luigi Zingales reject the view that shareholders care only about money.

A company’s ultimate shareholders are ordinary people who, in addition to caring about money, are also concerned about a myriad of ethical and social issues: they purchase electric cars to lower their carbon footprint; they buy free-range chicken or fair-trade coffee because they view this as the ethical—albeit more expensive—choice.

They are, in other words, prosocial in their day-to-day life—at least to some extent. “If consumers and owners of private companies take social factors into account and internalize externalities in their own behavior, why would they not want the public companies they invest in to do the same?” Hart and Zingales ask.

Friedman recognized that in some cases shareholders may have different objectives, but he concluded these objectives are better pursued by the shareholders on their own. This is certainly the case for Friedman’s leading example: corporate charity.

Friedman’s leading example: corporate charity. Ignoring tax considerations, according to Friedman, it is preferable that the money spent in corporate philanthropy be paid out to shareholders in the form of dividends and then allocated by them to charity, rather than allocated by corporate managers directly.

Friedman recognized that in some cases shareholders may have different objectives, but he concluded these objectives are better pursued by the shareholders on their own. This is certainly the case for Friedman’s leading example: corporate charity. Ignoring tax considerations, according to Friedman, it is preferable that the money spent in corporate philanthropy be paid out to shareholders in the form of dividends and then allocated by them to charity, rather than allocated by corporate managers directly.

Hart and Zingales argue that this conclusion holds only under the assumption that shareholders can individually reproduce or undo any corporate decision, without incurring any additional cost. This assumption holds for charity: a dollar in charity is the same whether it is donated by an individual or by a corporation. But it does not hold for most other social objectives: an individual cannot generally undo corporate pollution at the same cost that a company would have paid to avoid it. In this more general case, Hart and Zingales conclude that a company’s objective should be the maximization of shareholders’ welfare, not value.

The view that the social responsibility of the firm is to maximize profits has become dominant in both finance and law.

Asher Schechter is a writer and editor of ProMarket, the blog of Chicago Booth’s George J. Stigler Center for the Study of the Economy and the State. This is an excerpt of a post that first appeared on the blog, at ProMarket.org.
A small step for theory, a leap forward in governance

Since we published our recent paper, we have received criticism of the interpretation published on the ProMarket blog. One writer claims that the title of the post (“Where Friedman was wrong”) is misleading. His argument is based on the fact that Friedman was well aware that “human beings maximize utility, not income” and that people considering this discussion “are still saying that shareholder interests come first and only for a company; [they’re] just agreeing, as Friedman would, that those interests are shareholder utility, not money exclusively.”

We feel obliged to intervene and clarify. We agree that Friedman believed that people maximize utility, not income. In fact, in his 1970 article in the New York Times Magazine, he writes that the desire of shareholders “generally will be to make as much money as possible.” The “generally” indicates that he recognizes that shareholders sometimes have other objectives. Yet, Friedman concludes that “there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits.”

Friedman can conclude this because he has in mind a world where social activity and profit-making activity are completely independent (as is the case for corporate charity). There is no loss of efficiency in letting shareholders decide which charities should be financed. Under this restrictive assumption, Friedman’s conclusion is right. In the more general case—where, for example, undoing pollution is more expensive than curbing it to begin with—Friedman’s conclusion does not follow logically. In this respect, Friedman was wrong. Hence, the legitimacy of the title.

We admire Friedman and we have no desire to prove him wrong. What we do want is to correct a diffuse and consequential mistake that is generally made in teaching finance. We looked at the five most cited corporate finance textbooks. Four explicitly mention shareholder value maximization as an objective. None mentions shareholder welfare maximization.

More importantly, we want to correct the mistake that our teaching has produced as to the way public corporations are run. The figure (see “Profit-minded philosophy,” this page) shows the percentage of Dow Jones Industrial Average companies that mention value maximization as an objective: Friedman’s rule and MBA teaching had some impact on business practices. It was on the basis of this principle that the board of Wal-Mart opposed the inclusion in the proxy ballot of a shareholders’ proposal aimed at reconsidering the sale of high-capacity magazines, the ones used in mass shootings. It is on the basis of the shareholder-value principle that corporate boards and courts of law reject the ability of shareholders to influence corporate policy on important issues that shareholders care about. Moving from shareholder value maximization to shareholder welfare maximization may be a small step in theory, but it could trigger a leap forward in the way our corporations are run.

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The market power of ‘superstar’ companies is growing

Like the wealthiest households, the most successful companies are exerting outsized influence on the economy

Since the 2007-10 financial crisis, many writers have attempted to document and analyze the growing inequality among households in the United States and elsewhere. Thomas Piketty’s *Capital in the Twenty-First Century*, Matt Taibbi’s *The Divide: American Injustice in the Age of the Wealth Gap*, and Joseph E. Stiglitz’s *The Price of Inequality: How Today’s Divided Society Endangers Our Future* were all *New York Times* best sellers.

No equivalent literary subgenre has emerged to examine a related and similarly important sort of inequality: the growing dominance of industries and economies by superstar firms, and the implications of this dominance for technological, social, and economic progress.

