The populism puzzle

What caused the uprising that has transformed global politics?

Plus:

Black voters wait longer at the polls

Learn by failing? Not so easy
“That is why my six-year-old eats broccoli. But that’s not why my 15-year-old eats broccoli.”
Just a few months into 2020, it’s too early to proclaim definitively the theme of the 2010s. But there’s a good chance we’ll look back and associate it with populism. Populist votes upended politics in the United Kingdom and the United States in 2016, and the effects are still reverberating. (The 2019 British election confirmed that the UK will leave the European Union.) The outcomes have, among other things, led many people to take a hard look at democracy itself.

Many observers described the votes in favor of Brexit and Donald Trump as surprises, even mistakes. After all, political polarization typically follows economic shocks, according to research by Princeton’s Atif Mian, Chicago Booth’s Amir Sufi, and University of British Columbia’s Francesco Trebbi. But by 2016, the US and UK economies had largely recovered from the financial crisis, and unemployment was relatively low.

This is the puzzle of populism, and as described in our cover story this issue (page 26), researchers are working hard to solve it. Economists including Chicago Booth’s Marianne Bertrand, Lubos Pastor, Raghuram G. Rajan, Pietro Veronesi, and Luigi Zingales have their own perspectives, but the complete answer may not be found in economics. Booth social psychologists Nicholas Epley and Reid Hastie and political scientists have their own theories and frameworks.

There is some consensus, however, that 2016 was probably no aberration. This year’s US presidential election will likely provide more evidence that populist sentiment remains strong, on the left and right.

Polarization gets personal
Populism is one of those issues that has not only inspired academic research, but has also led to arguments in millions of households. In our feature on polarization (page 36), we introduce you to Reed Schroer, a 70-year-old Lutheran pastor in Rhodes, Michigan, for whom politics has become a wedge between him and a beloved family member. They went months without speaking.

Research finds that Americans are separated by their language choices, one example being that Republicans and Democrats use different phrases—death taxes and estate taxes, respectively—to discuss the same thing. Bertrand and Chicago Booth’s Emir Kamenica have found a correlation between Americans’ incomes and what they eat, watch, and do in their spare time.

This polarization, the researchers say, has held steady for about five decades. What’s different now is that divisions are increasingly personal.

Wherever you sit on the political spectrum—and whatever your hobbies or favorite TV shows—we hope that you can find something of interest in this magazine. There’s a lot more to discover online, where you’ll find a wide range of videos, interactive charts, and more articles to inform and challenge your thinking.

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DEPARTMENTS

1  Editors’ letter
4  Feedback
74  The Equation

DATAPoints

7  How racial bias infected a health-care algorithm
9  Antitrust law needs an update for digital firms
9  More women are studying higher-wage subjects
10  Text-reading machines can predict share prices
12  Ayelet Fishbach says a raise might not motivate you
13  A new explanation for stock market returns: short memories
14  Private-equity buyouts don’t tell a simple story
15  Ethical abuses in behavioral science
15  US tax-code changes have failed to curb short-termism
16  Income-based segregation stifles social mobility
17  States are already paying for unfunded pensions
18  Trade is now a top source of policy uncertainty
19  How likely is that company to survive a downturn?
19  Food restrictions may stoke loneliness
20  Learn by failing? Not so easy
20  How to create jobs in impact investing
21  Black voters wait longer at the polls
22  When an oil company comes knocking, hold an auction
23  How fiscal policy drives inflation
23  Workers care about their employer’s credit condition
24  Many retailers are making a basic pricing mistake

COVERSTORY

26  THE POPULISM PUZZLE
What caused the uprising that has transformed global politics?
By Hal Weitzman

36  Could anything unite the United States?
Cultural and political divisions have persisted for decades. Now there’s a growing gap in how Americans see each other.
By Rose Jacobs

Veronica Guerrieri, the Ronald E. Tarrson Professor of Economics and a Willard Graham Faculty Scholar, studies macroeconomics with a particular interest in labor and financial markets. She is managing editor of the Review of Economic Studies and the recipient of, among other awards, the 2015 Bernácer Prize for the best European economist under 40 in the fields of macro and finance. (Pages 16 and 74)

Lubos Pastor, the Charles P. McQuaid Professor of Finance and a Robert King Steel Faculty Fellow, researches financial markets and asset management. A member of the Chicago Booth faculty since 1999, Pastor is codirector of Booth’s Fama-Miller Center for Research in Finance, director of Booth’s Center for Research in Security Prices, and a member of the Bank Board of the National Bank of Slovakia. (Page 26)
FOOTNOTES

43 Market forces can help fill food banks
By Canice Prendergast

47 Where do goals come from?
A Meeting of the Minds discussion

50 The network is an entrepreneur’s best asset
By Waverly Deutsch

54 How to avert a disastrous group decision
By George Wu

58 Yelp has revived intimate capitalism
By John Paul Rollert

62 Stop worrying about wealth inequality
By John H. Cochrane

64 Is there a culture problem among startups?
The Big Question

68 Do lotteries do more harm than good?
The IGM Poll

70 Five skills of good managers
By H. Edward Wrapp

Pietro Veronesi, deputy dean for faculty and the Chicago Board of Trade Professor of Finance, studies the determinants of price valuations, bubbles, and crashes, as well as the interconnections between politics and finance. He is a former director of the American Finance Association and coeditor of the Review of Financial Studies, as well as a research associate of the National Bureau of Economic Research. (Page 26)

Canice Prendergast, the W. Allen Wallis Distinguished Service Professor of Economics, is interested in organizational and market design, be it for the contemporary-art market or real estate in shopping malls. In this issue, he writes about the challenges involved with allocating and distributing goods to food banks. (Page 43)
FEEDBACK

Does America have an antitrust problem? (Winter 2019/20)

Do ya think? Are you guys sure you are relevant in economics if you pose that as a question? It is an established fact. You should speak to remedies, like those proposed by @ewarren.

—Vagabundo

Does America have an antitrust problem?

TOO LATE FOR SOME

Four skills you need to scale a business (Winter 2019/20)

Forwarding to [WeWork cofounder and former CEO] Adam Neumann.

—I would add one more skill that is often overlooked by academics: the art of sales. It’s a trait, skill, and know-how process that’s especially critical for startups “creating market” and “raising capital.”

—Mark Kosminskas

Great article and certainly relevant to financial-services firms. Skill No. 1 (learning) is a prerequisite for Skill No. 3 (market) in my view. . . . I find myself often having to unlearn what I’ve already learned to make sure we are offering the right products to the right customers at the right price. Market demographics change, and organizations must continuously reevaluate their offering to stay relevant.

—Michael Lin

Does America have an antitrust problem? (Winter 2019/20)

This strongly correlates with the fact that older (aged 40–50-plus) founders tend to have more-successful startups. It might be because a) they intimately understand the problem that needs to be solved and b) they have the network to sell to others with the same problem.

—abadar

Niche wine for the win

Demand for niche products is growing (Winter 2019/20)

This also applies to me in multiple cases, including expanding varietals from popular winemakers to flushing in smaller producers in my imported wine section. It’s been one of my focuses, and the results have put my wine section and store at the top in the company.

—Jennifer James

Problem solvers, or lawbreakers?

Startups, forget about the technology (Winter 2019/20)

I find it interesting that the two example companies—Uber and Airbnb—that succeeded by “focusing” on solving problems did so by breaking the law and pushing externalities onto others. . . . To succeed as a business, you have to do something that others can’t do or won’t do. If you have a tech advantage, you can do stuff that others can’t. If you don’t develop a tech advantage, you have to do stuff others won’t. In these two cases, of Airbnb and Uber, it was breaking the law.

—I would add one more skill that is often overlooked by academics: the art of sales. It’s a trait, skill, and know-how process that’s especially critical for startups “creating market” and “raising capital.”

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—Michael Lin

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“The interaction between real cases and the strong academic support comes from the Oxford and Chicago Booth approach...this is why I suggest professionals take this course. You will gain a lot of experience to bring to your day-by-day life.”—Raffaello Rossi, Corporate CFO, Finamo Srl
As data science has developed in recent decades, algorithms have come to play a role in assisting decision-making in a wide variety of contexts, making predictions that in some cases have enormous human consequences. Algorithms may help decide who is admitted to an elite school, approved for a mortgage, or allowed to await trial from home rather than behind bars.

But there are well-publicized concerns that algorithms may perpetuate or systematize biases. And research by University of California at Berkeley’s Ziad Obermeyer, Brian Powers of Boston’s Brigham and Women’s Hospital, Christine Vogeli of Partners HealthCare, and Chicago Booth’s Sendhil Mullainathan finds that one algorithm, used to make an important health-care determination for millions of patients in the United States, produces racially biased results.

The algorithm in question is used to help identify candidates for enrollment in “high-risk care management” programs, which provide additional resources and attention to patients with complex health needs. Such programs, which can improve

How racial bias infected a health-care algorithm

A design flaw penalized black patients with complex needs
patient outcomes and reduce costs, are employed by many large US health systems, and therefore the decision of whom to enroll affects tens of millions of people. The algorithm assigns each patient a risk score that is used to guide enrollment decisions: a patient with a risk score in the 97th percentile and above is automatically identified for enrollment, while one with a score from the 55th to 96th percentile is flagged for possible enrollment depending on input from the patient’s doctor.

Obermeyer, Powers, Vogeli, and Mullainathan find that black patients are on average far less healthy than white patients assigned the same score. For instance, for patients with risk scores in the 97th percentile of the researchers’ sample, black patients had on average 26 percent more chronic illnesses than white patients did. The result of this bias: black patients were significantly less likely to be identified for program enrollment than they would have been otherwise. Due to algorithmic bias, 17.7 percent of patients automatically identified for enrollment were black; without it, the researchers calculate, 46.5 percent would have been black.

The bias stems from what the algorithm is being asked to predict. Health is a concept that can’t be narrowly defined or encapsulated in a single metric, and this makes it difficult to observe directly in data. The algorithm uses health-care costs as a proxy for health needs, and risk scores reflect the algorithm’s prediction of who will have the highest future health-care costs. On this dimension, the researchers say, the algorithm is well calibrated across races: for any given risk score, the future health-care costs of black patients were similar to those of white patients.

The trouble is that black patients typically generate lower costs than white patients with similar health profiles, because black patients are less likely to receive treatment. “Whether it is communication, trust, or bias, something about the interactions of black patients with the health-care system itself leads to reduced use of health care,” the researchers write. A black patient who generates $5,000 in health-care costs is, on average, sicker than a white patient who generates the same costs.

The algorithm in question is not the only factor used to guide enrollment for care-management programs. However, its focus on cost as the outcome of interest is typical of other algorithms used in the same way, the researchers write. What’s more, they deem the choice to focus on cost reasonable on some level, and not just because most health-care systems want to minimize expenses: health-care costs and health needs do have a strong positive correlation. Sicker patients tend to spend more on health care. “The mechanism of bias is particularly pernicious because it can arise from reasonable choices” on the part of the algorithm’s designers, the researchers write.

Obermeyer, Powers, Vogeli, and Mullainathan report that they took their findings to the algorithm’s manufacturer, which confirmed the finding of bias using a national data set of more than 3.5 million patients. The manufacturer then worked with the researchers to identify variables that could stand in for cost as a proxy for health needs; using a variable that combined cost predictions with health predictions (pertaining to the number of active chronic conditions patients would need to manage), they were able to create an algorithm that reduced bias by 86 percent, according to one measure. —Jeff Cockrell


Untangling a biased algorithm

Assessing an algorithm widely used to identify people with high levels of medical risk, research finds that the share of black patients should have been significantly higher.

Share of black patients at each health–risk score

- Health-risk scores according to the algorithm reformulated to reduce racial bias
- Scores according to the original algorithm

Patients above the 55th percentile were flagged for possible enrollment.

Obermeyer et al., 2019

Patients at the 97th percentile and above were flagged for automatic enrollment.
More women are studying higher-wage subjects

Starting with the group of Americans born in the 1950s, women in the United States have overtaken men in terms of how many complete college. However, college-educated women still trail their male peers in compensation, even though it has been nearly 50 years since women entered the workforce en masse and despite their strong and persistent upskilling. One potential explanation: many women specialize in lower-pay fields, such as elementary education, both in the college classroom and the labor market.

According to research by University of California at Riverside’s Carolyn Sloane, Chicago Booth’s Erik Hurst, and University of Chicago Harris School of Public Policy’s Dan Black, this has started to change. Their study documents that more-recent generations of college women are sorting into traditionally male-dominated majors. For example, for baby boomers born between 1950 and 1954, only one woman majored in engineering for every 20 men. For millennials born 40 years later, the ratio changed to one woman for every 5 men. This trend is also recorded in the physical and life sciences. Among biology majors, women outnumber men.

In traditionally female-dominated subjects such as nursing, foreign languages, and fine arts, there has also been gender convergence. However, in the case of business, a traditionally male-dominated major, the converging trend lasted until only the 1965 birth cohort, when it started to diverge again.

Beyond studying movements in college-major choices, the researchers wanted to examine the wage effects of these decisions. Until recently, research on the cost of schooling and occupational decisions was limited because large data sets that link college major selection, occupational choice, and compensation were not available. The researchers studied recent data from the US Census Bureau’s American Community Survey (ACS), including responses from millions of college-educated people about their choice of major and their career outcomes. They assigned every person a potential wage solely on the basis of their major choice—the wage they would receive if they were compensated like native-born white males in their peak earnings years who studied the same subject. The idea was to isolate the specific effect of these choices.

When Sloane, Hurst, and Black documented patterns in potential wages across five-year birth cohorts by gender, their analysis reveals that, on average, women chose majors producing lower potential wages than men did. But while there is an ever-present female penalty in potential wages, that gap has narrowed substantially. Overall, women in the 1950 birth cohort chose majors that reduced their potential wages, relative to their male counterparts, by 12.5 percent. Forty years later, that gap narrowed to 9.5 percent.

However, the study also suggests that even if women major in a high-wage field such as chemical engineering, they may still end up working fewer hours and making less. Curious about the connections between educational specialization and occupational specialization, the researchers find that conditional on making the same major choice, women still sorted into occupations with lower potential pay and fewer hours than their male peers. “Over all majors and across all cohorts, conditional on major choice, women are in occupations that have a work requirement that is about 3 percent less than comparable men. There is little trend in this gap across cohorts,” write Sloane, Hurst, and Black. Prior research by Harvard’s Claudia Goldin and Lawrence Katz supports the finding that highly educated women tend to choose professions that require fewer hours on the job. (See Goldin’s Summer 2019 essay, “Tackle gender inequality at home and at work,” online at Review.ChicagoBooth.edu.)

The result: over all ages and cohorts, women are in occupations where they earn about 13 percent less than men do.—Howard R. Gold

Antitrust law needs an update for digital firms

“It used to be one of the key issues in antitrust was power over price. But now so many digital transactions appear to be ‘free.’ Obviously, you’re paying for them—there’s a reason that tech firms are profitable. But it’s not the traditional price mechanism at work. It’s a data mechanism; it’s an information mechanism. It’s something that’s very different. And because so much of our antitrust law is about traditional markets, where power over price is a reasonable metric, we have to think of new metrics when price may not be the most relevant issue.”

—RANDALL S. KROSZNER, deputy dean for Executive Programs and the Norman R. Bobins Professor of Economics at Chicago Booth, speaking at Booth’s Economic Outlook in Chicago
Text-reading machines can predict share prices

A single word in a news report—a well-placed “undervalue,” for example—can drive a company’s stock price up or down. Investors can benefit if they can figure out which words matter within a few days, research suggests.

Investors and researchers have suspected for decades that text could be used to predict markets, some trying and failing. But applying machine-learning techniques originated by computer scientists, Harvard’s Zheng Tracy Ke, Yale’s Bryan T. Kelly, and Chicago Booth’s Dacheng Xiu have built a model that in early tests outperformed a similar strategy based on scores from RavenPack, the leading vendor of news-sentiment scores.

Traditionally, finance researchers and market practitioners have relied on accounting data and fundamentals to predict where the market is headed. But quarterly reports arrive slowly for a market moving at warp speed, which led researchers and traders to look for other sources of predictive information, including news. To find out if news reports could be used to predict stock prices, Ke, Kelly, and Xiu borrowed machine-learning techniques used by computer scientists, who are increasingly training machines to understand text.

Efforts to predict market direction by parsing financial journalism date back to 1933, when economist and businessman Alfred Cowles III classified pieces in the Wall Street Journal as bullish, bearish, or neutral to inform trading strategies. That didn’t necessarily work—Cowles’s theoretical portfolio would have underperformed the market by more than 3 percent a year from 1902 to 1929, the researchers note—but other people have continued to pursue the idea of extracting useful information from text. Among them, Northwestern’s Scott R. Baker, Stanford’s Nicholas Bloom, and Chicago Booth’s Steven J. Davis analyzed years of newspaper articles to identify words associated with economic uncertainty, and have used those words to inform dozens of uncertainty-related indexes.

Some efforts to assess sentiment in text rely on preexisting dictionaries created for other purposes—such as the Harvard-IV Dictionary, a manually selected list of positive and negative psychosocial words, and the Loughran-McDonald Master Dictionary, developed to highlight meaningful words in financial texts and the
Keywords in news articles can propel your portfolio

A trading strategy that quickly incorporated the results of a machine-learning analysis of news articles would have outperformed news-sentiment-score provider RavenPack.

One-day returns using trading strategies based on keywords in news articles

A study found that using keywords from news articles to generate a sentiment score for each article can be used to build a trading strategy that outperforms a similar strategy based on sentiment scores from RavenPack. The researchers used a simple strategy to buy assets associated with positive recent news sentiment and sell assets associated with articles containing negative sentiment. The resulting portfolio outperformed a similar strategy based on RavenPack sentiment scores.

Some funds have likely been using natural language processing to trade for several years, with dubious success. A 2016 article in MIT Technology Review called analyzing language data to predict markets “one of the most promising uses of new AI techniques,” but one of the handful of funds it mentioned, Sentient, liquidated in 2018. The research by Ke, Kelly, and Xiu provides an academic framework for applying such processing to markets.

To demonstrate their model’s predictive capacity, the researchers devised a simple trading strategy to buy assets associated with positive recent news sentiment and sell assets associated with articles containing negative sentiment. The resulting portfolio outperformed a similar strategy based on RavenPack sentiment scores.

—Meena Thiruvengadam
A lot of your research focuses on motivation, including at the workplace. What advice do you have for job seekers?

We are now switching jobs more than ever. In surveys, more than half of full-time employees in the United States say they’re interested in a job change. Everybody’s looking around. There’s much more turnover. But why are people unhappy where they are and want to move?

Ayelet Fishbach says a raise might not motivate you.

Jeffrey Breakenridge Keller
Professor of Behavioral Science and Marketing and IBM Corporation Faculty Scholar

Q1 A lot of your research focuses on motivation, including at the workplace. What advice do you have for job seekers?