“Superstar,” an idea first applied to companies by the late University of Chicago economist Sherwin Rosen, is an especially apt term for organizations such as Apple, Google, Facebook, Amazon, and Microsoft, with whom nearly everyone is familiar and upon which many of us rely on a daily basis. These companies and others like them have helped to engineer dramatic changes in the way residents of developed countries live, work, communicate, and socialize. But while it may be indisputable that superstar firms have been a force for technological and economic progress, there is a creeping concern that their growing dominance could stifle innovation and progress in the years ahead.

When he first explored the “economics of superstars” (both a description of his idea and the title of his paper) 36 years ago, Rosen argued that modern technologies would make it possible for the superstar performers in any industry to greatly expand the scope of their market while reducing market opportunities for everyone else. Winners would take all (or take most) of the value created. The technological advantages that Rosen presciently described were in the costs of replication, search, and delivery. Digitization has reduced the incremental cost of replication and delivery to virtually zero, and specialized intermediaries such as Google, YouTube, Amazon, and Alibaba have made it easier to find what one is looking for at great speed and at very low cost.

More than 30 years after the publication of Rosen’s paper, academic literature is illuminating how superstars affect the rest of the economy. The empirical data presented in several papers of recent years have helped answer a series of important questions, including how much economic power superstar firms command, where their advantages come from, and what role they play (if any) in exacerbating income inequality across households.

Superstar firms have acquired market power in all sectors of the economy

For most of the 20th century, the US economy was dominated by firms with “scale and scope,” to borrow a phrase from the late business historian Alfred Chandler of Harvard—companies such as General Electric and General Motors. In 1990, however, two management gurus, the late C. K. Prahalad of the University of Michigan and London Business School’s Gary Hamel, asserted that the era of conglomerates was over. Size, they proclaimed, would cede advantage to agility and entrepreneurship. As Prahalad and Hamel’s mantra of core competencies spread, large firms such as AT&T, GTE, and
Twenty-seven years later, size is back. According to the McKinsey Global Institute, 10 percent of the world’s listed firms generate 80 percent of all global profits. Firms with at least $1 billion in revenue now account for 60 percent of total global revenue and 65 percent of market capitalization. The pursuit of size has led to a rapid increase in mergers and acquisitions: according to the Institute for Mergers, Acquisitions and Alliances website, the number of deals grew from 26,845 in 1997 (with a value of $1.83 trillion) to 48,825 in 2016 (with a value of $3.62 trillion).

The standard metric of monopoly power is the concentration ratio, or the share of the market accruing to the top four (or 20) firms. In a 2017 paper, MIT’s David Autor, Christina Patterson, and John Van Reenen, along with University of Zurich’s David Dorn and Harvard’s Lawrence F. Katz, compute the four- and 20-firm concentration ratios for six sectors of the US economy: manufacturing, wholesale trade, retail trade, services, finance, and utilities and transportation, for 1982–2012. Together, the six sectors account for 676 industries, nearly 4 million companies, and 80 percent of total private-sector employment.

Autor and his coauthors find that the four- and 20-firm concentration ratios have been trending upward in all sectors—and in some of them, quite sharply upward. The four-firm concentration ratio increased by approximately 15 percentage points (in other words, it doubled) in retail trade and by more than 10 percentage points in finance.

Crucially, the upward trend in concentration ratios is more evident for sales revenue than for employment. Superstar firms are generating more sales revenue without increasing their employee base by much.

Superstar firms derive substantial advantages from their management and organizational practices
Superstar firms have proven to be especially adept at exploiting the killer combination of demand-side network externalities—those forces that make a product or service’s consumer appeal increase as its user base grows—and supply-side economies of scale. Apple has a 20 percent share of the smartphone market but captures as much as 92 percent of the industry’s operating profit. Google processes 3.5 billion searches each day and Facebook has 1.32 billion active users each day; together they take in, according to some estimates, as much as 60 percent of all digital advertising revenue.

Importantly, superstar companies excel in their use of the structured and creative management/organizational practices that large and complex projects require.

In 2010, the US Census Bureau conducted its first Management and Organizational Practices Survey. Nearly 40,000 manufacturing establishments participated in MOPS, which used 36 multiple-choice questions to poll businesses on their management practices (processes for setting targets, monitoring performance, and providing incentives), organizational practices (structure, span of control, and the use of information), and basic characteristics (the number of managers and nonmanagers, educational attainment of managers, and union participation).

Stanford’s Nicholas Bloom, MIT’s Erik Brynjolfsson and Van Reenen, Lucia Foster and Ron Jarmin of the US Census Bureau, and Tel Aviv University’s Itay Saporta-Eksten analyzed this data set by constructing an aggregate score for each manufacturer’s answer to the 36 questions (normalized to a 0–1 scale). As their results demonstrate, there is enormous dispersion in the quality of management and organizational practices across US firms.

Only 18 percent of establishments employed at least 75 percent of the structured management practices included in the survey, while 27 percent of establishments adopted less than 50 percent. The superstar firms that received the highest scores on the adoption of structured management practices significantly outperformed those with lower scores. Even small improvements in management led to significant increases in profits and firm valuation.

Superstar firms are frugal in their use of labor
In 1990, GM, Ford, and Chrysler had combined annual revenues of $250 billion, a combined market capitalization of $36 billion, and an employee base of 1.2 million. In 2016, the five tech superstars—Google, Apple, Amazon, Facebook, and Microsoft—cumulatively had annual revenues of $559 billion, a market capitalization of more than $2 trillion, and an employee base of 660,500.

Jae Song of the Social Security Administration, Stanford’s Bloom, David J. Price of Princeton, Fatih Guvenen of the University of Minnesota, and Till von Wachter of University of California at Los Angeles estimate that about one-third of the growth in income inequality across US households since 1980 can be explained
If one market participant reaches an unassailable point of power, it can create distortions that make everyone worse off.

by the compensation gap between employees at the superstar firms and their counterparts working elsewhere.

This kind of sway over aggregate income trends brings us back to the enormous economic and financial power that superstar companies wield today. That power can be, and often is, put to excellent use: these companies have the gumption to make the moon-shot investments that even modern-day governments are loath to make. They have the organizational ability to mobilize resources from around the world at warp speed and the management skills to coordinate complex projects. But they also have the incentive and the power to thwart competition and influence the rules of the game.

As Chicago Booth’s Luigi Zingales has noted, only eight countries in the world have national governments that generate as much revenue as Wal-Mart does. The largest corporations command resources—money and manpower—that make them more than a match for virtually any governmental agency, let alone their smaller competitors, consumer advocacy groups, or other organizations whose aims may run counter to these corporations’ pursuit of increased profits and market share.

Even if superstars exerted no direct influence on government—and there is plenty of evidence that they do, even in relatively well-functioning democracies, through lobbying, media influence, political contributions, and other means—their power could still work in opposition to a healthy economy. The bigger a company is, the more easily it can gobble up nascent competitors, or take anticompetitive measures against them—for instance, starving them by driving up the cost of materials. Low prices, high wages, and high-quality goods and services are the product of competition between healthy rivals; if one market participant reaches an unassailable point of power, it can create distortions that make everyone worse off.

None of which is to say that we actually are worse off, collectively, as a result of today’s superstars. Virtually everyone understands that Facebook, Google, Amazon, and other powerful firms have made enormous contributions to our contemporary quality of life. But the value of these contributions shouldn’t blind us to the dangers posed by the power modern superstars have accumulated.

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Watergate and presidential power in America

The scandal reflected two kinds of corruption

BY PHILIP B. KURLAND

Scandals in the United States, and not least political scandals, have usually been short-term affairs. In most such instances, the press publishes the charges of wrongdoing with its accustomed fervent, if not noisome, self-righteousness. The accused is quickly condemned by the public, often removed from office, and soon forgotten, or else left to the long-drawn processes of the criminal law. In the latter event, the press coverage will be intense and titillating during the period of the trial, but also soon beyond the interest of the American public. Seldom do the cases involve more than the peccadilloes of a single, temporarily high-placed official; seldom do the cases present basic problems of a constitutional nature. The Watergate affair is different. It is different because the immediate criminal acts are but symptoms of a deeper and more fundamental ailment. It is different because it is not concerned with underlings, but with personages who once held the governance of the nation in their soiled hands. It is different because the essence of the wrongdoing is not to be found in the greed for money. It is different because it raises important constitutional questions, not least of which is, as President Nixon constantly reminds us, the question of the proper status of the presidency itself in our constitutional democracy. Not the XYZ affair (a diplomatic scandal of the 18th century), not the corruption of the Grant administration, not the Teapot Dome scandal of the 1920s, not all of them together cut so deep a wound in the American body politic. Even so, the immediate events of Watergate are not so threatening to our democracy as the more fundamental ailment of which Watergate is only a symptom. In his recent tour de force (1973’s *The Imperial Presidency*), in some ways an *apologia pro vita sua*, Arthur Schlesinger noted the terminal illness that threatens us:
For Watergate was a symptom, not a cause. Nixon's supporters complained that his critics were blowing up a petty incident out of all proportion to its importance. No doubt a burglary at Democratic Headquarters was trivial next to a mission to Peking. But Watergate's importance was not simply in itself. Its importance was in the way it brought to the surface, symbolized, and made politically accessible the great question posed by the Nixon administration in every sector—the question of presidential power. The unwarranted and unprecedented expansion of presidential power, because it ran through the whole Nixon system, was bound, if repressed at one point, to break out in another. This, not Watergate, was the central issue.

Clearly, Schlesinger is right in his analysis. But, possibly because he was an agent of earlier administrations, he did not see that the disease was contracted before Nixon came to power. The power of arrogance, the cancer that could kill our republic, was fully impregnated by the Kennedy administration, grew under the Johnson administration, and only achieved its culmination under Nixon.

The context for the crisis

Watergate is not a place, not a series of recent events, not a point in time. Watergate is a compendium whose most important element is a state of mind, an attitude about how American government should function. Watergate is also a question whether these United States can survive as a constitutional democracy.

Is it erroneous to suggest that the immediate events of Watergate began with the Pentagon Papers leak? Is it heresy to suggest that the evils that were revealed by the Pentagon Papers were wrongdoings of presidents Kennedy and Johnson and their advisors rather than those of President Nixon and his advisors? Is it inappropriate to notice that the “Plumbers” were President Nixon’s contribution to the scandals of the Pentagon Papers? Is it irrelevant to notice that the Bay of Pigs and the Central Intelligence Agency are integral parts of the Watergate scandal? Is it improper to suggest that Truman's Korean venture is the direct precedent for the illegal war initiated by President Kennedy, stepped up by President Johnson, and continued to a delayed end by President Nixon?