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A NEW EXPLANATION FOR STOCK MARKET RETURNS: SHORT MEMORIES

WHY DO HIGHLY valued stock markets often fail to deliver adequate returns? Likewise, why do depressed stock markets sometimes bounce back, delivering big gains to investors? Economists have long struggled to explain the countercyclical nature of the equity premium, the excess return that investors earn for risking money in the stock market rather than putting their money in safe government bonds, but Chicago Booth’s Stefan Nagel and University of Michigan PhD candidate Zhengyang Xu suggest an explanation. “When people form expectations about the long run, they tend to rely on a relatively limited memory of what they have seen in their own lifetimes,” Nagel says. “Their expectations are tilted toward more recent data.”

Research has advanced a number of explanations for time variation in the equity premium, one being that at certain times, investors aren’t particularly risk averse. According to this theory, sometimes investors may pile into the stock market and drive up stock valuations, knowing full well that future returns may be low. At these points in time, valuations would be high, even though equity premiums would be low.

But this argument doesn’t explain why equity premiums increased during the 2008–09 financial crisis. According to the risk-aversion theory, investors were afraid to take risks, and therefore dampened stock valuations by avoiding the market even though they expected stocks to produce a high rate of return. The problem is that some survey data do not show that investors expected a high rate of return at the time.

The real reason investors were reluctant to pay high prices for stocks is that they were pessimistic about future stock market fundamentals, Nagel and Xu argue. And that’s because, according to the researchers’ theory, investors’ expectations of future fundamentals are informed by relatively recent experiences of growth. Nagel and Xu constructed a data series of dividend growth for the overall US stock market going back to the 19th century. They then tested whether the weighted average of dividend growth rates in earlier years accurately predicted future stock market returns.

“If you look at periods when dividend growth has been good, the stock market is highly valued and tends not to perform well going forward, consistent with it being valued too highly,” Nagel explains. The opposite was also true: after several years of low dividend growth, the market was undervalued, and future returns were strong.

The findings support mounting evidence that people’s economic expectations are shaped by what they have personally seen and experienced. And they could have implications for one of the biggest open questions in the field: What drives stock market volatility? Investors, far from being the rational creatures many asset pricing models assume them to be, may be weighting recent history too heavily, bidding up the market in booms and selling off in busts.—Dwyer Gunn


Investors’ expectations about the long run tilted toward more-recent data.
Private-equity buyouts don’t tell a simple story

Proponents of private-equity investment say it can unlock a company’s value and improve efficiency. Critics charge that private-equity buyouts can hurt performance, employment, and wages at target companies.

But the effects are more complex than either of these views suggests, according to Chicago Booth’s Steven J. Davis, University of Maryland’s John Haltiwanger, University of Michigan’s Kyle Handley and UMichigan PhD candidate Ben Lipsius, Harvard’s Josh Lerner, and the Census Bureau’s Javier Miranda.

In the past four decades, private-equity operations have reshaped thousands of American companies, affecting millions of workers and acquiring a reputation as business enhancers or destroyers—or both. As the researchers point out, some policy makers are pushing regulation. The European Union imposed the Alternative Investment Fund Managers Directive to prevent “asset stripping” in acquisitions. Massachusetts Senator Elizabeth Warren, a leading Democratic candidate for president, proposed a measure she calls the Stop Wall Street Looting Act of 2019 to broadly regulate private equity.

Davis and his colleagues find that the outcomes of private-equity deals differ greatly by type of buyout and with the broad economic environment during and after the deal. In some cases, employment at target companies plummets after a private-equity investment. In others, there’s a surge in both employment and productivity.

Starting with data on almost 10,000 transactions involving US companies from 1980 to 2013, the researchers focused on 3,600 buyouts that they could track over time. Deals included private-to-private and publicly-traded-to-private buyouts, divisional sales, and secondary sales made between private-equity groups. Using Census data, the researchers estimated the effects of buyouts on target company employment, productivity, and wages over the two years following a transaction, as compared with similar businesses not subject to buyouts. Overall, at the time of the buyouts, close to 7 million US workers were employed by the target businesses in the study.

In the case of public-to-private buyouts, which often attract heavy media attention, the researchers find that employment fell 13 percent over two years following a buyout. This adds fuel to critics’ contention that buyouts harm target companies and their workers.

In contrast, the researchers find, employment rose 13 percent when the target enterprise was privately owned. In the case of secondary buyouts, employment increased 10 percent.

Divisional buyouts created the biggest employment effect, with a plunge of 16 percent, largely reflecting facility closings. Intracompany job reallocation rose for all buyout types, in line with the view that buyouts act as a catalyst for the reorganization of target companies.

Private-equity buyouts caused overall employment at target companies to decline more than 4 percent, after accounting for postbuyout acquisitions and divestitures.

In perhaps the study’s most important finding, productivity rose an average of 8 percent over the two years postbuyout compared with similar companies. These large gains are especially remarkable, the researchers say, because target companies are typically older businesses in mature industries such as manufacturing, food service, or information technology.

Productivity gains were highest when deals happened amid tight credit conditions. In an easy-credit environment, the researchers suggest, private-equity groups may structure buyouts with an emphasis on maximizing private returns through financial engineering rather than through making operational improvements. Additionally, their results indicate that a postbuyout slowdown in economic growth or a widening of credit spreads curbs productivity gains.

Average compensation per employee fell almost 2 percent at target companies relative to similar companies, largely erasing a prebuyout wage premium at targets. The direction and magnitude of the wage changes associated with buyouts also differed greatly by deal type. In private-to-private deals, for instance, wages fell 6 percent on average. In divisional deals, on the other hand, compensation rose 11 percent.

Given the range of outcomes after buyouts, a one-size-fits-all policy intended to regulate private equity is not likely to be efficient, the researchers say. While politicians might focus on minimizing job losses related to private equity, the researchers argue that there is a keen need to better understand the link between private-equity buyouts and productivity gains. –Rebecca Stropoli


Snapshot of the aftermath of private-equity deals

Changes in employment and job reallocations have differed depending on the type of company targeted in the deal.

Changes at US companies two years after private-equity buyouts

<table>
<thead>
<tr>
<th>Buyout target</th>
<th>Employment</th>
<th>Intracompany job reallocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private company</td>
<td>+12.8%</td>
<td>+11.7%</td>
</tr>
<tr>
<td>Public company</td>
<td>-12.6%</td>
<td>+9.6%</td>
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<tr>
<td>Company division</td>
<td>-11.5%</td>
<td>+19.4%</td>
</tr>
<tr>
<td>Company already owned by another private-equity company</td>
<td>+9.9%</td>
<td>+9.4%</td>
</tr>
</tbody>
</table>

Davis et al., 2019
US tax-code changes have failed to curb short-termism

A lesser-noticed element of the broadly controversial US Tax Cuts and Jobs Act of 2017 is a provision that tweaked how much of highly paid executives’ salaries corporations can deduct from taxable income. The Republican-led Congress that pushed through the TCJA, the most sweeping tax overhaul in 33 years, was trying to steer top-executive compensation away from encouraging an emphasis on short-term results.

Lawmakers appear largely to have failed at this effort, suggests research by Stanford’s Lisa De Simone, Chicago Booth’s Charles McClure, and Indiana University’s Bridget Stomberg. After examining executive compensation for fiscal years 2017 and 2018, the researchers find no evidence that companies affected by the TCJA changed total compensation, compensation mix, or pay-performance sensitivity.

Since 1994, publicly traded companies were generally subject to a $1 million-a-year cap on the amount of top-executive compensation that they could deduct from taxable income under Section 162(m) of the Internal Revenue Code. They could deduct more if the pay was linked to the company’s performance. However, the provision appeared to encourage shifting compensation away from salary and toward stock options and other performance-linked pay.

Lawmakers were concerned that this focused managers too much on delivering short-term results, so the TCJA repealed the exception and disallowed all performance-based compensation, generally the largest component of executive pay.

This promised to dramatically lower the deductibility of executive pay, the researchers write. Congress also slashed the corporate tax rate to 21 percent from 35 percent, saving companies a bundle—also limiting the deductibility of certain highly compensated employees to only $1 million. The researchers cite the example of Apple CEO Tim Cook. His compensation for the fiscal year that ended September 30, 2017, was $102 million. Under the pre-TCJA rules, Apple’s after-tax cost for his pay was $67 million, thanks to about $35 million in salary tax deductions. But under the new system, which took effect in 2018, his compensation would have had an after-tax cost of almost the whole $102 million because the cap on deductibility would have reduced the tax benefit from $35 million to about $210,000, or the $1 million of deductible salary expense multiplied by the new corporate tax rate of 21 percent.

To study the effects on corporate compensation policies, the researchers analyzed a sample of salaries from CalcBench, a data-compilation service that provides real-time, searchable access to Securities and Exchange Commission filings. They limited the sample to executives who received total compensation above the $1 million threshold. They also examined fixed pay, performance-based pay, and total compensation for CEOs and other top executives.

The TCJA rules are effective for fiscal tax years beginning on or after January 1, 2018, so the researchers compared changes in executive compensation among affected businesses from 2017 to 2018 against a control sample of companies that were not affected until calendar year 2019. This allowed the researchers to compare the reactions of companies that were and weren’t affected that first year.

For the most part, the researchers find no difference between affected companies and the control group. They also find no evidence of a relationship between corporate taxes and executive compensation for a sample of health-care insurers that were subject to the early repeal of the performance-based-compensation exception.

The researchers conclude that tax considerations appear to have limited effects on the way businesses structure executive pay, although that may be, in this case, because some companies were reluctant to quickly change compensation contracts due to some initial uncertainty around TCJA grandfathering rules.

The research contributes to the policy debate on the effectiveness of the TCJA by providing early evidence on whether Congress achieved its objective of shifting the mix of executive compensation away from options to create a greater focus on longer-term company performance. The finding that corporations did not immediately respond to the law’s compensation provisions suggests Congress may have structured the law inefficiently or that the Treasury put off issuing guidance for too long, potentially causing delays in companies’ responses.—Martin Daks

In the midst of steadily declining poverty and unemployment, the income gap in the United States continues to widen. Income inequality has reached the highest level in five decades, according to a September 2019 Census report.

Could growing inequality be related to residential segregation? The Minneapolis Fed’s Alessandra Fogli and Chicago Booth’s Veronica Guerrieri find there was a significant increase in residential segregation by income during the decades when income inequality grew.

Fogli and Guerrieri developed a model that demonstrates how income-based segregation in the US has contributed to the broader income gap. Their findings suggest that income segregation has a substantial effect on overall income inequality, particularly as higher-income jobs increasingly seek higher-skilled workers.

The researchers used Census tract data on family income from 1980 to 2010 to model measures of inequality and residential segregation among metropolitan statistical areas. They used the Gini coefficient to measure inequality, and the dissimilarity index, which is a common indicator of the uneven distribution of two groups across geographical areas, to gauge segregation.

Fogli and Guerrieri find that as income segregation increased during this period, so did broad income inequality. And the more the skill premium rose, the more income segregation widened and the overall income gap grew. Thus, the chances of children from poorer neighborhoods being able to enjoy upward mobility decreased, further eroding the American dream, they argue.

The researchers’ model has two neighborhoods, and its key ingredient is neighborhood spillovers that affect children’s future incomes.

Neighborhood A is more desirable because it is populated by richer families that generate positive local spillovers: better schools that are mostly locally financed, peers who are exposed to more extracurricular activities, social norms that are more conducive to academic success, and social networks that could help...
when students enter the labor market. The more desirable Neighborhood A becomes, the higher home prices rise, locking out lower-income families and increasing segregation by income.

The researchers calibrated the model using data from 1980 and, to discipline the strength of a local spillover, they used the micro estimates of the effects of neighborhood exposure proposed by Harvard’s Raj Chetty and Nathaniel Hendren. Using the calibrated model, Fogli and Guerrieri studied how the economy responded to a skill-premium shock caused by technological progress that, as documented in the data, boosted the income of more-educated people. As the premium for skilled work rose, inequality mechanically increased because high-skilled workers became even richer.

However, the researchers argue that this was not the end of the story: families invested even more in their children’s education, in part by moving to better neighborhoods. Thus, real-estate prices in these neighborhoods spiked even higher as demand grew, pushing out lower-income families and reducing the hope for intergenerational mobility. This increased the gap in the strength of local spillovers in the two neighborhoods, further increasing inequality.

Finally, the researchers used their model to run a counterfactual exercise that helps answer the question of how much residential segregation contributed to the increase in US inequality after 1980. In particular, they looked at what would have happened if, after the skill-premium shock, families had been randomly relocated to Neighborhoods A and B, muting segregation. Fogli and Guerrieri then compared the inequality dynamics in this exercise with the ones in the baseline model. The difference between the two highlights the outsized effect of income-based segregation on the wage gap, which the researchers find contributed 28 percent to the broad increase in income inequality between 1980 and 2010.

As the skill premium continues to rise in the face of major technological advances, income-based segregation may increase, meaning the wage gap will grow ever wider and children from lower-income neighborhoods will have even fewer opportunities to experience upward mobility. –Rebecca Stropoli

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**STATES ARE ALREADY PAYING FOR UNFUNDED PENSIONS**

**KICKING** pension problems into the future is popular with politicians, enabling them to make promises and let voters worry later about borrowing costs. But large, unfunded state pension liabilities are a costly problem—and the cost is already reflected in current bond prices, research by Chicago Booth PhD candidate Chuck Boyer suggests.

To many Americans, it may seem unimaginable that states would fail to fully pay pensions promised to teachers, firefighters, and other public-service workers. It has been almost 90 years since the last state default. However, pension obligations are mounting in many states, and officials are struggling to cut costs and raise taxes to pay what is owed. And Boyer argues that the effects can be seen in the US municipal bond market.

When a company defaults, there is a clear legal framework for who gets paid back first. This isn’t the case for states, however, as there is no such legal structure, nor much precedent. The markets’ expectations, then, are built into bond prices. Bondholders, wary of how a default could play out, demand a premium.

Using annual fiscal reports released by state governments, Boyer looked at the ratio of unfunded pension liabilities to GDP from 2002 to 2016 and estimates that every 1-standard-deviation increase is associated with a 27–32 basis-point increase in bond spreads over the Treasury rate, up to a fifth of the average total spread. Unfunded pensions cost US states more than $2 billion in lost bond-issuance proceeds in 2016, he calculates, adding that he considers that a conservative estimate.

But the penalty that a state would essentially pay in the form of higher spreads varies from state to state. States where pensioners have more legal protections and their unions have more bargaining power (and maybe higher public support) are paying higher borrowing costs. In these areas, debt holders see a higher risk of default—perhaps assuming states would take care of pensioners before bondholders.

Boyer looked specifically at Illinois, where pension reimbursements are protected by the state constitution. In 2013, the state passed legislation that would have reduced the state’s liabilities by $160 billion by extending retirement ages and capping the amount of someone’s salary that could be used to calculate pension benefits. After the law passed, the state’s bond spreads fell by an average 12 basis points more than other states’ bond spreads. But in 2015, the Illinois Supreme Court overturned that legislation, and spreads shot up. In 2016, Illinois issued bonds to raise $3 billion. Had the state moved to fully fund its pensions, its spreads would have improved by 79 basis points, writes Boyer, and the state would have raised an additional $280 million.

He also argues that the pension problem has a larger effect on bonds with longer maturities, a clue that unfunded liabilities are most likely to affect state solvency 10–20 years down the road. But already, unfunded pensions are increasing states’ borrowing costs, compounding fiscal problems.—Jonathon Platt

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Trade is now a top source of policy uncertainty

Trade tensions have helped drive global policy–related uncertainty to new highs, according to Chicago Booth’s Steven J. Davis. “Trade policy under the Trump administration also has a capricious, back-and-forth character that amplifies uncertainty and undermines a rules-based trading order,” writes Davis.

Policy uncertainty is measured in indexes created by Northwestern’s Scott R. Baker, Stanford’s Nicholas Bloom, and Davis. They launched the US Economic Policy Uncertainty (EPU) Index in 2013, recording and tracking the use of key terms in influential newspapers to measure uncertainty in the public consciousness and the markets. They have since introduced policy uncertainty indexes for 25 countries, as well as more-specialized uncertainty indexes focusing on immigration and trade. (The indexes are posted and updated on a website, PolicyUncertainty.com.)

Traders and investors use the CBOE Volatility Index, or VIX, to track fear and risk in markets, but the VIX measures only uncertainty on Wall Street, not in the overall economy, where too much uncertainty can cause business executives to hold off on capital investments and hiring.

The researchers’ policy indexes have risen sharply several times in the past decade: during the 2008–09 financial crisis, the European debt crisis and the 2011–12 US debt-ceiling crisis, the June 2016 Brexit referendum, and the US election of President Trump that November.

More recently, trade-policy conflicts have caused several indexes to spike. The average US tariff rate, Davis notes, was less than 2 percent in December 2017 and was expected to rise to as high as 9–11 percent by the end of 2019, if all the threatened additional tariffs were implemented. The average US tariff rate on Chinese imports was projected to reach as high as 21.4 percent, but the “phase one” trade deal announced in December will reduce some US tariffs on Chinese imports.

“Under Trump, tariffs are threatened, announced, delayed, reversed, announced again, imposed, and removed—often in quick succession,” Davis writes. “Some countries get tariff exemptions, [and] some don’t. Exemptions vary in duration, and they come and go in a head-spinning manner.

“These various developments have led to a tremendous upsurge in anxiety and uncertainty about trade policy and its economic fallout,” Davis sums up.

In August, amid rising trade tensions, the US EPU index shot above 285, higher than it was after Brexit, Trump’s election, the US debt-ceiling crisis, and the September 11, 2001, terrorist attacks.

That same month, the global EPU index spiked to 348, a 20-year high. Besides responding to trade, the index registered uncertainty following continued conflict over Brexit; increased unrest in Italy, France, and Turkey; and an economic slowdown in China.

The US Trade Policy Uncertainty Index hit a 25-year high in August, surpassing the level it reached in November 1993, at the height of the debate over the North American Free Trade Agreement (NAFTA). Meanwhile, trade policy was cited as a factor in 26 percent of articles about equity market volatility from March to December 2018. From 1985 through 2015, it was mentioned in just 3 percent of articles about EMV. “Trade policy went from a virtual non-factor in US equity market volatility in recent decades to one of its leading sources in 2018,” writes Davis.

“US and global policy uncertainty have been highly elevated in recent years,” he concludes. “The huge rise in trade policy uncertainty since early 2018 is an extraordinary departure from recent history, as is the prominent role of trade policy in recent stock market volatility.”

—Howard R. Gold

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### How Likely Is That Company to Survive a Downturn?

**BEFORE** investors or lenders commit funds to a company, they’d love to have some assurance about the business’s viability. Could it, say, survive a brutal downturn?

Research by the University of Southern California’s Maria Ogneva, Stanford’s Joseph D. Piotroski, and Chicago Booth’s Anastasia A. Zakolyukina may provide some guidance. They have developed probability estimates—which can be used in risk-management assessment, in conjunction with conventional bankruptcy- or failure-risk measures—to identify companies that may be in particular danger of failing in recessions.

The researchers compared the characteristics of companies that failed during economic recessions or expansions, and evaluated accounting fundamentals that can predict the phase of the business cycle in which an enterprise may fail. They analyzed a sample of 3,511 business failures—including bankruptcies, performance-related delistings, and credit defaults—from January 1973 to December 2016, a period that covered six recessions.

With the help of a statistical-learning method, they identified 12 accounting fundamentals that could predict failure during a recession: enterprise size; age; the procyclicality of businesses’ profitability, profit margin, and sales; short-term borrowing; sales seasonality; profitability and profit-margin volatilities; the dividend payout ratio; and fixed-asset and research-and-development intensity. Although some of the identified fundamental variables are commonly seen in bankruptcy-prediction models, the risk that the researchers documented is quite different from conventional bankruptcy probability.

Unlike highly distressed companies, which can fail at any time, relatively healthy companies are more likely to be done in by hard times, the researchers argue. While the smaller and younger companies in the sample frequently fell into the former camp, the companies that failed during recessions tended to be older and larger. Although companies that failed had higher short-term borrowing than companies that didn’t, those that collapsed in recessions were on average less dependent on external financing than those that folded in expansions. Such businesses survived in expansions, and only a large adverse shock such as a recession pushed them into delinquency.

Homing in on companies at risk during a recession has broader implications for investors. According to the researchers, if an accounting variable could help predict these recessionary failures, it could also help identify characteristics associated with broader, systematic risk. And stock prices do reflect which companies are at risk in a recession, the researchers write. They sorted stocks, from healthy to distressed, by the probability of recessionary failure. As the probability went up, so too did expected returns. —Martin Daks

### Food restrictions may stoke loneliness

An increasing number of people have food restrictions these days, due to health reasons such as food allergies, as well as religious, moral, and environmental concerns. But food restrictions can be linked to feelings of loneliness, suggests research by Cornell’s Kaitlin Woolley, a graduate of Chicago Booth’s PhD Program, Booth’s Ayelet Fishbach, and Cornell PhD candidate Ronghan Michelle Wang.

In previous research, Woolley and Fishbach find that sharing meals can connect people, even strangers, in powerful ways. For their recent study, they postulated that “if eating similar food brings people together and strengthens bonds, food restrictions could limit one’s ability to bond over a meal.”

To find out, the researchers had 500 US adult participants answer questions about their food restrictions and feelings of loneliness. People with food restrictions reported feeling more socially isolated than those without. The same connection was found in 710 elementary schoolchildren in the United States, and it turned up when the researchers looked at a data sample collected by the Centers for Disease Control and Prevention between 2014 and 2017 of over 35,000 children.

It also held for college students who observed Passover, where eating leavened food is avoided: they were lonelier during the holiday, when they were eating different foods from their peers, although they felt more connected to their observant peers.

The link between food restrictions and feelings of isolation exists because people are concerned about how others perceive their restrictions, the researchers posit. Participants with food restrictions agreed with statements such as: “When eating with others, I worry about having to tell others at the table that I don’t eat a certain food.”

But when the participants with food restrictions recalled a time they ate a meal with friends, a meal at which everyone was able to share foods, the reported feeling of social isolation disappeared. —Alice G. Walton

![People with food restrictions may have trouble bonding with others over a meal.](https://www.chicagobooth.edu/publications/chicago-booth-review/article-and-citations/food-restrictions-may-stoke-loneliness)
Learn by failing?
Not so easy

Failure is often framed as a great teacher—the successful sometimes crow about the number of times they failed before hitting it big. But failure may not always teach us as much as it could, often because ego gets in the way, suggests research by Chicago Booth postdoctoral fellow Lauren Eskreis-Winkler and Booth’s Ayelet Fishbach.

In one experiment, the researchers had telemarketers learn the answers to 10 questions about customer service—by having them guess from two potential answers to a question and then giving them feedback about their guess. They subsequently tested the telemarketers on their knowledge. For example, they asked, “How much money, annually, do US companies lose due to poor customer service?” The participants had to choose between approximately $90 billion and approximately $60 billion (the correct answer). Around half of the participants received “success” feedback for the correct guess, and the other half received “failure” feedback for the incorrect guess.

When tested later on what they’d learned, the telemarketers who had received success feedback fared better, answering 62 percent of the follow-up questions correctly, compared with 48 percent for those in the other group.

The researchers then performed a similar experiment that involved symbols, with participants from Amazon Mechanical Turk. As before, success feedback produced much better performance in a follow-up test: participants in the success condition got 80 percent of the answers right, versus 59 percent in the failure condition.

In each successive variation of the experiment, a question only had two possible answers, thus the two types of feedback provided the same amount of information. In that case, why was success a better teacher than failure?

Eskreis-Winkler and Fishbach write that failure can be a big hit to one’s ego, which may reduce motivation. When study participants reported their self-esteem levels following a task, those in the failure condition registered lower self-esteem. And when the researchers removed ego from the equation by having some people learn from others’ wrong answers, not their own, participants learned equally from failures and successes. “Because people find failure ego-threatening, they will disengage from the experience, which means they stop paying attention, or, tune out,” the researchers write.

The results suggest that feedback about failure should be given with caution. And when giving negative feedback—perhaps after a fumbled presentation at work—the researchers suggest that ego be removed from the equation as much as possible, as “reducing the degree to which failure involves the ego will promote learning.”

Eskreis-Winkler and Fishbach further find that although it’s hard to learn from failure, people should still try—there may be benefits for society. Their follow-up work finds that because people don’t realize failures contain valuable information, they don’t share them with others. People’s erroneous belief that failures don’t contain information produces an asymmetrical world of information where failures are common in private but hidden in public.

Ego makes people reluctant to both learn from failure and share much about their failures. But “information on failures is a public good,” says Fishbach. “When it is shared, society wins.”—Alice G. Walton

Feeling successful

Participants performed better on tests after being told they were doing well.

Test No. 1: Participants received feedback on their answers

<table>
<thead>
<tr>
<th>Feedback Group</th>
<th>Success Group</th>
<th>Failure Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>After each guess, a message said, “Your answer was incorrect.”</td>
<td>After each guess, a message said, “Your answer was correct.”</td>
<td></td>
</tr>
</tbody>
</table>

Test No. 2: Participants answered the same questions again

<table>
<thead>
<tr>
<th>Percentage of correct answers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Failure group</td>
</tr>
<tr>
<td>Success group</td>
</tr>
</tbody>
</table>

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Ego makes people reluctant to both learn from failure and share much about their failures. But “information on failures is a public good,” says Fishbach. “When it is shared, society wins.”—Alice G. Walton

Eskreis-Winkler and Fishbach, 2019

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Black voters wait longer at the polls

Free and fair elections are the cornerstone of democracy, but voting in the United States is more convenient for some than others. Long waits discourage all voters and undermine their faith in the political process.

Anecdotes and surveys, such as the Cooperative Congressional Election Study, have suggested that black voters endure longer wait times than white voters. A deeper statistical dive—from University of California at Los Angeles’s M. Keith Chen and UCLA postdoctoral research fellow Ryne Rohla, Carnegie Mellon’s Kareem Haggag, and Chicago Booth’s Devin G. Pope—further demonstrates racial disparity in wait times.

In the 2016 presidential election, just 56 percent of the US’s 245 million eligible voters cast their ballots—one of the lowest turnouts among developed countries for a national election. According to a Pew Research Center survey, 25 out of 32 countries in the Organisation for Economic Co-operation and Development (for which data were available) boasted stronger voter-participation rates in recent elections.

One culprit for the lackluster engagement could be long wait times at the polls. Some research has suggested that long wait times may lead potential voters to leave before voting, and can undermine confidence in the political process. The issue of wait times rose to the national stage when President Barack Obama addressed it during his election-victory speech in 2012. In its 2014 report, the Presidential Commission on Election Administration concluded that “no voter should have to wait more than a half an hour” to cast a ballot.

To measure wait times during the 2016 election, Chen, Haggag, Pope, and Rohla analyzed geolocation data—captured in the form of pings gathered from voters’ smartphones. The pings corresponded to the location of each phone throughout the day, and were recorded every five minutes or so, any time a mobile application such as a navigation or weather app requested information about a phone’s whereabouts. Using ping data from 150,000 smartphones across 46 states, combined with US Census data from each polling site, the researchers were able to document wait times across the country and break them down by neighborhood racial composition.

The analysis indicates that voters spent an average of 19 minutes at the polls, and 18 percent spent more than half an hour. However, residents of entirely black neighborhoods waited 29 percent longer to vote and were 74 percent more likely to spend more than 30 minutes. The racial disparities persisted independent of differences in population, poverty rates, and other variables, the researchers find.

Pinpointing a precise mechanism for the problem proved more elusive, though Chen, Haggag, Pope, and Rohla were able to dispel a handful of theories. For example, the researchers wondered if black voters, including the many who have inflexible job schedules, were more likely to hit the polls in large bunches, leading to longer wait times—but after examining the data, they find any congestion effects had only a modest impact on the analysis.

They also examined wait times in areas where Republican-controlled election-official offices might be tempted to inconvenience black voters, who tend to support Democrats. Again, the data didn’t bear this out. “If anything, we find larger disparities in areas that have a lower Republican vote share,” they write.

Chen, Haggag, Pope, and Rohla concede that wrestling with racial disparity at the polls—and ultimately offering suitable prescriptions to fix it—would involve additional investigative research, including a hard look at the amount of resources available to manage specific polling sites.—Brett Nelson

Go to Review.ChicagoBooth.edu to see citations for research mentioned in this article.
When an oil company comes knocking, hold an auction

Discoveries of natural gas and oil in shale formations, coupled with improved technology to remove the deposits, have created demand for property or mineral rights in places such as west Texas and rural North Dakota. Much of that land has been barren, undeveloped, and worth little until now, so it would be easy to understand a landowner jumping on a six-figure offer from the first oil company that comes knocking. But Chicago Booth’s Thomas Covert and Boston College’s Richard L. Sweeney suggest those landowners would do well to consider formalizing the process with auctions.

For landowners, auctions beat private dealing

In a study of Texas oil-drilling deals, the researchers find that auctioned leases were substantially more lucrative for sellers than privately negotiated leases.

Oil and gas leases

<table>
<thead>
<tr>
<th>Negotiated deals</th>
<th>Auctions</th>
</tr>
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<tbody>
<tr>
<td>Up-front per-acre revenue to landowners</td>
<td></td>
</tr>
<tr>
<td>$1,100</td>
<td>$1,540</td>
</tr>
<tr>
<td>Total per-acre revenue to landowners</td>
<td></td>
</tr>
<tr>
<td>$3,130</td>
<td>$4,286</td>
</tr>
</tbody>
</table>

Output per acre

Discounted barrels of oil equivalent

233

A quirk in Texas law afforded Covert and Sweeney an opportunity to compare auctions against negotiated leases. Long before the discovery of oil, the Texas Constitution of 1876 allowed the state to sell millions of acres of lands, with proceeds benefiting the Texas Permanent School Fund—but buyers received only the surface rights. Following the discovery of oil, the Relinquishment Act of 1919 allowed these landowners to negotiate with oil and gas companies for drilling and mining rights on behalf of the state, with the landowners and the state splitting the revenues equally. The state’s underlying ownership of the mineral rights made public the otherwise private contracts between landowners and oil and gas companies. In 1973, the state began formally retaining all mineral rights on the lands sold from the Permanent School Fund. It uses auctions to award leases on this land.

The researchers analyzed the prices and productivity of 846 privately negotiated leases and 428 auctioned leases during the recent shale boom, from 2005 to 2016. They find that auctioned leases earned about 40 percent larger up-front payments than negotiated leases did, and that auctioned leases produced 60 percent more output.

While it might seem intuitive that companies bidding against each other in a formal process would raise the final lease price, it isn’t a foregone conclusion that auctions necessarily perform better. In theory, a savvy landowner could get a similar price by simply using private offers as bargaining chips in private negotiations, the researchers point out. Auctions also introduce costs that could keep some companies from entering the fray.

“If it takes time to figure out how valuable a lease is, it effectively costs money for firms to enter an auction. The highest-value bidder might not participate,” which could result in a lower price than in a negotiation, Covert says.

Nevertheless, the data show that auctions performed substantially better. Combining the effects of increased up-front payments and royalties on higher output, the researchers find that auctioned leases ultimately paid landowners about $350,000 more than the average, similarly sized negotiated leases did—$1.2 million, rather than $850,000.

The researchers also find that much of this effect came from the fact that auctions did a better job of matching the oil and gas companies with the lands that were best suited to their individual strengths.

“One theoretically appealing feature of a well-designed auction is that it should allocate an asset to its highest-value user,” the researchers write. “Texas mineral leases allocated by auctions generate more revenue for mineral rights owners and are better matched to firms who can use these minerals productively, relative to leases allocated by informal, decentralized negotiations.”—Brian Wallheimer

How fiscal policy drives inflation

In recent years, as the US economy has slowly recovered from the Great Recession, a puzzle has emerged: Where is the inflation? Despite a historically low unemployment rate, and interest rates that remain low by historical standards, inflation in the United States sits stubbornly below the Federal Reserve’s target rate of 2 percent. The Great Recession posed a similar puzzle: Where was the deflation? Inflation declined a bit, but the deflation spiral, widely predicted to break out once interest rates hit zero, did not happen.

There’s an explanation for this that challenges conventional economics, according to John H. Cochrane, a senior fellow at the Hoover Institution and distinguished senior fellow at Chicago Booth. Standard economic theory has long held that inflation is entirely controlled by monetary policy, but outside of extreme hyperinflations, has little to do with fiscal policy. This orthodoxy is wrong, according to Cochrane and other economists who’ve been developing the fiscal theory of the price level (FTPL) over the past 30 years. Under this theory, fiscal policy is also an important driver of inflation.

In research using data on inflation, monetary and fiscal policy, and economic conditions, Cochrane explores what drove US inflation between 1947 and 2018. His analysis links inflation to the real value of government debt, on the basis of the economic identity that the real value of government debt must be equal to the real present value of primary surpluses that the government is expected to run in the future to pay back the debt. (Primary surpluses are tax revenue less government spending, excluding interest payments.)

In conventional theories, the Fed’s interest-rate policy completely determines price levels and inflation. Congress and the Treasury are assumed to raise or lower taxes and spending as needed to pay off the debt, even if deflation drives up the value of that debt. But in the FTPL, the real value of government debt drives prices, much as the present value of future dividends determines a stock price.

To understand inflation, Cochrane says, compare the amount of outstanding debt with the present value of future surpluses—and with the discount rate, or return that holders of government debt require. Unexpected inflation implies that investors think the government is not going to have the surpluses needed to repay debt, or that they require a higher return to hold debt. In either case, they try to sell government bonds, driving up the price of everything else.

The data shed light on a historical correlation that has puzzled FTPL researchers: a reduced rate of inflation during recessions. In the Great Recession, for example, falling tax receipts and increased government spending (including on stimulus and bailouts) caused deficits to worsen dramatically, and expectations of future surpluses plunged. However, inflation dropped, while a simple view that says deficits cause inflation would have predicted a rise in inflation.

Why did inflation drop? As interest rates fell, investors wanted to buy more of safe but low-return assets such as government bonds, and less of everything else. This desire pushed up the real value of government bonds, both by increasing bond prices and by decreasing the overall price level (i.e., less inflation), so bonds were worth more in real terms. In finance, this is a discount-rate effect: for an asset, a low discount rate translates to a higher real value.

Just as research finds that the discount rate is the most important driver of stock prices, Cochrane finds that the discount rate has played an important role in US inflation as well. Historically, unexpected inflation has largely corresponded with rises in real interest rates that lower the value of debt, and vice versa—not to changes in expected surpluses.

Turning specifically to the effects of monetary and fiscal policy, Cochrane finds that a monetary-policy shock—in the form of an interest-rate increase unaccompanied by changes in the fiscal surplus or growth—led to an immediate and persistent increase in inflation. Meanwhile, a negative fiscal-policy shock, or a decline in surpluses, also resulted in persistent inflation, about half of which was offset by changes in the discount rate.

Cochrane’s research has meaningful policy implications, for both the Fed and fiscal-policy makers. It suggests that the models the Fed uses to describe how its actions affect inflation are wrong, and that the Fed by itself cannot stop inflation or deflation. Monetary and fiscal policy need to act together to keep the price level stable.

The findings point to the danger of running consistent annual deficits, together with the short-term nature of US debt, Cochrane argues. The government rolls over about half the debt every two years. If there’s another global recession and “people lose faith in the US government to eventually start running surpluses, they refuse to roll over the debt, you get a spike in interest rates, a spike in inflation, and you can have an immense crisis.”—Dwyer Gunn


KEY INSIGHT

WORKERS CARE ABOUT THEIR EMPLOYER’S CREDIT CONDITION

When a company’s credit deteriorates, employees start expanding their network on LinkedIn in a potential bid to insure against worsening conditions at their employer. Using data from the social network, researchers find a significant increase in networking efforts for workers at companies that received downwatches, or announcements that precede a likely or impending corporate credit rating downgrade. Skilled employees tended to connect more than others, and the reactions to downwatches were stronger as seniority increased, they find.

Many retailers are making a basic pricing mistake

Retailers have long set prices ending in 99 cents, knowing that buyers view $4.99, for example, as significantly less expensive than $5. But many companies underestimate consumers’ left-digit bias and should be using these prices more than they do now, according to research by Chicago Booth’s Avner Strulov-Shlain.

Strulov-Shlain analyzed price data from 1,710 popular products in 248 stores of a single US retailer, as well as data on 12 products carried by more than 60 chains and in 11,000 of their stores. He finds that one-quarter to one-third of all prices ended in 99 cents. To learn how much companies should charge, Strulov-Shlain built a model that combines previously established left-digit bias models with a profit-maximizing formula that takes left-digit bias into account. Using the model and retailers’ pricing data, he estimates what price sensitivity and left-digit bias the companies had in mind when setting prices. Many items would have been better priced with a 99-cent ending, because demand dropped when the dollar digit changed, he finds.—CAR

How retailers and customers treated a 1-cent difference

Retailers know that buyers see this 1-cent difference as significant. However, Strulov-Shlain finds:

- **Customers** behaved as if the price difference were 15–25 cents.
- **Companies** reacted as if customers behaved like the price difference were 1.5–3 cents.

Products with prices ending in .99 drew greater demand

Measure of demand for products
Higher value = greater demand

But less than a third of products had prices ending in .99

Retail prices for 1,710 products
Shares sorted by price ending

26.9%
Prices that ended in 99 cents

58.5%
Other prices with cents that ended in 9 (89 cents, etc.)

14.6%
Prices with cents that did not end in 9
The populism puzzle

What caused the uprising that has transformed global politics?

BY HAL WEITZMAN  ILLUSTRATIONS BY NATE KITCH
When UK voters elected a Conservative government in December 2019, they effectively re-endorsed their view, expressed in a referendum three years prior, that Britain should leave the European Union. The news was celebrated by, among others, US president Donald Trump, who drew a parallel with his own attempt to be reelected in 2020 by tweeting, in a paraphrase of comments by Fox News host Steve Hilton, “Here in America it will be the same victory as BREXIT, but even more so.”