Is it bad taste to assert that the secret bombings of Cambodia were no more secret than the original use of advisors in Vietnam or the use of CIA mercenaries in Southeast Asia at an earlier date?

For me, all these questions and more are necessary to the understanding of Watergate. Watergate did not occur as a biological sport. It is not a matter of yesterday, but of many yesterdays. Did money play a different role in the 1972 campaign than in the 1960 Democratic primaries and the contest that followed? Were the tactics that secured the nomination for the Democratic candidate in 1972, a candidacy that assured a Republican victory, more wholesome for our democratic institutions than those indulged by the Nixon campaign forces?

Watergate, however you define it, is a modern day Pandora's box. The evils it has loosed are immeasurable. The problems it has raised are horrifying and apparently unsolvable. There are two different kinds of constitutional questions that derive from Watergate. The first are those constitutional issues that have engaged the attention of the news media and the public. Essentially these constitutional matters derive from questions of who is guilty of what, of how guilt is to be determined, and on what evidence. This kind of question has been, or probably will be, resolved by some appropriate tribunal.

The second set of constitutional questions is more important, if less sensational and therefore less noticed. These are concerned with the conditions that have made Watergate possible, i.e., with the present structure of our government and the problem of the survival of our democracy. These questions are likely to remain obscure and unresolved for want of attention or a proper forum, and with the great possibility of dire consequences.

Washington's vision

George Washington's decision not to be available for a third term as president of the US was announced in what we have all come to know as his Farewell Address. Every American schoolboy knows of the Farewell Address. And yet, it must be conceded that none of the advice so painstakingly offered in the address has been abided.

Washington warned against political parties, and they have come to dominate American affairs. He advised against “overgrown military establishments which, under any form of government, are inauspicious to liberty, and which are now regarded as particularly hostile to republican liberty.” He admonished us that “it will be worthy of a free, enlightened, and at no distant period a great nation to give to mankind the magnanimous and too
novel example of a people always guided by an exalted justice and benevolence.”

Included among his cautions was one that is particularly relevant to the subject of our discussion today. In 1796, he told us:

*It is important . . . that the habits of thinking in a free country should inspire caution in those entrusted with its administration to confine themselves within their respective spheres, avoiding in the exercise of the powers of one department to encroach upon another. The spirit of encroachment tends to consolidate the powers of all departments in one, and this to create, whatever the form of government, a real despotism. . . . If in the opinion of the people the distribution or modification of the constitutional powers be in any particular wrong, let it be corrected by an amendment in the way in which the Constitution designates. But let there be no change by usurpation; for though this in one instance may be the instrument of good; it is the customary weapon by which governments are destroyed. The precedent must always greatly overbalance in permanent evil any partial or transient benefit which the use can at any time yield.*

We are governed today by a far different constitution than that which Washington bequeathed us. And the most basic changes have not been brought about by means of constitutional amendment, as Washington would have had it. We have seen the concentration of power in the presidency that has been achieved by the usurpation of which Washington warned us, aided largely by the abdication of responsibility by the Congress. We are, indeed, threatened by that despotism which he decried, whether it may be called “benevolent” or not.

Watergate, however, has brought the specter of totalitarianism to the attention of the American public. Now, as hardly ever before, we are cognizant of the crisis that we face. For the first time in many years, Congress is seeking to assert itself. The question is whether or not it is too late to restore the constitutional balance that our Founding Fathers created.

The trend toward concentration

Heretofore, crisis has been the handmaiden of presidential power. Whether the crisis was economic, as was the case when Franklin Delano Roosevelt first came to power, or a military crisis of the kind that has plagued every generation of Americans, at least since World War I, it has always brought with it exaltation of executive authority. And each time, until the advent of the Vietnam War, this concentration of authority has been justified not only by our leading liberal politicians but also by our leading liberal scholars, either on the ground of necessity or expediency.

Since Roosevelt’s tenure, all meaningful government power has been vested in the national government. The only governmental powers that states now exercise are those allowed to them by the national government. State government is politically as well as economically bankrupt. And, within the national government, power has, since Roosevelt’s day, been concentrated in the executive branch. This is not a result of the Nixon incumbency.

As long ago as 1968, before Richard Nixon was elected to his first term as president of the US, Louis Heren, then Washington correspondent for the *Times of London*, wrote a perspicacious, if wrong-headed, book, which described the dominance of presidential power in American government in this fashion:

*The modern American Presidency can be compared with the British monarchy as it existed for a century or more after the signing of the Magna Carta in 1215. . . . Indeed, it can be said that the main difference between the modern American President and a medieval monarch is that there has been a steady increase rather than a diminution of his power. In comparative historical terms the United States has been moving steadily backward.*

The point I should like to make here, however, is that the dangers to American democracy and freedom against which George Washington warned lie not only in the adhesion of power to a single man, the president, but the adhesion of power to the executive office: an executive office that includes the National Security Council, the Council of Economic Advisers, the CIA, and the Office of Management and Budget among its unchecked, unlimited, and unelected “guardians” of the American people. To use Mr. Heren’s analogy, what we have witnessed in the Kennedy, the Johnson, and the Nixon administrations is a return to that period of English history when the power was not wielded solely by the king, but by the king and his council, to the period that led up to the American Revolution.

A startlingly perceptive and insightful work, Harvard Professor Bernard Bailyn’s *The Ideological Origins of the American Revolution*, published in 1967, demonstrates that the intellectual case for the American Revolution was based not so much on those simplifications about George III that are taught in our history courses, as on the notion that the English constitutional system on which all men’s liberties depended had been perverted by the men around the Crown in conjunction with the king rather than by the king alone. Read Bailyn’s words, and his use of the words of those who lived in the era that gave birth to our nation, and ask yourselves whether the explanation does not fit our day equally well:

*The most common explanation, however, an explanation that rose from the deepest sources of British political thought, located “the spring and cause of all the distresses and complaints of the people in England or in America” in “a kind of fourth power that the constitution knows nothing of, or has not provided against.” This “overruling arbitrary power, which absolutely controls the King, Lords, and Commons,” was composed, it was said of the “ministers and favorites” of the King,*
who, in defiance of God and man alike, “exerted their usurped authority infinitely too far,” and “throwing off the balance of the constitution, make their despotic will” the authority of the nation.

For their power and interest is so great that they can and do procure whatever laws they please, having (by power, interest, and the application of the people's money to placemen and pensioners) the whole legislative authority at their command. . . . the rights of the people are ruined and destroyed by ministerial tyrannical authority and thereby . . . become a kind of slaves to the ministers of state.

This “junto of courtiers and state-jobbers,” these “court-locusts,” whispering in the royal ear, “instill in the King's mind a divine right of authority to command his subjects” at the same time as they advance their “detestable scheme” by misinforming and misleading the people.

Bailyn also wrote, “For the primary goal of the American Revolution was . . . the preservation of political liberty threatened by the apparent corruption of the constitution.” The American Revolution was a political revolution, not a social or economic revolution. It was fought to restore the constitutional balance that Englishmen and Americans thought essential to the liberties they claimed. In the two centuries that have elapsed, the “corruption of the constitution,” which they deplored, has once again occurred. And, if our liberties are to be preserved, we should be looking to the means to restore the constitutional balance among the three branches of government.

The first step toward the restoration of our constitutional democracy would be the abolition of the “fourth branch of government”—to quote again from Bailyn’s sources—“a kind of fourth power that the constitution knows nothing of, or has not provided against.”

**The power around the president**

I don’t know yet when the euphemism “the White House” first came into use as a description of something other than the presidential mansion at 1600 Pennsylvania Avenue. But it was exactly when “the White House” became what it now is, a fourth branch of American government, that we were committed to take the road that led to Watergate. And this long journey probably began with the single step of the statutory authorization of Roosevelt in the Reorganization Act of 1939. Therefore, the first step back toward our constitutionally established democratic principles is to remove the powers accumulated in the so-called Executive Office of the President, to dissipate the Office of Management and Budget, the National Security Council, the Council of Economic Advisers, the czar of this and the emperor of that. Put these functions back in offices that are subject to congressional control and public scrutiny, or in administrative agencies that can be made totally free of Executive Office corruption.

Watergate, however, is the consequence not of one but of two kinds of corruption. The first is that which I have described as the “corruption of the constitution.” The second kind of corruption revealed by Watergate is the corruption of the people and particularly of individual officeholders. We have forgotten what a little-known Supreme Court justice, Noah Haynes Swayne, in a lesser-known Supreme Court case (Trust v. Child), once wrote: “The theory of our government is, that all public stations are trusts, and that those clothed with them are to be animated in the discharge of their duties solely by consideration of right, justice and the public good.”

The fact is, of course, that no institutions, however perfect, can function without the appropriate human beings to run them. The Founders had in mind not only a concept of the presidency but the kind of man they wanted when they prepared Article II. Despite their great respect for Washington, they limited the executive power as national government had ever before limited executive power. The need for a Washington was, nevertheless, pervasively felt. The problem of finding the right men for the right governmental posts has long plagued us. The distinguished French historian François Guizot supplied the introduction to Jared Sparks’s biography of Washington. In 1837, Guizot wrote:

> The disposition of the most eminent men, and of the best among the most eminent, to keep aloof from public affairs, in a free democratic society, is a serious fact. . . . It would seem as if, in this form of society, the tasks of government were too severe for men who are capable of comprehending its extent, and desirous of discharging the trust in a proper manner.

Today we are suffering not only from a corruption of the constitution through perversion of the institutions of government, but a corruption of the constitution because the men we have chosen for high office are unworthy. A US president who tells us that he is “not a crook” thereby affords little reassurance of his qualifications for office, even if we could still credit him with a capacity for the whole truth. It is not enough that the US president is “not a crook.” There is more to honor and duty than not stealing from the public fisc. The reassurance we need—and have not received, because deeds and not words are the only cogent evidence here—is that the authority of the US government is not expended merely to effectuate the personal whims or wishes of those in high authority nor to benefit their personal friends and do harm to their personal enemies. We live in an age when it is no longer the love of money that is the root of all evil; for our time, it is the love of power that is the root of all evil.