The 2016 Brexit referendum, and its transatlantic counterpart—Donald Trump’s victory in that year’s US presidential race—surprised opinion pollsters, and prompted many observers to question conventional political thinking. This more-recent UK election, and a US presidential campaign that has so far been dominated by candidates on the edges of the political spectrum, demonstrates that political populism is a still-potent force. Two of the world’s most stable and well-established democracies appear to have embraced populism and shunned globalization, which has led to much soul-searching about the future of liberal democracy.

The results have also challenged economic thinking, and Chicago Booth’s Lubos Pastor and Pietro Veronesi have been among the researchers studying the implications. “As economists, we have been taught to think that globalization is good, because people get to specialize, and you have free trade, and that’s a way of making somebody better off without making anybody worse off,” says Pastor. “Yet here—with the Trump and Brexit votes—you saw half the population rebelling. You saw the median voter turning against globalization.”

The real puzzle is this: Why did the United States and the United Kingdom turn to populism at a time of economic growth? Historically, economic shocks typically result in political polarization, according to an analysis of historical data from 70 countries by Princeton’s Atif Mian, Chicago Booth’s Amir Sufi, and University of British Columbia’s Francesco Trebbi. But the 2016 votes took place after several years of positive, albeit sluggish, economic expansion. (See “A period of economic expansion,” next page.) Pastor and Veronesi have come up with an economic model that they say can explain this apparent contradiction, and argue that growth itself can lead to populism.

Some economists question the assumptions of Pastor and Veronesi’s strict economic model but have themselves crafted frameworks based on economic phenomena such as automation, inequality, and globalization. Meanwhile, researchers from various disciplines are considering other potential causes including immigration, the failure of political elites, and the growth of identity politics.

Solving the populism puzzle is proving tough, and controversial. But this debate has clear policy implications. If populism can be explained, it can, perhaps, be addressed.

**What is populism?**

The first step in solving the populism puzzle is to define terms. And while there is no clear consensus on what populism means, several key themes emerge from the academic literature.

First, most researchers frame populism as politically ambidextrous, evident at both ends of the political spectrum. A defining element is anti-elitism. Pastor and Veronesi describe populism as a political ideology that pitches ordinary people—cast as homogeneous and inherently good—against immoral and corrupt elites. Typically, populist leaders claim to be the only ones who can represent the people in this struggle.
A second theme is opposition to globalization. For Pastor and Veronesi, populist leaders are those who prioritize national interests over international cooperation, prefer strong leadership to diplomacy, and favor protectionism over free trade. A team of researchers led by Luigi Guiso at the Einaudi Institute for Economics and Finance defines populist leaders as those who champion short-term protectionist policies without regard for their long-term costs.

Anti-elitism and antiglobalization combine in a third theme: identity politics and scapegoating. “Populist nationalists identify minorities and immigrants—the favorites of the elite establishment—as usurpers, and blame foreign countries for keeping the nation down,” Chicago Booth’s Raghuram G. Rajan writes in his 2019 book, The Third Pillar. Left-wing populists often demonize the wealthy. More generally, Guiso and his coresearchers argue that a key characteristic of populism is pandering to people’s fear and enthusiasm.

University of Chicago’s Will Howell, coauthor with Stanford’s Terry Moe of the forthcoming book Presidents, Populism, and the Crisis of Democracy, points out that anti-elitism, opposition to globalization, and scapegoating are longstanding. What is different about the most recent wave of populism, he says, is that these trends weave together to create an overwhelmingly negative platform whose primary aim is to attack existing institutions and elites, without offering any plans to combat the grievances.

Ultimately, whether a politician is deemed populist depends on which theme researchers emphasize. Pastor considers Elizabeth Warren and Bernie Sanders—the US senators from Massachusetts and Vermont, respectively, and Democratic presidential contenders—to be populists because of their anti-elite rhetoric and their support for protectionism. Howell does not because both have detailed plans for what they would do in office.

Are voters rational?

Many observers have tried to combat populist tendencies by suggesting that voters who favored Brexit and Trump made a mistake. This notion fueled a strident campaign in the UK for a second referendum on Brexit, a position killed off by the 2019 election result. Similarly, some commentators in the US have argued that Rust Belt voters mistakenly supported Donald Trump because he promised to reinvigorate US manufacturing and create jobs—not realizing that many economists say trade barriers, which he favors, work against these outcomes.

But did voters really make a mistake? “That’s an arrogant perspective,” says Pastor. Instead, he says, “Let’s just respect the decision of the median voter and try to understand it.”

The researchers set out to explain why a rational voter would support a populist choice, building on extensive research that charts rising income inequality over the past four decades, driven in particular by income growth of the super wealthy. (For more, read our Winter 2017 feature “Never Mind the 1 Percent, Let’s Talk about the 0.01 Percent,” online at Review.ChicagoBooth.edu.) In their model, growth aggravates inequality, since those at the top benefit most from economic expansion.
The researchers focused on consumption inequality, on the premise that conspicuous consumption—by the wealthy buying yachts, mansions, and expensive art (including the limited-edition duct-taped banana that sold for $120,000 at Art Basel)—makes inequality more salient than other measures such as income or wealth inequality.

Booth’s Nicholas Epley, a social psychologist, says research from his field supports this idea. “The magnitude of inequality is so big that we can’t really represent what it’s like to have $100 billion, but we certainly see people who seem to be doing extremely well and making lots of money.”

Pastor and Veronesi see populism as a rational and inevitable response to growing inequality fueled by economic growth. “Growth aggravates inequality, which eventually subdues globalization,” they write. “Not only can the backlash happen in our model; it must. It is inevitable, just a matter of time.” Their model suggests that even had Hillary Clinton, the 2016 Democratic challenger, won the Electoral College and not just the popular vote, or if the Brexit referendum had gone the other way, populism would have eventually attracted enough voters to triumph.

The notion that voters are averse to inequality—a form of anti-economic-elitism—is foundational to Pastor and Veronesi’s model, and they build it into their voters’ assumed preferences. The researchers cite a raft of academic work indicating that people tend to dislike inequality. In their books The Spirit Level and The Inner Level, British epidemiologists Richard Wilkinson and Kate Pickett tie social problems such as illiteracy, crime, and poor health to inequality, and argue it also causes status anxiety at all income levels. Pastor observes that in an unequal society such as the US, dropping out of the top 1 percent of income earners matters a lot to a family, whereas in a more equal society such as Denmark, such a drop may cause less anxiety since the income differentials are smaller. “That explains why we are happy assuming inequality aversion for everybody, rich and poor,” Pastor says, noting that both Trump and Brexit found support among the wealthy and the poor.

Prior research supports the idea that inequality, or people’s aversion to rising levels of it, may well be a key driver of populism. A 1999 paper by Ernst Fehr of the University of Zurich and University of Munich’s Klaus M. Schmidt found that many people dislike large inequalities—and in fact will give up material payoffs to achieve more balance. (Fehr is now finding that people averse to inequality are more likely to vote for populist proposals.)

**Did voters behave rationally by supporting populism, or were they confused?**

Chicago Booth’s Lubos Pastor and Pietro Veronesi find that indicators of income inequality, such as the top 10 percent of earners’ rising share, can be tied to voters’ support for a country’s more nationalist political parties.

**Voter backlash to growing inequality**

**As the gap widens between the top 10 percent and the other 90 percent . . .**

**Standard-deviation increases in the top 10 percent’s share of all income**

![Graph showing the increase in the top 10 percent's share of all income]( Pastor and Veronesi, 2019)

. . . the country’s nationalist political parties increase their share of the vote

**Percentage points**

30  Chicago Booth Review  Spring 2020
Similarly, in Pastor and Veronesi’s model, the election of a populist candidate leads people to consume less, but inequality is lower. As the economy grows, the marginal utility that people derive from additional consumption declines, which prompts voters to more willingly sacrifice some consumption in exchange for greater equality.

Pastor and Veronesi frame equality as a luxury good. Ironically, economic growth has left most voters well-off enough to be willing to trade lower growth for greater equality. In the Brexit vote, for example, the UK Treasury’s pre-referendum analysis warned that if the country left the EU, households would be £2,400 to £2,900 worse off annually. Pastor and Veronesi’s model suggests that rather than making a mistake, Leave voters calculated that losing wealth was a price worth paying for greater equality.

Epley accepts the idea that voters behaved rationally by supporting populism, but argues that it is still possible that they may have been confused. “It’s perfectly rational to believe something that’s not actually true and act on those beliefs,” he notes, recalling the late University of Chicago and Chicago Booth economist and Nobel laureate Gary S. Becker’s dictum that rational analysis assumes people maximize their well-being as they—and only they—conceive it. People can rationally behave on the basis of inaccurate beliefs, Epley notes.

Pastor responds that this approach raises a thornier question: Who determines which preferences are correct and which are not? Harvard’s Dani Rodrik, in his 2011 book The Globalization Paradox, argues that the combination of democracy, national self-determination, and economic globalization is unstable. In Pastor and Veronesi’s model, Rodrik’s trilemma is resolved through the retreat of globalization.

Questioning economic explanations of populism

Beyond the specifics of Pastor and Veronesi’s formal model, there is a bigger question of how useful economic explanations are in explaining populism. Economists cannot even agree under which economic conditions populism is likely to flourish. For Pastor and Veronesi, populism is provoked by growth, but this contrasts with economic analyses that tie populism to financial crises or economic downturns. In their global analysis, Mian, Sufi, and Trebbi find that historically, financial crises routinely lead to political polarization and growing extremism. They conclude that the rise of populism was a predictable political result of the Great Recession—and therefore an outcome that is as cyclical as the economy.

Granted, Sufi is surprised that more than five years after their research was published, populism remains a powerful political force. He now says he is not sure that economic conditions correlate with populism. “There’s got to be something missing in the purely cyclical argument, precisely because if anything, it’s getting worse, even though the economy, if anything, is getting stronger.” This mismatch, and the length of the populist backlash, has led Sufi and many other economists to look for longer-term explanations. “Was it really what happened in the recession, or something more fundamental that was just made obvious during the recession?” he asks.

Pastor argues that the financial crisis deepened people’s inherent aversion to inequality. “The America that used to be so tolerant of inequality discovered during the financial crisis that there were some people, like bankers, who seemed to have become wealthy in a way that wasn’t exactly fair,” he says. “People’s tolerance for inequality dropped.”

However, Sufi remains skeptical of the inequality argument. He points to the work of Princeton’s Anne Case and Sir Angus Deaton, who catalog the rise in the US of “deaths of despair”—by drugs, alcohol, and suicide—as well as slowing progress against heart-disease deaths among less-educated white communities. Case and Deaton reject inequality as the principal cause of such phenomena, arguing that macroeconomic trends such as inequality and growth “can account for part of the increases in mortality and morbidity, but only a part, and . . . it leaves more unexplained than it explains.”

Sufi says the populism puzzle may have more to do with polarization than inequality per se. “Inequality fosters an environment in which people are going to be more upset generally,” he says, “but it doesn’t explain polarization in the way that we have now.” (For more on polarization, read “Could anything unite the United States?” page 36.) And while economists have done much to measure polarization, “I don’t think economists are the people to be asking about populism,” Sufi says. “The people who have said really smart things are the political scientists and sociologists.”
**Technology, globalization, and community**

Rajan certainly borrows from sociology in *The Third Pillar*, in which he argues that there are three principal societal forces: the state, the economy, and the community. (Read more in a Q&A with Rajan, “Raghuram G. Rajan says capitalism’s future lies in stronger communities,” and in an excerpt from the book, “Technology is splitting the job market,” Spring 2019 and online.) When the three are in balance, a society has the best chance of providing for its people’s well-being. But the source of today’s discontent is imbalance—local communities have become unsustainably weak, which explains the gap between national statistics that paint a picture of economic growth and low unemployment on the one hand, and voters’ lived experiences on the other.

Similarly, Rajan says that aggregate measures such as the stagnant median wage fail to capture the unevenness of people’s economic lives. “It’s particularly felt in these communities that are left behind, whether they are historically disadvantaged or newly disadvantaged,” he says.

Ultimately, Rajan says populism can be explained by economic forces, especially automation and trade competition. These have combined to create devastating job losses in some communities, particularly of middle-income jobs held by people without a college education—the same demographic analyzed by Case and Deaton.

Rajan also emphasizes “the secession of the successful,” in which people with skills and greater education leave their native communities and cluster together, creating a lack of social mobility for those left behind in communities with fewer job opportunities and lower-quality schools. These residents tend to have fewer transferable skills and cannot afford to move to areas with brighter outlooks.

Inequality does not explain populism, argues Rajan, echoing Sufi, Case, and Deaton. He notes that there is a great deal of inequality in cities such as London and New York; yet in these places, populism has little political support compared with more rural areas. “Big cities feel the both good and bad effects of automation, so [the effects] even out,” he says. “Yes, a few people’s jobs are automated away, but different jobs are created, and there are more incomes because of the effects on productivity. There is a basis for economic activity, which hasn’t gone away. You lose your job as a factory worker, but you get reemployed in a laundromat or as a security guard. It’s a lousier job, but at least there’s a job. In a smaller town, when the big employer leaves, the laundromat also closes down.”

**The tension between capitalism and democracy**

Rajan’s analysis points to a societal bifurcation in mature market economies. The haves, possessing skills that are increasingly rewarded by the economy, can shape the political system to their benefit. The have-nots, with stagnating incomes, feel that the economy and the political system have been rigged to keep them out.

The persistence of this long-held resentment has transformed populism from a fringe protest movement to a mainstream political force. In 2012, Booth’s Luigi Zingales published *A Capitalism for the People*, a book written as the populist Tea Party and Occupy movements were in full swing. In his original draft, he has said, he predicted that Donald Trump, or a similar figure, could become the US president, noting the similarities between cronyism in his native Italy and what he saw happening in the US. Zingales removed the section after a colleague told him the idea was so preposterous that it would make the book look not serious. Now he says he wished he had kept it, as Trump was the natural outcome of increased cronyism that was making the US grow in similarity with Italy. The US, he says, was bound to have a plutocrat-turned-president, like Italy’s Silvio Berlusconi.

Zingales identifies an inherent tension between capitalism and democracy: capitalism inevitably leads to some inequality, which is tolerated by society to the extent that its benefits are clear and the inequality itself is seen to be relatively fair. Making the benefits clear requires economic growth that is distributed across society, while the fairness requires opportunities for economic mobility. In Zingales’s view, the US has violated these conditions. “The surprise for me [in 2012 and today] is not that populism is exploding now, but why it took so long,” Zingales says. A quintessential American value has always been that hard work pays off, a creed that, Zingales writes, “has reduced antimarket pressures in the US and helped to make capitalism popular and secure.” But the stagnation of median wages now serves as the prime example of how capitalism’s benefits have failed to accumulate to most Americans.

One suggested cause of stagnant median incomes is global trade competition, whose connection to populism has been well documented in academic research. A group of researchers led by MIT’s David Autor has tied populist politics in some US congressional districts to rising import competition. Research by Italo Colantone and Piero Stanig of Bocconi University finds higher support for Brexit in parts of the UK hit harder by economic globalization,
and greater support for nationalist parties in European regions most affected by Chinese imports.

But a second aspect of globalization has been somewhat overlooked, Zingales says: in the second half of the 20th century, the rest of the world gradually copied the US model of having a well-educated workforce and a free-market economy governed by the rule of law. As a result, US workers, who in 1945 had enjoyed something of a monopoly in attracting global investment, slowly lost their prime position. “Today, investors can safely invest in economies such as Vietnam or Cambodia, which was inconceivable 40 years ago, let alone 70 years ago, after World War II,” he notes.

**In elites we distrust**

In *A Capitalism for the People*, Zingales includes income inequality as one of three factors that he argues provoke populism. His other two: a struggling middle class and a distrust of elites.

Trust has long been an issue of interest for Zingales. For more than a decade, he and Northwestern’s Paola Sapienza have co-sponsored the Financial Trust Index, an annual survey of Americans’ attitudes toward the stock market, banks, mutual funds, and large corporations. They conducted the first survey in 2008, at the height of the crisis, when the index stood at 22 percent. Ten years later, it had risen to 28 percent, mainly fueled by an increase in trust in the stock market.

In spite of the growth of populism, the survey records a marked decrease in anger about the economy—which has fallen from a high of more than 60 percent of respondents in 2011 who felt angry to 27 percent in 2018. But a supplement to the 2018 poll revealed that politicians were trusted by only 5 percent of respondents, compared with 65 percent who trusted in doctors, 29 percent who trusted in economists, and 19 percent who trusted in lawyers. This result echoes that of a randomized online survey conducted in 2011 and 2012 by Princeton’s Ilyana Kuziemko and a team of researchers, in which more than 89 percent of respondents agreed that “politicians in Washington work to enrich themselves and their largest campaign contributors, instead of working for the benefit of the majority of citizens,” with 47 percent “strongly” agreeing.

This mistrust in politicians speaks to another explanation for the rise of populism: the failure of political elites. For UChicago’s Howell, this failure is the fundamental cause of populism, while economic factors often bubble up as the symptoms. “Failure sometimes takes the form of rising inequality, or unbridled immigration, or rampant corruption,” he says. “There are lots of problems that populism has pointed to, but this sense that the government has failed, has let us down, because of indifference and even scorn for average citizens—that is the stuff of populist appeals.”

This explains why in both the US and the UK, populist leaders have cast themselves as warriors against political elites. President Trump, who originally ran on a “Drain the Swamp” platform, has repeatedly attacked Congress, the judiciary, the Federal Bureau of Investigation, and what he calls the deep state more generally. UK prime minister Boris Johnson attempted to prorogue Parliament to prevent the House of Commons from blocking his Brexit deal. (He was overruled by the courts.)

For Howell, and for many political scientists, challenges such as automation, rising inequality, left-behind regions, or stagnant median wages do not, in themselves, lead to populism. Rather, it is the lack of a coherent, effective policy response to these challenges that makes populist appeals attractive.

This failure is stated or implied in most explanations of populism. Even Pastor and Veronesi, whose research is predicated on the inevitability of populism, concede that one could imagine a theoretical social planner who implements policies—such as high taxes on luxury goods— that save globalization. But they deem the required policies too complex and unrealistic to affect their model.

One way elites have failed is by neglecting to construct sufficient social safety nets, say some economists. Booth’s Marianne Bertrand points out that Germany and Canada, which haven’t seen high levels of populism recently, have more of a social safety net than the UK and US. The salience of globalization’s trade effects is greater when there is less of a formal mechanism to dampen the effect. “It’s not just ‘trade is bad,’” she says. “I think it’s that trade is bad in an environment where there’s no government spending in place to try to ease the adjustment to these shocks.”

Elites may have also failed at bringing in fresh perspectives from those who feel marginalized, often through turnover among political leaders. This idea mobility, in Zingales’s view, might reinvigorate established institutions.

Out-of-touch elites also may have underestimated the difficulties faced by the rest of the population. The 2012 book *Why Nations Fail*, by University of Chicago Harris School of Public Policy’s James A. Robinson and MIT’s Daron Acemoglu, argued that economic prosperity depends chiefly on building inclusive economic and political institutions. In their latest book, *The Narrow Corridor*, they construct a model that shares much in common with Rajan’s three pillars, arguing that liberty is only durable when countries
balance the state and society. Brexit is not a challenge to UK political institutions, argues Robinson (who is British), noting that UK politicians have for decades used the European Union as a scapegoat for a host of issues. Robinson holds EU leaders responsible for the rise of populism across Europe. “They underestimated how difficult it was going to be to change institutions in Greece or Eastern Europe,” he says. “They thought that was going to be some smooth process. They underestimated the dislocation caused by all this labor mobility.”

Robinson cites work by researchers who analyzed the rise of the Sweden Democrats, a populist right-wing party that has risen rapidly to become the country’s third-largest political force. University of California at Berkeley’s Ernesto Dal Bó and Frederico Finan, Uppsala University’s Olle Folke, and Stockholm University’s Torsten Persson and Johanna Rickne find that candidates from the Sweden Democrats included more outsiders and “vulnerable insiders,” whose jobs are more likely to be automated away, while candidates from more-established political parties were more likely to be “secure insiders” from sectors less easily automated. “There is that element of increasing out-of-touchness,” says Robinson. “Clearly [former UK prime minister] David Cameron had absolutely no idea there was so much antagonism toward the European Union, otherwise he’d never have agreed to a referendum.”

Bertrand points to another finding of this paper, that the rise of the Swedish far right came after a center-right coalition cut both taxes and social-insurance programs, reforms that led to large shifts in inequality in a society historically known for its robust welfare state. This suggests that in their pursuit of fiscal orthodoxy, politicians may have inadvertently boosted populism.

**Immigration, identity, and imagined community**

One challenge of pinning populism on long-term trends is the question of timing: Why did populist politics surge in developed economies in the 2010s?

Rising immigration is one possible explanation. Famine, drought, civil wars, and organized crime have driven tens of millions of people to leave poor and conflict-ridden countries in recent decades, many of them bound for Europe and the US. The number of international migrants rose from 155 million in 2000 to 244 million in 2015, from 2.8 percent to 3.3 percent of the global population, according to the United Nations’ International Organization for Migration.

Immigration motivated many supporters of Brexit and President Trump. In a string of opinion polls, pro-Brexit voters cited controlling immigration as their first or second reason for wanting to leave the EU, while 52 percent of Trump voters wanted to tighten immigration controls, according to the Voter Study Group, a collaboration of 29 analysts and scholars from across the political spectrum, including University of Chicago political scientist Cathy J. Cohen.

While some of these voters tied immigration to a lack of opportunities for nonimmigrants, Bertrand says the rise in migration provided a perfect focus for workers affected by long-term economic forces such as automation. “The evidence of the impact of immigration on the stagnation of the middle class is very limited,” she notes. “We have much better evidence that technology is a big force. But it’s easier to get angry at other people than to get angry at machines.”

Epley sees immigration and inequality as two of many factors that feed into identity politics. “It isn’t inequality per se, so much as the divide it creates between ‘us’ and ‘them,’” he says. Epley notes there are other sources of division, citing research led by Jacob Westfall, now a data scientist at Home Depot’s data-driven pricing group BlackLocus, which finds that Americans consistently overestimate the extent of political polarization. “Partisanship can be driven by beliefs about partisanship—believing that the other side is more extreme than it actually is,” Epley says, “and it’s not obvious to me that that has anything to do with inequality.”

Epley notes that economic trends can fuel identity-based behavior, such as attacks on minorities and newcomers. University of Georgia’s E. M. Beck and Stewart E. Tolnay of the University of Washington analyzed lynchings of African Americans in the Deep South between 1882 and 1930, and find racial mob violence was more common at times when cotton prices were low and inflation was rising. You might well expect economic stress to lead to violence, but the fact that it led to racial violence suggests it has something to do with identity, Epley says.

In *The Third Pillar*, Rajan indicates how technology and globalization could fuel the assertion of identity, acting as “centrifugal disorientating tendencies” for those in communities that have been left behind. As well as turning people in these communities against out-groups, this disorientation provokes a nostalgia for a perceived glorious past. “When the proximate community is dysfunctional, alienated individuals need some other way to channel their need to belong,” Rajan writes. “Populist nationalism offers one such appealing vision of a larger purposeful imagined community.”
Identity politics reflect political rather than economic factors, says Howell. “There is a reasonably well-defined group of people—predominantly white, Christian, working-class Americans who mainly live in Red [Republican-voting] America—who constitute Trump’s base, who imagine themselves as true, real Americans,” he says. “Populism is a form of identity politics, but it’s not exclusively about identity. It’s in the aftermath of political failure that these appeals take on an identity characteristic. It’s the sense that you were right to expect the government to do something on your behalf, because you are quintessentially what it means to be American.”

Booth’s Reid Hastie—who wrote 2014 book Wiser: Getting Beyond Groupthink to Make Groups Smarter, coauthored with Harvard’s Cass R. Sunstein, analyzes the mechanisms of phenomena such as polarization—says the psychological explanation for populism should look beyond identity. There are three big psychological factors whose interaction with macroeconomic forces help explain political populism, he says: instrumental politics, when people vote according to rational self-interest; symbolic politics, when people support candidates who speak to their personal values; and partisan politics, when voters rely on cues such as party affiliation. “I see all three factors in play,” Hastie says. “Noncollege-educated white men might be mostly driven by symbolic factors, but college-aged populists might be mostly driven by instrumental factors. Anti-immigrant sentiment might be mostly an identity issue linked to symbolic politics, but views about taxing the rich might be mostly instrumental.”

Hastie speculates that one response to the “why now?” question relates to the growth in social media, and he notes that polarization and groupthink can amplify causal forces. “If there is a tendency for electronic media to create partisan echo chambers, populist tendencies can be amplified for individuals who start out oriented in the populist direction.”

What should be done?

For some scholars, populism is a scourge that needs to be defeated. For others, it is a wake-up call. Some think populism can be harnessed for good. Others are pessimistic about where it will take us.

Yet many economists agree that redistribution is critical to any response. “The textbook perspective is that globalization is good because it makes the pie bigger. Then we can always redistribute [wealth] and make everybody better off,” Pastor says. “The problem is that this latter part is not happening. People talk about how [wealth] could be redistributed, but it’s not actually getting redistributed. And that’s where populism is coming from.”

Given their focus on consumption inequality, Pastor and Veronesi posit that an appropriate response would be a form of progressive consumption tax, such as a very high value-added-tax rate on luxury goods, accompanied by negative taxes on consumption for the poorest, a solution Pastor admits is unrealistic.

Rajan, while not opposed to redistributive taxes, says those alone won’t address the concerns of communities that have lost their economic infrastructure. He prefers localism—policies that devolve power to local communities yet prevent them from becoming insular. These policies could include reforming zoning laws, encouraging affordable housing, and creating tax incentives for people to stay in poor neighborhoods.

Howell agrees there is work to be done in restoring local communities but argues that the most serious challenges will only be solved by national governments. “When you think about global immigration patterns, climate change, or structural changes to the economy or globalization, it’s hard to see how, community by community, we’re going to make headway on this.” His preferred response is to reform and strengthen national political institutions.

Bertrand wants to see redistribution used for policies that help support displaced workers, whether with economic benefits or education and retraining. But echoing Rodrik’s trilemma, she is pessimistic that politicians are capable of addressing some of the serious challenges. “So many issues that we face cross border lines—such as climate change and immigration—that it’s hard to imagine how we’re going to deal with them with national governments,” Bertrand says.

Robinson and Zingales both see populism as a movement that could be used for positive ends. And both cite the US populist movement of the 1890s, which emerged at a time of rapid technological change, economic growth punctured by financial crisis, rising inequality, anti-immigrant sentiment, declining trust in institutions, and a process of globalization whose benefits were not felt by many Americans. That movement evolved into the progressive politics of presidents including Theodore Roosevelt, William Howard Taft, and Woodrow Wilson, who set about reforming political and economic institutions, ultimately making them stronger and more inclusive.

Robinson notes that progressives achieved this by building a coalition that included, for example, people advocating for stricter immigration controls. In an article in Foreign Policy, Robinson and Acemoglu argue that a 21st-century coalition could focus on the shared priorities of both sides, such as improving access to health care, raising the quality of education, and updating infrastructure. Constructing such a coalition might require agreeing to tighten immigration, they note, pointing to Denmark, where the Social Democrats adopted more restrictive controls, but also cut the vote share of the right-wing populist Danish People’s Party by more than half in the 2019 election.

Zingales supports the idea of trying to make politics more inclusive, although he focuses more on changing public decision-making to introduce more direct democracy. But these days, he is less troubled by the challenge posed on behalf of the have-nots than by the response of the haves. “The problem these days isn’t populism; it’s elitism,” he says.

What really caused populism, in his view, may be secondary to what populism may cause. While social scientists debate the populism puzzle, a new, bigger challenge may emerge. Zingales worries that elites could conclude that liberal democracy is too precarious to be left to voters. “We are heading toward a battle between democracy and, for lack of a better term, technocratic authoritarianism. And whether it’s the Chinese form or some elite of the US Democratic party, it doesn’t matter—it’s very dangerous.”
Could anything unite the United States?

Cultural and political divisions have persisted for decades. Now there’s a growing gap in how Americans see each other.

BY ROSE JACOBS  ILLUSTRATIONS BY NATE KITCH
Reed Schroer, a 70-year-old Lutheran pastor from Rhodes, Michigan—about an hour north of Flint—never saw eye to eye with his brother-in-law. Over 50 years, they argued about religion, taxes, and organized labor. But they also had what both would describe as a good relationship, built on an interest in scripture, a devotion to the rural communities of northern Michigan, and, ultimately, their love for Schroer’s sister.

In 2016, that balance was upset by events in Washington, and Schroer found himself increasingly frustrated by the “conspiracy theories and right-wing talking points” his brother-in-law embraced, and less and less able to convince himself that the man’s rhetoric, which Schroer found odious, belied his core beliefs—or that the two could even find a way to talk about it. The men went more than eight months without speaking. “He always drove me nuts, but in the past I might get so frustrated I would storm out of the house to cool off, and he’d chase me down the street saying, ‘I love you, man,’” says Schroer. Now, this communion has been replaced by silence and alienation.

Schroer’s experience resonates across the United States today, in families and institutions. As the Democratic Party battles over whether a moderate or liberal presidential candidate stands the better chance of winning the White House in November 2020, many Americans are asking a similar but broader question: Has the country ever been so divided?

Academics, for their part, are attempting to measure what often feel like widening gaps. In 2017, Stanford’s Matthew Gentzkow looked at a series of Pew Research Center surveys of Americans’ views on policies ranging from government regulation to welfare, immigration, and the environment, and noted that fewer individuals in 2014 than 10 years earlier held positions that put them across the political divide from their own, self-identified political party. “Most Americans hold relatively moderate views on, say, immigration,” he writes. “But the frequency of Republicans holding pro-immigrant views, or Democrats holding anti-immigrant views, has decreased substantially.” Where Americans’ political views and social attitudes, charted, might once have looked like a bell curve, with the majority gathered at a moderate center, the line increasingly shows two separate humps where Democrats and Republicans congregate.

Gentzkow, along with Brown’s Jesse Shapiro and Amazon’s Matt Taddy, has also looked at the polarization of politicians, as measured by the language they use. Republicans, they find, are more likely to talk about death taxes, where Democrats use the term estate taxes. This might not be surprising to anyone who witnessed the “antiabortion” versus “pro-life” semantic split following Roe v. Wade, and yet the researchers find that this polarization is a relatively modern phenomenon. “Partisanship of language has exploded in recent decades, reaching an unprecedented level,” they write. “From 1873 to the early 1990s, partisanship was nearly constant and fairly small in magnitude. . . . Beginning with the congressional election of 1994, partisanship turned sharply upward.” They can now guess a politician’s party on the basis of a one-minute speech with 73 percent accuracy, compared with about a 55 percent chance over the 120 years from the late 19th century to the late 20th.

Nor do divides appear confined to politics and policy. Chicago Booth’s Marianne Bertrand and Emir Kamenica examined three national surveys that probe Americans’ consumption habits, leisure time, and social attitudes. They find that different groups of Americans—rich and poor, black and white, men and women, politically liberal and conservative, college educated and not—tend to eat different food, watch different television programs, pursue different hobbies, and adopt different social attitudes. The algorithms the researchers developed for their study were
able to predict people’s income bracket with nearly 90 percent accuracy on the basis of the brands of products and services they bought; they could do the same for gender by looking at what TV shows and films people watched and what magazines they read; and they could predict race with 75–85 percent accuracy using self-reported stances on topics such as marriage, law enforcement, and government spending.

**Politics matter outside the voting booth**

Bertrand and Kamenica point out that cultural gaps in the categories that they studied, between rich and poor or black and white, for instance, are worrisome in part because they might dampen social and economic mobility. The real-world effects of growing partisanship are less obvious, but research is beginning to probe how a politically divided populace plays out in areas ranging from corporate finance to macroeconomics to medicine and law.

For example, growing partisanship may affect spending. Individual investors appear to react to elections, according to a 2017 study by University of Colorado’s Yosef Bonaparte, Alok Kumar at the University of Miami, and Jeremy K. Page, with individuals moving toward riskier assets if their political party is reflected in the White House. Past research has produced mixed results about whether Republican households tend to increase spending under Republican presidents and Democratic households under Democratic presidents. Whereas Arizona State University’s Christos Makridis, for example, finds that conservatives increased spending on nondurable goods following Donald Trump’s presidential victory, confirming a trend observed by Yale’s Alan Gerber and Gregory Huber in 2009, Princeton’s Atif Mian, Chicago Booth’s Amir Sufi, and Nasim Khoshkhou at Argus Information and Advisory Services argue that while politics influence individuals’ economic expectations, the correlation breaks down when it comes to household spending.

Chicago Booth’s Elisabeth Kempf and Cornell’s Margarita Tsoutsoura recently looked at how partisanship might affect companies on a larger scale, examining the potential effect on credit ratings and, subsequently, company investment. They used voter-registration records and press releases about debt-rating changes from the three main ratings agencies—Standard and Poor’s, Moody’s, and Fitch—to determine whether an analyst’s political affiliation affects her assessment of a company’s financial outlook.

The researchers looked at the months surrounding President Trump’s election in 2016, and find that analysts registered as Democrats were more likely to issue downgrades to the companies they covered after November 8 than were Republican analysts. This effect was greater with analysts who voted more frequently. This result is in line with their wider analysis of political affiliation and presidential elections going back 18 years, which suggests that analysts whose politics do not align with the sitting president’s are more likely to downgrade companies’ debt than analysts who share a political party with the president.

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Research is beginning to probe how a politically divided populace plays out in areas ranging from corporate finance to macroeconomics to medicine and law.
Credit analysts have company in their susceptibility to bias: political scientist Eitan Hersh and psychiatrist Matthew Goldenberg, both at Yale, find in a 2016 paper that a doctor’s treatment plan and level of concern for a patient dealing with a politicized health issue such as abortion or drug use can be affected by that doctor’s politics. Several studies detect similar patterns in judges. But Kempf and Tsoutsoura’s results suggest that even supposedly rational actors who have an incentive to make accurate ratings calls cannot escape their own biases. “These are highly sophisticated people in a competitive environment,” says Kempf. “Most people would not expect this sort of thing to affect them.”

As the evidence indicates, partisanship’s impact reaches beyond household-, clinic-, or courtroom-level decisions. Credit ratings have a direct impact on a company’s cost of borrowing, which in turn influences corporate investment decisions that can affect suppliers, employees, and the wider economy. “Understanding the potential implications of [increased political polarization] for the US economy is important,” write Kempf and Tsoutsoura, pointing out that political bias among corporate managers and asset managers would also have ripple effects in the economy.

There may also be multiple mechanisms by which political bias among individuals affects the economy at large, as the research reveals a surprising degree of political homogeneity within ratings agencies and within sectors. Moody’s and Fitch were much more likely to employ Republican analysts, and Standard and Poor’s to employ Democrats; Democratic analysts were more likely to cover utilities groups and financial companies, while Republican analysts focused more often on the energy sector. “When you see this kind of sorting within companies, you can imagine workplaces becoming echo chambers,” says Kempf. “That can be a good thing as far as workplace cohesion, but it can also reduce diversity in opinions and exacerbate biases.”

Our politics, ourselves
Political identity is one of many levers that can affect an analyst’s decisions. A person’s hometown, race, gender, or creed might too. Identities such as these are predictors of voting: Stephanie Chen of the London Business School and Chicago Booth’s Oleg Urminsky conducted a survey in 2017 that finds people who said their British or English identity was central to their sense of self were more likely to support the United Kingdom’s plans to leave the European Union than those who said those identities were not central. The researchers also find, through US surveys, that people who strongly identified with one political party or another were more likely to vote for that party’s candidate even if they personally were dissatisfied with the individual politician they were voting for.

The research provides a roadmap of sorts for unity. Political divides—wide though they are, and in some cases growing—might be bridged if people are able to recognize the degree to which they have come to their own politics via personal identity and personal experience—and that individuals on the other side are simply doing the same. University of Michigan’s A. Yesim Orhun and Booth’s Urminsky published a paper in 2013 suggesting we are ripe for this sort of recognition, since people seem to believe others make decisions in the same way that they themselves have, whether the decisions involve choosing presidential candidates or scenic postcards.

Ahead of the 2008 US presidential election, Orhun and Urminsky probed what students who supported candidate Barack Obama (then Democratic senator of Illinois) thought about people who supported candidate John McCain (then Republican senator of Arizona). They find that strong supporters of Obama imagined that McCain backers also felt very positively about McCain; similarly, Obama backers who despised McCain assumed McCain backers would despise Obama, and Obama backers with some positive views of McCain assumed McCain backers would have some positive views of Obama. A second study of registered voters demonstrated similar patterns, even when people changed their view of a candidate (spurred, in this case, by a televised political debate). Survey respondents tended to assume that other people, even supporters of the candidate they opposed, changed their opinions in a similar fashion. The pattern was replicated outside the political sphere, as Orhun and Urminsky asked study participants to rate the aesthetic value of two posters or two postcards, and guess how other people felt about the options. “People rely on their own evaluations to make sense of others’,” write the researchers.

The political is personal
Might these findings start to explain why, despite the decades of cultural division, the US has not come apart at the seams? In a 2019 book, *Democracies Divided*, Thomas Carothers at the Carnegie Endowment for International Peace and Andrew
O’Donohue, a research fellow at the Istanbul Policy Center, asked experts in nine countries, including Brazil, Indonesia, Kenya, Poland, and Turkey, to create case studies of political polarization at home. The researchers, looking for patterns across borders, note that the phenomenon is consistently linked to divisive leaders and the social media they leverage. Aside from underscoring that the US is not alone in experiencing rising polarization, the evidence that populations are often divided from the top down supports the idea that grassroots empathy can be an important countervailing force.

If it is, however, Gentzkow’s 2016 paper, which reviews research findings about polarization, offers little hope for unity in the US. Some of the research he discusses suggests that, in addition to a widening gap in political views, dwindling empathy—the kind of empathy identified by Orhun and Urminsky—is contributing to a sense that America is more divided now than ever.