A system of presidential selection—not, incidentally, the one created by the constitution—that leaves the voters a choice between the devil and the deep blue sea, as it did in the 1972 election and in some earlier elections, helped bring us to this grievous point in our history. But that is another tale that requires another time for the telling, however short of time we may be.

The crisis called Watergate has provided us pain and suffering, outrage and disgust, fear and trembling. It has also afforded us an opportunity not likely to come again, to reexamine the “corruption of the constitution” from which we have been suffering these many years and to try to effect a remedy before it is too late.

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Philip B. Kurland was William R. Kenan Jr. Distinguished Service Professor Emeritus in the College and the Law School at the University of Chicago. He died in 1996.
WHAT CONTRIBUTED MOST TO THE FINANCIAL CRISIS?

Nearly a decade has passed since a number of calamitous events shook the global financial system and sparked what became a years-long crisis. To help explain the conditions that put the economy in dire straits, Chicago Booth’s Initiative on Global Markets sent its US and European experts panels a list of 12 factors that may have contributed to the meltdown, and asked them to assign a weight of 0–5 for each depending on its “importance in contributing to the 2008 global financial crisis.” As the results demonstrate, many factors received a considerable degree of blame, underscoring the complexity of the crisis—and, perhaps, the difficulty of preventing the next one.

See more online
All responses to this poll can be seen at igmchicago.org/igm-economic-experts-panel.

About the IGM Economic Experts Panels
To assess the extent to which economists agree or disagree on major public policy issues, Booth’s Initiative on Global Markets has assembled and regularly polls two diverse panels of expert economists, all among the leading researchers in their fields in the United States and Europe. The panels include Nobel laureates and John Bates Clark medalists, among others. Questions are emailed individually to the panel members, who may consult whatever resources they like before answering. Members of the public are free to suggest questions.
### Factors

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<th>Factors</th>
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<td>Underestimated risks (financial engineering)</td>
<td>4.11 (4.19)</td>
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<td>Mortgages: Fraud and bad incentives</td>
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<td>Housing-price beliefs</td>
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<td>Ratings-agency failures</td>
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<td>Too-big-to-fail beliefs</td>
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<td>Government subsidies: Mortgages, home owning</td>
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<td>Savings and investment imbalances</td>
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<td>Loose monetary policy</td>
<td>1.96 (2.01)</td>
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<tr>
<td>Fair-value accounting</td>
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### Average rating, weighted by experts’ confidence

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<th>US panel</th>
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<td>4.00 (4.00)</td>
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José Scheinkman, Princeton

“Inflated housing prices would have collapsed, but with much less severe global consequences if financial institutions had not chosen to hold as much housing risk (due to greed or stupidity) or if regulators and rating agents had done their jobs.”

Robert Hall, Stanford

“The government’s policies of bailing out financial institutions created a fragile financial system. Financial collapse resulted in a major loss of confidence.”

Hélène Rey, London Business School

“Many factors contributed to the 2008 global financial crisis. But at the heart of the mechanism was a dysfunctional financial sector with misallocation of capital, bad incentives, insufficient supervision, and some fraudulent behavior.”
How do the early-childhood years affect your ability to climb the socioeconomic ladder?

Kalil: Children need both cognitive and what we call noncognitive skills to succeed in life, to perform well in school, to perform well in the labor market, to get along with other people. These skills are crucial both for improving social mobility and for mitigating inequality.

Although there is opportunity for skill development throughout the life course, the early years are critically important. Early childhood is a period of rapid brain development, when the path to skill development is laid down. So it’s a formative period, and parents and the home environment play an important role in helping children acquire those key skills. Children’s ability to think and to solve problems, as well as their preliteracy and premath skills, and their understanding of the world and how to get along with others all have to do with the quantity and quality of time that caregivers spend with children on particular activities, such as reading books, playing puzzles, simply talking to children, helping them solve problems, etc.

That kind of interaction typically comes from parents, but it could come from anyone. It need not be only the mother; it need not be only the father. There is a range of important caregivers, typically, in a child’s life.

How does innovation relate to social mobility?

Akcigit: Along with colleagues, I’m studying the importance of innovation for the macroeconomy. And our overarching research question is: Why do we care about innovation, from a macroeconomics standpoint? And we find three answers to this question.

Chicago Booth’s Amir Sufi and University of Chicago’s Ufuk Akcigit and Ariel Kalil discuss how early-childhood development, innovation, and inequality affect social mobility.
First, innovation is the sole driver of long-term economic growth. In the long run, economies are growing only due to technological progress and innovation. The second answer we find is that when we look at the relationship between well-being, or happiness, and innovation, we see a strong association between innovation at the regional level and the happiness of the region’s individuals. And the third aspect of it is that innovation is leading to growth in average incomes, but how does that growth evolve across generations and how does it get spread? And what we see in the data, starkly, is that innovation, or the turnover in the economy, is strongly associated with social mobility. In regions where there’s a lot of turnover, there’s also high social mobility. And this is particularly true if innovations are coming from new entrants, young entrepreneurs.

And one more interesting result we find is that this strong association between entrant innovation and social mobility gets much weaker in regions where incumbents are spending more money on lobbying activities. Because, as you can imagine, innovation is a process of creative destruction, where new entrants are coming and replacing the incumbents. And this, of course, creates the chance for the child of an assembly-line worker to become the business owner. If incumbents are slowing down this process, that is going to have a negative impact on social mobility.