Gentzkow cites research—published in 2012, by Stanford’s Shanto Iyengar; Gaurav Sood, then a postdoctoral scholar at Princeton; and Yphtach Lelkes, now at the University of Pennsylvania—that looked at a 1960 study of how Americans perceive people who are in political parties different than their own. Iyengar, Sood, and Lelkes compared the results with YouGov polls from 2008 that asked the same questions. In 1960, only one in five people surveyed thought individuals from the opposing political party were “selfish”; in 2008, nearly half of survey respondents felt this way. In 1960, more than a quarter of people called their political opponents “intelligent”; in 2008, fewer than one in six respondents did.

“Americans may or may not be further apart on the issues than they used to be. But clearly what divides them politically is increasingly personal, and this in many ways may be worse,” writes Gentzkow.

For Schroer, this is an apt description of his situation. “I’m anything but a liberal,” he says. “I’m a Second Amendment kind of guy. I think too much government is not a good thing. I never worshipped Obama. What broke my heart with my brother-in-law is that I thought we had the same framework: Patience is a virtue. Showing courage in the face of oppression is a righteous thing. It’s better to give than to receive. The basic Christian value set. If he said those were still his lodestars and could make the case that his politicians were working for something like that for the country, there would be something to talk about. I’m still waiting for that conversation. I’m a Second Amendment kind of guy. I think too much government is not a good thing. I never worshipped Obama. What broke my heart with my brother-in-law is that I thought we had the same framework: Patience is a virtue. Showing courage in the face of oppression is a righteous thing. It’s better to give than to receive. The basic Christian value set. If he said those were still his lodestars and could make the case that his politicians were working for something like that for the country, there would be something to talk about. I’m still waiting for that conversation.

Instead, in Schroer’s view, his brother-in-law has thrown the rules of engagement out the window, with “notions of what is evidence, what constitutes proof, how you evaluate an idea” all useless. The sense that they’ve arrived at their present positions on recognizable, if different, paths is gone. “With him, everything was tactical or sentimental,” Schroer says. “I finally said, ‘I don’t want to do this anymore. I don’t want to be in the world you seem to live in and I certainly don’t want to get dragged into it.’ I refused to continue the argument.” Surmounting this personal gap, played out in the aggregate, may be the key to our future.—CBR

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You needn’t be a food-insecure person to have some familiarity with the United States’ network of organizations devoted to fighting hunger. You may have volunteered at one of the country’s 60,000 food pantries and meal programs. Or donated to one of its 200 food banks. Or know one of the 10 million–12 million Americans who visit a food pantry in a given year. This network is as vast as it is vital.

This vastness, and the heterogeneity it implies, presents considerable challenges for Feeding America, a not-for-profit organization that distributes food to many of those food banks. Feeding America is the country’s third-largest not-for-profit, after the Red Cross and the United Way, and it distributes about 4 billion pounds of food every year. A lot of that food is earmarked for specific areas or populations by the people who donate it, but hundreds of millions of pounds every year are distributed according to Feeding America’s discretion. Getting the right food, and the right amount of food, to the right people in a reasonably efficient manner is incredibly difficult—so difficult that Feeding America asked a team of academics about 15 years ago to help devise a more effective solution than the one it was using. We did so, using every economist’s favorite phenomenon: market forces.
Together with my colleagues—including Chicago Booth’s Harry L. Davis, Donald D. Eisenstein, and Robert S. Hamada, as well as directors from numerous food banks and staff at Feeding America—I spent 18 months hashing out every detail of a new food-allotment system for Feeding America. Along the way, we created a new currency, discovered the true price of breakfast cereal, and helped provide thousands of additional meals to hungry individuals.

**Who needs the food?**

Much of the food that goes to food pantries doesn’t actually come from a check that you write to your local food depository. Instead, it comes from either manufacturers or distributors. Feeding America will get a phone call from a big manufacturer that has a truckload’s worth of mac and cheese in its warehouse in Wisconsin that it’s offering to give away. This presents Feeding America with a couple of surprisingly complicated questions: Do food banks want it, and if so, who gets it?

They’re complicated for a number of logistical and other reasons, but also because of one fundamental problem that Feeding America always faced, which was that it never really knew who needed that truckload most. If it just asked, “Who wants this truck of mac and cheese?” everyone would stick their hands up. But if there’s one thing that markets are good at, it’s allowing desire to be expressed. And markets’ most basic trick is that when somebody raises her hand and says she wants something, it means she doesn’t get something else.

Prior to our market-based approach, Feeding America’s process for deciding who should get that truckload of mac and cheese that’s sitting in Wisconsin started by looking at its partners—food banks, food pantries, etc.—and those partners’ goal factors, or the size of their potential client bases. For each partner, it took the size of the client base relative to the national average, and the total amount of food it expected to collect nationally, and figured how much food each client should receive: if Feeding America was expecting to distribute 4 billion pounds of food, and a partner served a population that was 5 percent of the national client base, it planned to send that partner 5 percent of 4 billion pounds. From this calculation, it compiled a list of partners ranked according to the volume of food they’d be receiving.

When the call came in that a truckload of food was available, it would dial the first partner on the list. That organization usually would have about six hours to make a decision. If it said yes, it was responsible for going to get the food—it would use its own truck and pay the cost of transporting the food itself. If it said no, it’d be moved down to the bottom of the list for the next call. (Feeding America didn’t move through the list exactly in sequence, since some partners covered big areas and others small areas, some covered wealthier areas than others, and so on.)

The partners who declined were moved down on the list in part because there was some imperative to keep the donors happy. It turns out that if a distributor or manufacturer calls again and again with offers that aren’t accepted, it stops calling. So Feeding America created a penalty for declining donations.

**The shortcomings of central planning**

There were a couple problems with this system. One big one was that three-quarters of food banks’ food comes through direct donations, such as from local retailers, and therefore Feeding America had no idea what its partners had and how much of it they had. This was particularly a problem because of spoilage: not only did sending, say, yogurt to some place that already had yogurt mean that it didn’t go to some place that needed it, it also created some likelihood that the yogurt would spoil and go to waste.

An example that illustrates how insensitive this system was to individual partners’ specific food needs was provided by one of the people who was on the committee that developed our market system. He was a food bank director in Idaho, and he would routinely get phone calls from Feeding America saying, “Great news, we have potatoes for you.” But of course, he already had warehouses full of potatoes.

Another problem was that there were some areas of the country that were very close to a lot of distributors and food production, and others that were not. If you’re a food bank in Wisconsin, you’re getting a lot of food anyway. If you’re in East Texas, you’re not near a lot of production and distribution. So some food banks are systematically better off than others.

A third problem was the six-hour decision window the partners had when they received an offer. Often what would happen was that after six hours, the
partner would say it couldn’t get the food, and then Feeding America would call somebody else, and that partner would have another six hours. This, in the language of economics, is a very illiquid market. It moves really slowly.

And finally, there was a logistical problem. If you pick two random points in the US, on average they’ll end up being about 1,000 miles apart. In other words, donations were often located quite a long way from whichever food bank or pantry they were being offered to.

A market for donations
Our solution to this problematic operating procedure was to create a marketplace for donations and a new type of currency, which we called shares. Twice a day, Feeding America’s partners submit sealed bids for the donations available in the market—on a given day, there’s usually about 60 truckloads of food—via a website, and they receive an email shortly after the auction ends to notify them whether they’ve won. Partners’ budgets of shares vary in proportion to how many clients they need to serve. So if you’re a food bank in Mississippi, which is the poorest area that Feeding America has, you’d get more shares per capita. But if you’re in Los Angeles, you will also get lots of shares, because there’s a huge population to serve. We also created a money-supply rule that, at midnight each day, recirculates whatever shares have been spent that day—again, according to the magnitude of each area’s need.

There are three broad reasons why a system based on markets and a specialized currency has been useful in addressing Feeding America’s problems.

First, as noted earlier, everyone doesn’t value all types of food equally. The market gives each partner a way to express what it needs and doesn’t need.

Second, money is what’s called “a store of value.” Suppose that I’ve already got a ton of donations this month, and I don’t really want or need any more food. I can take my shares and sit on them and wait until next month, next year—whenever my need is greater—to spend them.

Finally, the bidding process that partners use to purchase food allows Feeding America to price donations in a way it previously couldn’t. For example, the most valuable type of food is cereal: cereal is great because it’s durable, it doesn’t need refrigeration, and almost everybody likes it. If you had asked the people at Feeding America, prior to the creation of our market, whether food banks preferred to get cereal over apples, they would’ve said sure, of course they do. But they had no way of knowing how much more they preferred cereal. The market has revealed the price dispersion between different types of food, and it’s far greater than anyone would have guessed.

There are other advantages as well. One is that the market is more liquid than the old system—most of the time, the food is picked up from the donor within 12 hours of it going on the market, whereas in the past, it would sometimes be sitting for three days. This is a strong incentive for donors, many of whom are motivated not entirely by altruism, but also by a need to get this excess food out of their warehouses.

And what about all that excess food I mentioned food banks and pantries had sitting around? Under our system, that partner with an extra truckload of yogurt can take it and put it on our market and become a seller. It’s another way to increase food usage.

Of course, there were challenges to implementing this new system. One of the biggest was making sure it would be fair for everybody. And the threat to fairness was mostly from one dimension: simply put, some food banks are really big, and some are really small. The small food banks have, naturally, smaller staffs and fewer resources overall, which makes them less able to monitor something
like our donation marketplace. When you combine this issue with the fact that they also have, by design, fewer shares to spend, it could potentially mean that budgeting and making wise spending choices are more difficult.

As a result, we came up with a number of solutions for these small partners. One is to offer them credit: if they want to get something that’s very expensive, but they don’t have enough money in their account, basically we have a banking system and a mechanism for loaning shares that they can then pay back. We also set up what we call joint bidding—since most donations are by the truckload and might entail tens of thousands of pounds of food, more than a small food bank really needs, multiple small food banks can pool their resources, bid jointly, and divide the donation among themselves.

**The power of fake money**

The results of the shift in allocation mechanisms have been dramatic, according to a number of measures. One of the most staggering results from the market’s implementation was on the overall size of the food supply. The more efficient, more liquid market we created was accompanied by a large uptick in how much food Feeding America received. From 2004 to 2006, food allocated by these donations increased by about 130 million pounds, enough to feed about 80,000 extra people every day.

But another striking outcome, especially for an economist, was in price discovery. Under the old rules, a pound of one type of food was given the same value as a pound of any other type of food—there was no rate of exchange between them. But we have found that if you allow people to exercise choice and you assign relative values to different items, those values will vary greatly. For example, on our market, you can get 1 pound of cereal for about 35 pounds of fresh fruit and vegetables. Food banks are very different in the choices that they make. Some organizations want the inexpensive things—the produce, the drinks, the snacks. Some organizations only want the expensive goods, such as cereal. Some partners are getting 15 pounds of food for every share that they spend; others are getting close to 0 pounds per share.

The ability of Feeding America’s partners to express their preferences this way has improved things for everyone, but perhaps especially for the smaller organizations, for whom we were concerned about fairness. Virtually every small food bank responded to the implementation of this market by buying large quantities of relatively inexpensive food. Larger food banks purchased more expensive goods—but they also saved more of their shares. The fact that those large organizations were no longer having their arms twisted to go pick up donations meant that there was now more food to go around for everyone else. So the resource-poor organizations ended up getting more of both the low-cost and the high-cost items as a result. Regular use of the credit system—12 percent of bids are made on credit—further facilitated this.

We can quantify the benefit of allowing everyone to express their preferences and get the food they actually want, instead of the food they’re assigned to collect, as was the case under the old system. Because each organization is getting the food it actually needs, it values that food more than the food it was getting before—25 percent more, by my calculation, on the basis of the extreme positions they take during bidding and the distance they’re willing to travel for the food they want.

What does that mean in terms of dollars? We can calculate this by looking at how food banks bid on lots of food that are different distances away. If you have already employed the driver, the extra cost of driving another trucking mile is about 80¢. So if a food bank in Chicago bids one amount for a truckload of potatoes in Iowa and a smaller amount for a truckload of potatoes in Colorado, the difference in shares should be equal to the greater expense of driving to Colorado instead of Iowa. So we can see the rate of exchange between dollars and shares, and the data suggest that the surplus value the food banks are getting from the market system is equal to something like $70 million per year.

The market also addressed the logistical problem I mentioned earlier. Feeding America’s partners still have to travel a reasonably long way, on average, to collect donations, but the distance has been cut from around 1,000 miles to roughly 650 miles each way. This alone represents an additional $14 million savings.

Across many dimensions, then, the market has performed well for Feeding America and its partners. But things are changing in the food-bank world, and my collaborators and I are revisiting the particulars of the system to see whether and how they should adapt to those changes.

One of the essential premises of the current system is that food manufacturers and distributors will make mistakes, and end up with too much food, and give that food to Feeding America when they can’t sell it themselves. But there’s a secondary market for food that didn’t exist previously, in which discount stores are buying a lot of the food that used to get donated. As a result, the quality of the food that’s donated has gone down over time. And that, in turn, has meant that some of the wealthier food banks have basically dropped out of our market over the last few years.

So despite the market’s successes, the system needs some reengineering. As was the case prior to our intervention, the challenges the system faces are real and considerable. But as our experience with Feeding America has made clear, market forces, properly guided, can do amazing things.

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**Canice Prendergast is the W. Allen Wallis Distinguished Service Professor of Economics at Chicago Booth. This essay is based on a talk given as part of Booth’s Rustandy Center for Social Sector Innovation’s Perspectives in Social Entrepreneurship Series.**

Go to ChicagoBooth.edu to see citations for research mentioned in this essay.
Where do goals come from?

A philosopher and a psychologist compare notes on the mysteries of personal growth

Self-improvement is pervasive in human culture: it has inspired a vast trove of books, numerous industries, and countless resolutions. But how are our aspirations formed, and what are the best ways to pursue them? How do nature and nurture help us define and achieve our goals? Is the value of advice in the giving of it, or the receiving? The second event in the A Meeting of the Minds: Business and the Human series, sponsored by Chicago Booth and the University of Chicago’s Stevanovich Institute on the Formation of Knowledge, brought Booth’s Ayelet Fishbach, a psychologist, and University of Chicago’s Agnes Callard, a philosopher, together to consider these and other questions of personal development. Moderated by New York Times op-ed columnist David Brooks, the discussion took advantage of each scholar’s academic perspective and expertise to examine how and why humans strive to improve themselves.

David Brooks: We’ve got people with two different disciplines coming at the same sorts of issues, so I thought we’d start with one discrete topic, to see how you approach the topic differently. That topic is advice.

Now, I’m a columnist: that’s what I do. I give advice. And at my classes, I give a lot of advice. My students call my course “Therapy with Brooks” because I pass along advice I’ve heard. And I think it’s really useful to give advice, because it feels so good for me to give it.

One bit of advice I always pass to my students on marriage or how to deal with a relationship—and I got this off the internet, so it must be good—is: They say you should never go to bed mad at your spouse. And the person who wrote this advice said, “Sometimes, just go to bed. You’ll wake up in the morning. You’ll feel better. Just go to bed.” So that seemed to be very wise advice.

The other bit of advice, from the same source, is: “If you’re a wife and you’re really mad at your husband, and you feel inclined to bitch about him to somebody’s mom, bitch to his mom and not yours. His mom will forgive him. Yours never will.”

These seem to be good advice. So how do you think about advice? What’s good advice, and what’s bad advice?

Agnes Callard: If you have my mom, you should not bitch to her, definitely.

I don’t believe in advice. So we disagree. I’m a philosopher, and the first thing I do is make a bunch of distinctions. So let me distinguish advice from two other advice-like things.

One of them we’ll call instruction. What I mean by instruction is: Suppose that there’s something I want to do, like get my copier to work, or get across town, and I ask, “How do I do that?” And you say, “Take this bus,” or “Just press that button.” I’ll call that instruction. In the case of instruction, I have this pretty concrete goal. And someone just might have the relevant information about how I get to that goal. I would say that’s not advice.

The other thing I want to distinguish from advice is something like mentoring or training, where you have a close personal relationship with the person that you’re interacting with, and so you can key them in to what will work for them, because you understand their psychology. You understand what they want. You understand that, in their case, the thing to say is, “It’s OK to go to bed angry,” because of the way they work and the way their marriage works. So I also would say that’s not advice. It’s mentoring.
The dream about advice is that we can be totally hands off with someone and yet still help them in a substantive way. You can’t do that. You can say things that make you feel good, as they make you feel like you’re wise. I think people love to give advice because they feel like they know so much. In particular, people who have succeeded in life are often asked to give advice, as though you know how to succeed. But of course you only did it one time, right? You don’t have empirical evidence of trying it a bunch of different ways, so that you know how to succeed. You just know one particular path that you took, right? That’s not a good basis for knowledge. Mostly it makes us feel as though the process by which we got to where we are now was one where we knew all along. But that’s an illusion, a retrospective story that we tell.

Ayelet Fishbach: Agnes, as a philosopher, starts with distinctions. I start with data.

I give people advice. I also ask them to give me advice, and then I see what’s more motivating for them. What gets them to act?

We did this with quite a few folks. We started with kids in middle school who were struggling with doing their homework, and we offered advice to half of them. We asked the other half, “How about you give advice to another kid that’s struggling with doing her homework?” And then we just observed it: Who’s doing their homework more? It turned out that those that were giving advice were doing their homework for more hours than those that were getting advice.

We also did this with adults. We asked unemployed people how to get a job. “What do you do to get a job?” And when you ask people who are unemployed to give you advice on how to get a job, the first thing that they say is, “What do I know?” And then you say, “OK, but just tell me: What do you know?” Turns out that they know quite a lot.

Brooks: Why is that? Is it because the advice is stupid, or because people can’t follow through on the advice because the problem is one of motivation and not information?

Fishbach: Because people already know what to do. Because most of the time, most of the advice that we give people, they already know what to do.

If you are giving people who are struggling with their weight advice what to do, they know. They know exactly what they’re supposed to eat. They know that they should exercise. The problem is motivational; it’s not with the knowledge. If the problem is not with knowledge but with motivating yourself, you can get your inner strength by thinking about what you know, by thinking about what you can do to help yourself, more than by listening to me telling you the things that you already know.

Callard: I didn’t know about any of Ayelet’s research when I came to my conclusions, and I’m very proud that I got to them without any consideration of the data. So it’s a confirmation.

I actually do think that sometimes other people know things that you don’t know, and they can help you. It’s just that I think that usually you need some personal connection in order for that to work, in order for them to see what you have to supply you, what you need from them. In the context in which we usually give advice, the kind of connection that would allow for the flow of useful information isn’t there. That’s my hypothesis, based on no empirical evidence.

Brooks: We’re going to see this distinction through the night, the data distinction. And I’m a journalist, so I just do random stuff that seems interesting.

Let’s talk about motivation. Because we’ve spent the last 30 years with this cognitive revolution, [Princeton’s Daniel Kahneman and [Chicago Booth’s Richard H.] Thaler and all these people, really understanding decision-making processes and bias in heuristics. But it seems to me we’ve barely passed beyond St. Augustine in understanding our desires, and where our desires come from.

So I can choose to order broccoli or not, but I can’t choose to like broccoli. There are these distinct motivational states that drive us, and they well up somewhere deep inside. And so how do we think about that? Maybe I’ll start with Ayelet. How do we think about motivations, and how they’re lit, destroyed, buried, or inflamed?

Fishbach: First, we’ve been thinking about motivation for a while. Empirically, we started seriously thinking about motivation with that [1972] Walter Mischel study on delayed gratification. Thaler, who definitely made his mark studying decision-making, was writing about the planner and the doer, and that’s a self-control conflict. The doer is the person in you who does stuff, and the planner is someone who tells the doer: “Don’t do it.” So there is a self-control conflict.

There are many things that we are discovering now: how to think about motivation, how to think about motivating yourself. You were raising, for example, the healthy-eating problem: How do we get ourselves to eat more healthily?

My research suggests that using intrinsic motivation is the way to go. So don’t just eat broccoli, but find a healthy food that you enjoy eating, because we find that what predicts a healthy diet is one’s ability to find food that they like eating. What predicts adhering to New Year’s resolutions is your ability to find resolutions that you like pursuing. So intrinsic motivation matters quite a bit for motivation.

“**When you ask people who are unemployed to give you advice on how to get a job, the first thing that they say is, ‘What do I know?’ And then you say ‘OK, but just tell me: What do you know?’ Turns out that they know quite a lot.”**

— **AYELET FISHBACH**
We find that being in a certain social environment, certain people support your motivation, so designing environments such that you are with people who support your goals matters. We look at how people manage multiple goals. We look at how people sustain their motivation by thinking about what they’ve completed thus far versus what there is yet to do.

Brooks: But St. Augustine said 1,600 years ago to replace a lower love with a higher love, and don’t try to crush a love. I want to know where my dislike of broccoli comes from. Or why are some students just tremendously driven in philosophy, and some are not? You used the phrase intrinsic motivation. I want to know what that means—what’s intrinsic? Where is the intrinsic field?

Fishbach: What it means to be intrinsically motivated is to feel that you are doing something for the sake of doing it. And in the extreme sense, that rarely happens. It’s hard to think about a job, or studying philosophy, as extremely intrinsically motivated in the sense that all the benefits are from doing it. There are usually also benefits from completing it. You will get a degree from the University of Chicago, for example.

But people vary in how intrinsically motivated they are—that is, how much they get benefits from doing it, as opposed to only from completing it. And this variation matters. The person who gets benefits from doing the thing while he’s doing it is going to stick with it longer. Immediate rewards really help sustain the motivation. If it feels good at the moment, someone will be able to do it.

I have to use data, so I will mention one piece of data. We went to the University of Chicago library and basically asked students as they were entering the library how much they enjoyed whatever they were going to study, and how important it was. And we also asked them to text us when they were doing studying that. It turns out that what predicted how much time the students spent in the library was how much they enjoyed the material that they were studying. How important the materials were did not predict the time that they spent in the library at all; that was not significant. For me that’s pretty strong evidence that the good student is the student who is able to get the immediate benefit from that, who is able to find interest and enjoyment in what she is studying.

Brooks: OK, Agnes, there’s a famous allegory, I think by Plato, who observed that passions are like horses, and reason is the charioteer. Now, what Ayelet is saying suggests that that’s probably not the right model, to trust the charioteer. Maybe it’s better to try to educate the horses a little better. What do you think about that? Just that charioteer model of how life works, where you have this very smart brain up here, and it’s controlling our desires, and letting out the sluice gates when it wants to, and tamping them back down.

Callard: Well, in Plato’s story, the control thing doesn’t work out so well. The horses can easily go nuts. So Plato was aware of that problem.

It matters a lot when you’re talking about someone’s desire in something. It matters a lot whether you’re talking about the beginning, the middle, or the end of a certain story. If we talk about how you don’t like broccoli, I guess that’s probably the way it’s going to be for you. But if my kids are two or three years old, and they only want to eat beige things, that’s not OK. I have to get them to like some of the things that they don’t like. They might not immediately take any intrinsic pleasure in eating vegetables. So I just say, “OK, no dessert if you don’t eat your vegetables.” Whatever works that night.

There’s a longer process that we go through. I get intrinsic pleasure out of, for example, talking in front of an audience like this. This is fun for me. I like it. But I didn’t always like it. I used to be scared of it. And I get intrinsic pleasure out of reading Plato. And even out of conversations with certain people, like my best friend. I did not like her when we first met. We hated each other. We thought we would never be friends.

Those are cases where my intrinsic motivations change over time. Part of what I want to do is understand: How do intrinsic motivations come into being? Because they don’t just well up. We’re not just saddled with them. It’s not that I accidentally happen to end up with a desire to speak in front of people. The things that I did in my life leading up to this moment are relevant to the story of how I ended up with this desire. What do you think about that in my book is: How can we tell that story in a way that is sensitive to the importance of environmental facts? I happen to have ended up in a high-school debate team, and I enjoyed doing debate, and I failed at it. I lost mostly. I wasn’t a good debater, but I liked it.

The fact that my school had a high-school debate team is relevant to my enjoying speaking in front of people. But it’s not like you just throw someone in a high-school debate thing and then out pops me. There was something I was doing over the many years, say, between high school and now, where there was a value that I was trying to get into view. At first, that value took a funny form. It took the form of, “I want to win this competition with this person. I want the judge to think I’m smarter than her.” And that’s not a great motivation for wanting to speak in front of people. It’s not perfect. But it’s also not that bad. It’s a start, and we don’t start in the same place where we finish. So my kid might start with eating broccoli because he wants dessert, right? That is why my six-year-old eats broccoli. But that’s not why my 15-year-old eats broccoli. He actually likes broccoli.

We can have this sense that there is more out there to value than what we currently value. And we can work toward it, with environmental assistance. I’ve never met a student who was totally blase. Some of them might be more excited than others, but I think of that as them being further or less far along in this process. They haven’t gotten the value as squarely into view as the others. So the question is: How do you help people? How do you move them along so that they can get it better into view, so that they can be more intrinsically motivated? —CBR

Ayelet Fishbach is the Jeffrey Breakenridge Keller Professor of Behavioral Science and Marketing and an IBM Corporation Faculty Scholar at Chicago Booth. Agnes Callard is associate professor in philosophy at the University of Chicago.

“Part of what I want to do is understand: How do intrinsic motivations come into being?”
— AGNES CALLARD

Continuing the conversation
Visit Review.ChicagoBooth.edu to read the full transcript of this conversation, and to watch a video of the event.
The network is an entrepreneur’s best asset

Data-driven practices will improve the chances that your contacts will come through with information and resources

Entrepreneurs have a lot to think about when building a business, and one of the most important may be strengthening and tapping their networks. More than 20 years of academic research has tied business networking to entrepreneurial success, demonstrating that networking is an important way to validate opportunities, connect to resources, and access information.

Research has suggested that entrepreneurs have on average twice the number of online network connections as nonentrepreneurs. Although the raw size of an entrepreneur’s network does not necessarily correlate with startup success, engagement with a tightly connected subset of that network does. An MIT study demonstrates that university-educated entrepreneurs who had large, active alumni networks were more successful, as measured by the number of employees at and revenue associated with the companies they started. And research done here at Chicago Booth finds that it’s not enough to just have a network; how you use your network is important, and trusted contacts can be particularly helpful at overcoming early challenges. (Read “Networking differently could increase your salary,” Fall 2016, and “Good startups have great networks,” Fall 2017, and online at Review.ChicagoBooth.edu.)

So with that in mind, when I was chartered this past summer by the deans’ office at Booth to undertake a project to figure out how the school could better support its global network of entrepreneurial alumni, I interviewed nearly 100 University of Chicago alumni—entrepreneurs, angel investors, and venture capitalists—and I conducted a survey that received 350 responses from 40 countries—217 responses from the United States and 133 from internationally located alumni. As several of the alumni were both founders and investors, we had a total of 279 entrepreneurs and 157 angel and venture investors represented. Of the alumni surveyed, 60 percent were members of either their local Chicago Booth or University of Chicago alumni club, and 16 percent said these were their most useful networking groups. While this survey does not represent a random sample of entrepreneurs, it is interesting to examine the findings.

Online networking tools

In our alumni community, the use of online tools is pervasive. Only 24 of our respondents, less than 1 percent, reported using no networking tools of any kind. LinkedIn, Facebook, and WhatsApp were the top three social networks for both the US-based and international alumni. (See “Startup players’ top networking tools,” this page.)

Fifteen of our alumni in Asia said they used WeChat, while Twitter was only mentioned by nine US-based respondents.

According to the entrepreneurs and investors in our survey, LinkedIn was by far the most important online networking tool they used, ranking No. 1 with 55 percent of the US-based respondents and 38 percent of the international alumni.

Does professional networking deliver?

The survey asked respondents about 12 ways to use a professional network. Our alumni entrepreneurs and investors found their professional networks to be most effective in helping them do due diligence on a market or opportunity (42 percent of respondents said this was the case), get management advice (41 percent), learn about a new industry (38 percent), find professional service providers (37 percent), and identify best practices (37 percent). On the other hand, more than 20 percent of respondents found their networks to be less than helpful in getting

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**Startup players’ top networking tools**

Share of entrepreneurs, angel investors, and venture capitalists who use each

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<thead>
<tr>
<th>Social Network</th>
<th>US</th>
<th>International</th>
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<tbody>
<tr>
<td>LinkedIn</td>
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<td>WhatsApp</td>
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Deutsch, 2020
customer introductions, raising capital, or sourcing talent to hire. More than 30 percent of respondents reported that they did not need their networks to help them find a job or obtain introductions to suppliers or software recommendations, or for emotional support.

Networking activity varied a lot among the respondents. While 31 percent of the respondents reported that using their networks produced mixed results, an equal number could be considered very successful networkers, whose networks were effective in delivering everything they asked of them. There were also 61 disappointed networkers (17 percent of respondents) who had found little to no success when they reached out to the network for help. Surprisingly, 35 percent of our respondents used their networks for two or fewer professional activities, with 12 percent who hadn’t used their network for any of the 12 methods we had listed. Several respondents suggested other things that they use their networks for, the primary one being identifying opportunities and sourcing deals (28 mentions), followed by getting mentoring and socializing, each of which had less than 10 mentions. Eleven percent of the respondents stressed in comment fields that the most effective networking they did was in person, not online.

If we look at how founders compared with angel and VC investors, the entrepreneurs were less likely to effectively raise money and find talent using their networks and were more likely to ask for emotional support. (See “Founders’ and investors’ use of their networks,” this page.)

There were also some differences in the way that US-based founders and investors, compared with their international counterparts, used their networks. US-based respondents were more likely to have effectively used their networks to source talent and conduct due diligence, and the US-based investors were more likely to use the network to learn about a new industry. (See “Approaches in the US versus internationally,” next page.)

**Information is the currency of online networking**

Leveraging the network specifically for learning about an industry and conducting due diligence may provide an advantage for US-based founders and entrepreneurs. As the noted physicist and creator of the atom bomb, J. Robert Oppenheimer, said, “The best way to send information is to wrap it up in a person.” This is especially true for entrepreneurs. Much of the information they need isn’t published in a book or sitting on a website; it is in the head of someone who has expertise or experience. Data analyzed by the authors of the earlier-mentioned MIT research paper suggest that information exchange is the biggest benefit of online networking, and it’s important for entrepreneurs to actively build their networks to add and leverage information experts. The researchers find that having connections with information brokers such as lawyers correlated with future entrepreneurial success, whereas connections with resource providers such as venture capitalists, for example, did not. Another key value proposition of the alumni network identified by the researchers was an entrepreneur’s ability to connect with alumni who had reached senior levels of management in established companies, or who had had entrepreneurial success themselves and therefore had achieved a level of expertise.

The net result of all this analysis? The project I was given and which we have now named the UChicago Global Entrepreneurs Network should, in fact, help advance our alumni’s startup success. As the authors of the MIT paper put it, “For a university this means that it should foster and encourage students to build up more and closer connections with alumni.”

**Advice to entrepreneurs**

Using the network means reaching out and asking people you don’t know well or have only a weak online link with to help you. Asking for help is one of the most valuable skills an entrepreneur can cultivate. There are plenty of blogs out there that will give you advice on getting the most out of your networking, but here are a few data-driven best practices to improve the chances that your network will come through with valuable information and resources for your company:

- **Leverage LinkedIn.** Venture capitalists, customers, and potential employees will use LinkedIn to check you out, and you should use it to do due diligence and for meeting preparation, as well. Make sure you keep your profile and company profiles up to date. This is a simple fix. According to LinkedIn’s data, profiles

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**Founders’ and investors’ use of their networks**

Share of survey respondents reporting to what extent they had tapped their professional networks for business help

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<tr>
<th>FOR FUNDING</th>
<th>Founders</th>
<th>Investors</th>
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Numbers don’t add up to 100 percent due to rounding.

Deutsch, 2020
with professional headshots tend to get 14 times the number of views as those without. As the business-focused social network, LinkedIn generates 80 percent of B2B leads, so having endorsements from investors, advisors, and especially customers can help build credibility for your startup. Use LinkedIn to tell the story of your company. Highlight your milestones and learnings. The investors in our survey were very interested in being able to use their networks for sourcing great companies to fund.

**Activate your technologists’ alumni networks.** Some 30 percent of our alumni founders were unsuccessful in tapping their networks as a source of talent. But research from Rowan University’s Lee Zane and Drexel University’s Donna De Carolis looked specifically at people who launched technology companies and finds that, for these founders, having a large alumni network correlated with an ability to recruit and hire technical talent. Make sure your top technology employees invest in building out and using their university and college networks.

**Adopt double opt-in procedures for making and asking for introductions.** Having contacts online is useless unless you connect with people. Asking for introductions to investors, potential customers, or experts is not impolite or invasive if you do it well. Put together a brief paragraph explaining why you want the introduction and how the other party will benefit from knowing you. Then ask your contact to check with the person to ensure she is open to the connection. That way, if the introduction is made, you know she is willing to talk to you. Do the same for the people in your network. Don’t surprise them with an introduction, tell them about the person you want to introduce and ask if you can make the connection.

**Diversify your network.** Research by Arizona State University’s Christopher S. Hayter highlights the way in which tight academic networks are important for spurring and supporting startups but can constrain their growth if entrepreneurs don’t expand and evolve their professional networks as they scale their companies. Diversity provides advantages in the early stages of company creation, increasing the likelihood of finding the right information, resources, and skills needed; and it becomes more essential as the company grows. In the MIT study, the most successful entrepreneurs, those who had created large companies and received the most outside funding, had more links beyond the alumni network compared with founders of slightly less successful ventures. —CBR

Waverly Deutsch is clinical professor at Chicago Booth and the Polsky Director of the UChicago Global Entrepreneurs Network. Go to Review.ChicagoBooth.edu to see citations for research mentioned in this essay.

### Approaches in the US versus internationally

**Share of survey respondents reporting to what extent they had tapped their networks**

#### FOR TALENT SOURCING

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#### FOR LEARNING ABOUT A NEW INDUSTRY

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Numbers don’t add up to 100 percent due to rounding.

Deutsch, 2020
How to avert a disastrous group decision

Plan for faulty groupthink in advance

The sixth installment of our quarterly Business Practice feature involves a group decision gone (or going) awry:

You work in the corporate office of a national fast-casual restaurant as a marketing manager. Your boss, the vice president of marketing, has asked you and several of your colleagues—all peers in terms of your standing within the company—to put your heads together on a strategy for boosting weeknight dinner traffic. Several of your colleagues have made promising suggestions, but to your surprise, the idea that’s taken hold most firmly is the one from your fellow marketing manager Velma: planned shortages of certain staple menu items, designed to stoke demand.

You think this is a terrible idea, and although Velma’s personal powers of persuasion have helped her sell it to the rest of your group, you’re confident senior management will recognize it for the calamity it is, and it will reflect poorly on all of you. You have pointed out flaws in this strategy, politely, in two separate group meetings, but the group keeps moving toward presenting it. You do not want to be associated with this idea. What should you do?

Please describe how you would address this problem, including scripting any conversations you would have with Velma, your boss, your teammates, or anyone else you feel is relevant.
This scenario is a bit different from previous installments of Business Practice. In most of our earlier situations, it is clear with whom you should have a conversation: a boss, a coworker, a potential employer, etc. In this case, the organization (or at least your team) is out of sorts—everyone seems to be following along with Velma’s lousy idea. Should you keep your mouth shut? If not, with whom do you talk? And what do you say?

Why is this question difficult?
I have spent years studying and teaching decision-making. Decision-making in organizations can be tricky. Or worse. When I ask students and executives to reflect on their organizations’ decision processes, there is generally a collective groan.

While organizations can make better decisions than individuals on their own, they often do not. In fact, the decision errors that I teach in my decision-making class are generally amplified in group settings. For example, research by the late Janet A. Sniezek conducted at the University of Illinois with Rebecca A. Henry finds that groups tend to be even more overconfident than individuals, and University of Toronto’s Glen Whyte finds groups are more susceptible to sunk costs.

Other research on group processes, such as that by Miami University’s Garold Stasser and Arkansas Tech’s William Titus, provides some insight into how groups can end up pursuing a truly bad idea. The problem starts because Velma, incorrectly, believes her idea to be a good one. Velma is a gifted advocate, so it takes some time before you recognize the idea’s inherent shortcomings. “Running out of popular items? Really?” However, once you’ve come to this realization, you also become aware that no one else has voiced any negative opinions. Maybe they too all think that Velma has a good idea. Do you really want to argue against an idea that everyone else thinks is terrific? Do you want to be that person? And maybe Velma actually does have a good idea? Then you’re at once that person and an idiot.

Of course, even if you are right, confronting Velma is going to be uncomfortable and possibly counterproductive. Velma very likely will become defensive. Indeed, for this reason and others, group discussion often leads to a polarization of viewpoints, with individuals walking away with even more strongly held attitudes and opinions.

Top-rated responses
Below are the top three responses. I’ve gotten permission to list the names and backgrounds of the respondents. All responses included in this article were subject to light editing for grammar and style.

1 Response: “I understand that we have decided to go with Option A. Option A makes sense for several reasons.” (State them. Ummm, we read [Arizona State University’s Robert] Cialdini’s book, perhaps?) ‘However, before we proceed, I want to make sure we are really considering this fully.’

It is worth considering whether you approach the group together or have one-on-one conversations. I would probably vet the ideas with one or two thought leaders. Let them help you by pushing back. And then raise it in a meeting. Good luck.”

Average rating: 5
Participant: Leslie DeChurch
Background: Education

The Basics of Business Practice

Business Practice is a quarterly tool created in cooperation between Chicago Booth Review and the Harry L. Davis Center for Leadership at Chicago Booth. Its purpose is to allow readers to rehearse their responses to challenging professional situations, and to get crowdsourced feedback on those responses from other readers. For each installment of Business Practice, we:

- Describe a workplace scenario that includes a strategic or interpersonal conundrum
- Invite readers to script a response to the scenario
- Allow respondents to rate each other’s answers on a scale of 1 (“Strongly disapprove”) to 7 (“Strongly approve”)
- Send every respondent (who provides an email address) personalized results showing how others reacted to his or her approach to the situation

Don’t wait until your team starts spinning toward a bad decision before considering how to stop it.
Response: “First I would take Velma aside, and expressing a very sincere desire to help her and the team, would impress upon her the risk that this idea will be received poorly and will not have the desired effect. Then I would problem solve with her about how to modify/enrich the idea to make it less risky and potentially more successful.