In a parallel study, we try to also understand how politically connected firms affect innovation. Where incumbents are politically connected, where they are hiring moonlighting politicians, we observe a much lower entry rate into those industries. And, of course, that is going to have negative consequences on social mobility as well.

“*If we have a lot of social mobility, that allows new entrants to catch up with incumbents.*”

— UFUK AKCIGIT

Who are the innovators? What do we know about them?

**Akcigit:** What we find across numerous studies is that, first, education is an extremely important ingredient for becoming an inventor. The second important ingredient is having rich parents—that helps a lot. But this strong association between having rich parents and becoming an inventor disappears completely once you control for a child’s education. Parental income matters because [rich parents] are able to afford a better education for their children. So an immediate conclusion suggests the importance of education for innovation, which later on also leads to social mobility.

**Kalil:** A child’s skills are jointly produced, however. We can’t assume that a lack of opportunity for learning in the home environment can be made up for by schooling. For one thing, children who arrive at school with fewer skills will get less out of the learning environment that is provided to them there. Secondly, the sheer amount of time that children spend in home environments, or in the company of caregivers, trumps the time they spend in school. There certainly can be cases where there’s a fabulous school environment; but in general, we should not think that better education is a solution for improving social mobility on its own. We can certainly think about a joint effort. But it’s really not one versus the other; it’s those two environments combined.

How does inequality relate to social mobility?

**Sufi:** Social mobility is a dynamic concept referring to how people move throughout the income or wealth distribution, whereas inequality is more a static statement
about, currently, how does the top 10 percent of the wealth distribution compare to the bottom 10 percent? They’re related in that we might think high inequality may exacerbate the decline in social mobility, but the evidence is a bit mixed on that.

**Akcigit:** If we have a lot of social mobility, that allows new entrants to catch up with incumbents. If there’s a lot of turnover in the economy, that’s going to have a negative impact on inequality because it’s going to shrink the income distribution. On the other hand, as I highlighted earlier, there is a connection between being from a rich family and becoming an inventor, and that has an impact on social mobility. It looks like we are not giving an equal chance to everybody.

**Sufi:** We’ve seen a sharp rise in measures of inequality over the last 40 years. A lot of people have focused on a “keeping up with the Joneses” story, because simultaneous with that rise in wealth inequality, we’ve seen a sharp rise in household-debt levels, measured just about any way you want to measure them. And a lot of people say, “Oh, that’s because lower-income households, people in the median of the income distribution, they need to borrow more to get an education, to buy a car, to buy a home, in order to catch up, in some sense, with more-wealthy people.”

The narrative that we actually believe is more relevant is more of a push rather than a pull factor coming from the financial sector. Because people who are extremely wealthy consume, or spend, so little of their wealth, as you get a rise in wealth inequality, more and more money comes into the financial system. That system, of course, is charged with going out and trying to find good investment opportunities, good ways of making use of those funds. In our view, perhaps there just aren’t enough good investment opportunities in, say, the private sector. So a lot of that savings gets transformed into borrowing by lower-income people: subprime mortgages, subprime auto loans, more education loans.

The ease with which households below the 70th percentile of the wealth distribution can get credit has increased over the last 30 years. One prominent example is the ease with which people can borrow against the value of their homes. Thirty or 40 years ago, it was almost impossible to take out what’s called a home-equity loan, or cash-out refinancing, where you literally go to the bank and say, “I want to take out more money because my home’s value has gone up.” Now, and especially in 2004–06, it was incredibly easy to do that.

Subprime auto loans are another innovation. People far down in the credit-score distribution can now borrow almost the entire value of the car when they buy a car. So that’s one way in which inequality is affecting the financial system and thereby affecting borrowing patterns.

**How does that compare to the long-term view of innovation and social mobility?**

**Akcigit:** We digitized all the patent records since 1836 in order to uncover the inventors in each of those patent files. Then we merged them with the decennial US census records between 1880 and 1940, which made it possible to see all these historical inventors of this golden age to whom we owe bicycles, refrigerators, safety pins, you name it.

And it’s an interesting question: Who are they? There are some facts that are similar to today: for instance, back then, innovation was strongly associated with social mobility as well. But historically, innovation was a little bit more of a democratic activity in the sense that most of the inventions in the beginning of the century were done in garages. When you look at the patent records, about 70 percent of patents were assigned to individuals. Whereas today, more than 90–95 percent are assigned to nonindividuals, to corporations or universities.

**Kalil:** We’ve taken a similar historical perspective to look at change in inequality in learning opportunities between rich and poor kids, for example. One thing we’ve noticed is that, over time, there has been an increase for rich and poor families alike in the
amount of time that they spend with kids. And to such a great extent that, at present, the home environments of low-income kids look a lot like the home environments of rich kids 30 years ago. So you could say, well, that’s a good thing. But just as low-income caregivers have increased their time, so too have high-income caregivers. And so, in fact, the gap has shrunk very little, because high-income parents are doing orders of magnitude more than they did 30 years ago.

**What are some policies or solutions that can decrease inequality or foster innovation and social mobility?**

**Akcigit:** One policy conclusion coming from our analysis is that access to education is a very, very important tool. I also mentioned that innovation has an unusual relationship with happiness, and the reason is that, through innovation, you’re also replacing some companies, which means there can be many workers who are going on unemployment. And especially these days, when technology’s evolving at a fast pace, we observe that it’s typically the older workers who are not able to find a new job quickly. We see that the relationship between innovation and happiness gets much tighter in regions where unemployment benefits are higher. If we take into account not only the winners but also the losers in innovation, we can create bigger gains from this entire process. This doesn’t mean we necessarily have to increase unemployment benefits, but introducing some training programs for the people who are losing their jobs could be an important policy tool.

Another important policy conclusion coming from these studies is that we need to adapt procompetitive policies, which will make it easier for new entrants to come in and create this turnover that we want.

**Sufi:** Debt, as a financial contract, really is a pretty terrible contract if you’re a middle- or low-income person, because it essentially forces all the risk on you. The example I always give is: you have a $200,000 house and a $100,000 mortgage, and house prices drop by, let’s say, 50 percent. Well, then, you end up eating the loss, not the bank. Your mortgage is still going to be worth $100,000. The way debt contracts work is that they concentrate those losses on the debtors, who tend to be lower-income people. One idea is to try to put more equity-like financing into the market so that risk is shared more equally between the rich and the middle- and low-income households.

**Kali:** A puzzle that we have to solve is: How much cognitive and emotional stimulation is necessary for healthy childhood development? Is there some absolute level that will indicate, “This child is ready to succeed”? Even college-educated and/or rich parents are not spending five hours a day reading or playing puzzles with their kids, but what they’re doing is spending, let’s say, 20-30 minutes a day on a particular kind of learning activity that’s relevant for children’s development, and they’re doing it every day. What we see in lower-income households is that these activities happen much less frequently. When low-income parents do spend time with their kids, the actual number of minutes does not differ that much from their high-income peers; it’s just that it happens, as I said, less frequently. There are many different demands on low-income parents, many fewer resources, much less social support, many fewer peers around them who are reinforcing these kinds of activities.

Our research suggests that they aspire to interact with their children, but somehow, for many people, life gets in the way of the things we want to do. My colleagues and I have thought about how to design an intervention that helps parents set goals, reminds them of the goals they’ve set, and gives them some sort of social reward or feel-good feedback for meeting their goals. We send them text messages to congratulate them on meeting their goals. It’s really as simple as that. We do these simple, light-touch, low-cost kinds of interactions, and we find dramatic increases in the behavior of interest.
How to maximize shareholder welfare

A company may want to focus solely on making money for shareholders, but these investors are likely to have social goals as well, such as reducing pollution and promoting fair practices. The problem is that shareholders can’t always offset a company’s “dirty” policies; nor can they always rely on government to curb such activities. Under these conditions, a company that’s maximizing shareholder value may not be maximizing its shareholders’ welfare, according to Harvard’s Oliver Hart and Chicago Booth’s Luigi Zingales. As a way to maximize welfare, the researchers suggest letting shareholders vote on company policy. Voting would ensure “clean” policies prevail, but only if enough shareholders care about them. To read more about how this concept could change the way corporations are run, turn to page 64 of this issue.

A “clean” policy wins if:

\[ \lambda m > \pi_{\text{DIRTY}} - \pi_{\text{CLEAN}} \]

The social damage from “dirty” policy.

Median shareholder’s level of social consideration.

Profit from “dirty” policy.

Profit from “clean” policy.

More profits.

Profits & the common good.
### Executive MBA Information Session: Singapore

**DECEMBER 6**
Executive MBA Information Session and Master Class, Singapore. Chicago Booth’s Michael Gibbs will conduct a master class for alumni and prospective students. Other information sessions will be held this winter in Dubai, United Arab Emirates, and Munich.

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### DECEMBER
- **JANUARY 10**
  Polsky Collaboratorium, Chicago. Students, researchers, technologists, and faculty can network, pitch cutting-edge research and technologies, and explore commercialization opportunities.
  [polsky.uchicago.edu/events](http://polsky.uchicago.edu/events)

- **JANUARY 11**
  [ChicagoBooth.edu/eo](http://ChicagoBooth.edu/eo)

- **FEBRUARY 7**
  Meet the Dean, Hong Kong. Get to know new Chicago Booth Dean Madhav Rajan and hear his thoughts about the future of the school while networking with alumni, students, and faculty.
  [ChicagoBooth.edu/alumni/events](http://ChicagoBooth.edu/alumni/events)

- **FEBRUARY 23**
  17th Annual Private Equity Conference, Chicago. Hosted by Chicago Booth’s Private Equity Group and the Polsky Center for Entrepreneurship and Innovation, the conference features a lineup of distinguished industry speakers and panelists.
  [student.ChicagoBooth.edu/group/pe/conference.htm](http://student.ChicagoBooth.edu/group/pe/conference.htm)

- **MARCH 19–23**
  The Advanced Strategy Program: Building and Implementing Growth Strategies, Chicago. Develop a strong strategic intuition at the senior executive level.
  [ChicagoBooth.edu/asp](http://ChicagoBooth.edu/asp)

### JANUARY
  [ChicagoBooth.edu/eo](http://ChicagoBooth.edu/eo)

- Economic Outlook, Chicago.
  [ChicagoBooth.edu/eo](http://ChicagoBooth.edu/eo)