“If that doesn’t work, I would arrange another group conversation in which I would more strongly lead the group to figure out how risky this idea is. I would do this not by blatantly stating my concerns and objections, but rather through a series of questions: 1. What is the upside of this idea—best potential outcome? 2. What is the downside of this idea—worst potential outcome? 3. What is the potential our leadership team will react positively/negatively to this idea, and what is the consequence for our team in either case? 4. If it all goes horribly off the rails, what would we do next? 5. Can we adjust our thinking to mitigate the risks we’ve identified?

“This approach has worked well for me at all levels of leadership. It works best if you have already established a reputation for being a team player and helping others to succeed, rather than being seen [as] someone who is [in] it to advance your own interests at the expense of others.”

Average rating: 5.11
Participant: Julie Peterson
Background: Education

Response: “Write a formal analysis, detailing the intended and unintended consequences of Velma’s plan, including the PR disaster if a major publication got inside information leaked about the ‘planned shortages.’ Assign some dollar estimates to the various outcomes, add them up on a probability matrix, and see what the likely financial results might be.

“When [the plan] goes badly, be on record as a discordant voice.”

Average rating: 5.17
Participant: Robert William Sweitzer
Background: Education

Sample responses

To give you a sense of the range of ratings, I’ve listed a few responses spanning the range from unfavorably rated (5 percent in the distribution, meaning that 95 percent of responses were rated better), to average (50 percent in the distribution), to favorably rated (90 percent in the distribution). All of these responses had five or more ratings.

5 percent response
Answer: “Open a competing restaurant and prove your ideas are better by being more successful and driving them out of business.”
Average rating: 1.76

50 percent response
Answer: “It’s never a good idea to present a single solution to senior leaders.

“So I would persuade my colleagues to present a number of alternatives (say three), as well as the relative pros and cons of each.

“I would also have private corridors conversations with individual colleagues to plant the seed that Velma’s proposal is a bad idea, or, at a minimum, that there are other, lower-risk alternatives.

“In the presentation itself, I would emphasize that disagreement is good, and that we came up with a number of alternatives, which will be presented. In the presentation itself, I would insist on presenting my own idea and would casually point out the risks of Velma’s proposal.”

Average rating: 3.71

90 percent response
Answer: “History provides ample examples of why this is a bad idea. So, I would first try to make sure that Velma is aware of similar strategies that ended with serious consequences.

“If that doesn’t work, I would openly express my views to the group and try to raise awareness of the potential risks. If that failed, and I saw existential or very serious consequences to the firm, I would escalate my concerns to appropriate levels in the organization.”

Average rating: 4.77

To examine more systematically which elements led to more favorable evaluations, I coded the responses on various dimensions. First, I examined the target of the next conversation: Velma, the team, and/or the boss. Most of the responses included a single target, though some included multiple targets.

The group was the most common target and also resulted in the highest ratings. Speaking to Velma was less favorably evaluated, while approaching the boss received the most negative evaluations.

Responses also varied in content, with most responses making an argument (“Directly outline, with data/numbers, why this method will not work.”), and fewer asking questions (“I think it is worth discussing with the team why they think it is a good idea.”) and seeking some cover (“When the unintended consequences are realized, reinforce to your boss that you shared this with him and the team.”). Yet asking questions was the most-favorably-evaluated approach, followed by making an argument, and then seeking cover.

Finally, I examined the tone of the response, coding responses as “direct,” “subtle,” or neither. Here are examples of direct and subtle responses:

**Direct:** “I would first have a private meeting with Velma and point out the flaws in the proposed plan and the risk of presenting such a plan to upper management.”

**Subtle:** “I would set up a brainstorming session with the entire team before the proposal is further developed, talking about how I think the idea is good but does raise a couple of concerns in my head.”

Subtle responses were evaluated most positively, followed by direct responses, and finally neutral responses.

### Strategic takeaways

- **Taking this problem out of the group and to your boss is tempting—it’s a shortcut around the hard work of persuasion and cooperation. But, assuming your boss agrees with you about the quality of the idea, it can also sabotage your standing with your coworkers, making this project and future projects more difficult. The ratings reflect this.**

- **Ratings were highest for solutions that revolved around addressing the group, not addressing Velma directly. Perhaps that’s because the problem here is not that Velma has a bad idea, but that the group has all bought into it.**

- **Asking questions about the situation—Why do I hate this idea? Why doesn’t everyone else?—isn’t a reflexive response.**
response for many people, but it’s an approach that was evaluated more highly than making an argument or looking for cover.

An ounce of prevention
This installment of Business Practice considered a commonplace problem in organizations: dysfunctional group processes. The best advice I can give, as someone who teaches and studies decision-making, is to minimize the chance that this situation occurs in the first place. Many organizations have not thought deeply about how to improve their group decision-making processes. Much of the time this doesn’t matter, but sometimes it leads to us going with our organizations’ equivalent of Velma’s dumb idea.

There are lots of good, accessible books on the pitfalls of group decision-making, including one by my Chicago Booth colleague, Reid Hastie, and a former University of Chicago colleague, Cass Sunstein: Wiser: Getting beyond Groupthink to Make Groups Smarter. I highly recommend this book to anyone who wants their organization to make smarter decisions.

Hastie and Sunstein offer eight approaches for improving group decision processes. I’ll focus on a few:

Prime critical thinking. Establish a norm for being deliberate and thorough in which dissent is expected. It is a good idea in any decision-making task to begin with a reminder that you want to conclude with a recommendation, as well as a record of the pros and cons for your favorite solution. The leader should start discussion by commenting that it is imperative to flush out all the important considerations, including the negatives and unintended consequences. This makes it much easier for team members to constructively criticize even excellent solutions.

Train inquisitive and self-silencing leaders. Leaders need to embrace having everyone speak and share their information and opinions.

Encourage devil’s advocates. Incorporate processes (or people) that explicitly embrace unpopular points of view.

These three approaches aim to get a fuller set of options on the table, and to encourage a reasoned, unbiased discussion of alternatives.

Group decisions are hard. Even the best of processes will generate their share of failures. It is nevertheless harder and riskier to deal with these problems once they have arisen, as in this scenario.

As Benjamin Franklin is widely credited with observing, an ounce of prevention is worth a pound of cure. Don’t wait until your team starts spinning toward a bad decision before considering how to stop it. Take measures now to help keep bad decisions from gaining momentum in the first place.

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Dentists have a distinct advantage whenever the need for negotiation arises. They float over you like the face of God, telling you what you must do in service of a sound body. You, meanwhile, are busy drooling.

Even a routine cleaning holds the potential for such a pricey conversation, but the circumstances are far more perilous for a first-time patient. Trust me, I know. Nearly a year ago now, I found myself in a dentist’s chair in an office whose only commendations were its inclusion in my health-insurance plan and its proximity to my home.

You live in a fine neighborhood, I told myself. There’s no need to worry.

There certainly was. The tip-off should have been an office that was as busy as a free buffet at a funeral home; but instead of taking the empty corridor as a sign to feign a stomachache and head for the exit, I eagerly filled out all of the patient information in the hopes of being on my way in under an hour. I succeeded, but not before a hurried X-ray whose results were never shared, the hard sell for a suite of “essential” services I knew I didn’t need, and a cleaning that might just as well have been done with a bristle brush and a trowel.

It was an unpleasant experience—it always is when someone takes advantage of you—but what’s remarkable about it, at least to someone who studies the history of capitalism, is how little the original architects of laissez-faire feared that their system might embolden such individuals, the pariahs of the marketplace: the hucksters, the hustlers, the swindlers, the flimflammers, the snake oil salesmen, the money-grubbing merchants, the two-faced tradesmen, the Potemkin retailers, the fly-by-night financiers, and the confidence men. (As well as the dodgy dentists.)

In other words, the people you really don’t want to do business with.

The reason for such sangfroid in the face of a potential parade of horribles had everything to do with the conditions of early capitalism. A fine illustration is provided by “A Plan of the Town of New Haven,” a map of one of New England’s earliest settlements. It was drawn up by James Wadsworth, an occasional cartographer, in 1748, the year he graduated from Yale College.

At first glance, one can’t help but be struck by the neatly geometrical layout of the settlement: nine squares, assembled three by three, forming the perfect square that represents the earliest exercise in colonial city planning. Yet, if you look more closely at the small buildings that fill these blocks, you’ll find entries next to them such as “Joel Potter” and, then a line below it, italicized, “Shoemaker.” There are similar designations for “Jo. Burroughs” (“Hatter”) and “Dav. Gilbert” (“Tanner”)—not to be confused with the other villager who kept that putrid pastime, “Dav. Gilbert Jr.,” one door down.

The same holds true for all of the merchants and tradesmen in this small community, and, taken together, they illustrate the world of intimate capitalism that Adam Smith had in mind when he wrote The Wealth of Nations a few decades after Wadsworth tried his hand at mapmaking. The fabled trio from that book—the butcher, the brewer, and the baker—are all small-town figures whose professional activities are a component part of a particular community. Their lives are characterized by constant exchanges, and not merely of an economic sort. At
the tavern, in the town square, across the hearth, the lives of these men were interdependent and intertwined, so much so that there was no meaningful distinction in the minds of neighbors between their private affairs and their professional pursuits. To the residents of New Haven, the fact that Joel Potter was a shoemaker was hardly a trivial detail. On the contrary, it surely must have seemed an essential part of his identity, for everyone who knew Joel Potter would have seen him, day by day, as a man preoccupied with his trade.

Such a state of affairs, the social conditions of intimate capitalism, shaped how a tradesman made sense of his self-interest and went about pursuing it. Indeed, for Smith, an individual’s self-interest was never more than an amalgam of interests that jostle for priority and attention. The composition changes over time—an old codger on the edge of oblivion probably prefers family time far more than he did as a man-on-the-make in his early 20s—but what stays consistent is that we can never entirely satisfy all of our interests at once and that, in addition to the burden of choice, how we pursue one particular interest influences the likelihood of realizing, or retaining, the others.

For the men on Wadsworth’s map, the art of managing these interests was especially complicated, for social and economic affairs were always interwoven. To ignominy or advantage, any activity behind the shop counter would be remembered in the town square. If the butcher put his thumb on the scale, the brewer watered down his beer, or the baker boxed his apprentices about the ears, word would immediately make its way around town, and such behavior would be rewarded by disapproving looks and decreased traffic. Conversely, a winning smile and a way with customer service won a busy shop and the bounty of friendship.

One colonial shopkeeper who viscerally understood the high stakes of intimate capitalism was Benjamin Franklin. In his autobiography, a work largely concerned with Franklin’s early years in the printing business, Philadelphia’s first son reflected at length on how one’s personal and professional activities are the tesserae of public reputation, a mosaic whose appeal overwhelmingly determines the likelihood of commercial success.

Such concerns took on a special urgency when the 22-year-old Franklin passed from being a precocious apprentice to the proprietor of his own printing house. This was his big shot, and in what I have long considered the quintessential passage of his memoir, he reflected on the behavior necessary to ensure his fate. “In order to secure my Credit and Character as a Tradesman, I took care not only to be in Reality Industrious & frugal, but to avoid all Appearances to the Contrary.” Franklin continues:

I drept plainly; I was seen at no Places of idle Diversion; I never went out a-fishing or shooting; a Book, indeed, sometimes daubacht’d me from my Work; but that was seldom, snug, & gave no Scandal: and to show that I was not above my Business, I sometimes brought home the Paper I purchas’d at the Stores, thro’ the Streets on a Wheelbarrow. Thus being esteem’d an industrious thriving young Man, and paying duly for what I bought, the Merchants who imported Stationary solicited my Custom, others propos’d supplying me with Books, & I went on swimmingly.

If “Credit” and “Character” appear codependent, that’s because of the way gossip functioned in the commercial sphere Franklin occupied and Adam Smith assumed. It was a world of routine engagements, where any bad behavior on either side of the shop counter would boomerang on a tradesman, ruining his credibility as a borrower and a businessman. Indeed, good character was so critical that the “Reality” of it, alone, wasn’t enough. A tradesman like Franklin had to be known throughout the community for the component parts of a good reputation—honesty, industry, prudence, and thrift—for nothing less than his viability in business depended on it.

Franklin and Smith died within a few months of each other in 1790, so they didn’t live long enough to see the industrial revolution fundamentally transform the social conditions of capitalism, which moved from small towns to super cities, from the intimacy of the shop counter to the anonymity of the factory floor. In this new terrain of anonymous capitalism, the quintessential commercial experience was the interplay of actors—buyers and sellers, employers and employees—who had no overlapping experience or interests beyond the economic. A robber baron could blithely sign off on the brutal conditions in his mills, for he never had any fear of being provoked to paroxysms of shame by his social peers. They would never set foot inside them, and those who did on a daily basis were members of another community altogether.
This is not to say that, with the advent of anonymous capitalism, all commercial engagements would inevitably be given over to the grossest conduct, merely that moral correctives would come about in two ways that Adam Smith never put much stock in: the prod of conscience and the power of markets. Perhaps it was the case that more than the occasional merchant would be guided by an inner light, routinely preferring what is right to what is merely expedient; and, who knows, maybe we would discover that the natural tendency of markets, when liberated from social suasion, is to reward us for saintly behavior. To Smith, however, the first case would have seemed exceptional, the second utterly unlikely. Intimate capitalism never assumed that men were angels but rather that people, when presented with the choice of losing a buck or looking like a bum, would actively prefer the former. They would have to choose between doing well and doing good, rather than simply trusting that the two always went hand in hand.

The rise of anonymous capitalism changed the stakes of self-interest, for it largely eliminated the social sting of bad conduct in moneymaking endeavors. This made for a commercial status quo that persisted for over 150 years, long enough that, when I began teaching business ethics in 2005, I treated it as an essential feature of contemporary capitalism, a quality which, if it didn’t exactly inspire the aforementioned parade of horribles, it no doubt paved the way for them.

But things have changed in the past 15 years. In a fashion Adam Smith could never have predicted, we have seen something akin to a revival of the social forces that once shaped intimate capitalism, a turn of events courtesy of the internet.

“The worst dental service I have ever experienced over my 60 years of life,” one William H. declares in an online review of the practice I visited. “I could have cleaned my teeth with a toothpick and done better.” Another, John H., seconds the verdict. “The ‘teeth cleaning’ was literally just [a] few scrapes followed by flossing,” he writes. “But then I was asked if I wanted a ‘deep cleaning’ for an extra $300!” He notes that he declined. “I hope this place burbs [sic] to the ground.”

By the time I arrived, nearly six months later, the office hadn’t gone up in flames, but if I’d read these reviews, or most any of the other 93 on the website Yelp, where the practice has a wince-inducing rating of 2.5 stars out of a possible 5, I would have saved myself the trouble.

Yelp, which started less than a year before I began teaching in 2005, has become the principal hub in an ecosystem of online gossip that is helping to re-intimize capitalism. In the second quarter of 2019, it reported a monthly average of nearly 140 million unique users. That’s far less than Facebook or Twitter or other sites that similarly disseminate virtual gossip, but Yelp’s outsized influence is due to the fact that its explicit mission is to provide a word-of-mouth forum for commendations and criticism of commercial actors. If I want to know something about the credit and character of a counterparty—whether it be a potential employer or a place for deep-dish pizza—Yelp is the obvious place to turn.

Similar to other consumer-sourced websites, what Yelp has effectively done is to recreate the lines of gossip that once fed intimate capitalism and the social forces that patrolled self-interest. In his work, Smith never envisioned a world where the overwhelming majority of people we do business with are alien to us, but this became the standard experience with the rise of industrialization and urbanization, when the number of commercial counterparties the average person did business with grew far beyond the reckoning of intimate relationships.

The advent of the internet has not changed this impersonal state of affairs entirely. I still couldn’t tell you much about the men and women who trim my hair, fix my brakes, or flip my burgers, certainly no more than they might say about me. Some among them may become friends or neighbors, but unlike the world of Adam Smith, I can’t assume as much of the people I do business with.

No, in an ironic twist Smith would have uniquely appreciated, the internet has revived the power of gossip to shape capitalism while also removing any traditional sense of intimacy as a trust requirement in commercial relationships. Consider it: we have no human connection at all with the horde of online merchants who peddle the goods that supply our daily needs—goods that, even until a few years ago, we always bought in person. We don’t know these individuals, and in order for the wondrous efficiency of online marketplaces to have its full effect, we can’t. And yet, crucially, if we couldn’t be certain of their credit and character, we wouldn’t want to know them in the first place. It is only because of the eagerness of other people we don’t know to gossip online about their experience as buyers that we know who sells to patronize (and, therein, economically reward) and which to effectively put out of business.

The internet now polices capitalism in the way that word of mouth around town once did, and while it lacks something of intimate capitalism’s promised social stigma for bad behavior—when I leave negative feedback for SqueekeePants27 on eBay, I don’t know who he is and neither do his friends—anonymous capitalism nonetheless more immediately, and implacably, doles out economic justice to commercial miscreants.

For example, a study of Yelp conducted by Harvard’s Michael Luca finds that a one-star increase in [a merchant’s] rating leads to a 5-9 percent increase in revenue.” Such results shouldn’t be surprising, for they simply affirm the quiet verdict of common sense. No one actively seeks out bad service or shoddy treatment; we stumble into it, or shoddy treatment; we stumble into it, as I did in the case of the dentist whose character had no credit. How we may warn ourselves ahead of time, readily and reliably, and how we may alert others in turn, are opportunities capitalism originally promised. Now, after a long spell, it seems to have reclaimed them.

The internet now polices capitalism in the way that word of mouth around town once did.

John Paul Rollert is adjunct professor of behavioral science at Chicago Booth.
THE GRUMPY ECONOMIST  
JOHN H. COCHRANE

Stop worrying about wealth inequality

Don’t focus on wealth; focus on consumption

Economics and politics are converging on the issue of wealth inequality and a wealth tax. It is a prominent feature of the 2020 US presidential campaign, in particular the proposals by Senators Elizabeth Warren (Democrat of Massachusetts) and Bernie Sanders (Democrat of Vermont) and their economic advisors.

What is wealth anyway? Is its inequality really growing? Why do we care about wealth inequality, as opposed to other measures of inequality? Why do we care about any measures of inequality, rather than just measures of standard of living and opportunity? Why are some measures of wealth inequality growing?

Start with the last question. A good part of the rise in wealth and wealth inequality, defined and measured as the market value of net assets, consists of higher market prices for the same underlying physical assets. In turn, higher asset prices stem almost entirely from lower real interest rates and lower risk premia, not from higher expectations of economic growth.

This raises a deep “why do we care” question. Suppose Bob owns a company, giving him income of $100,000 per year. Bob also spends $100,000 per year. The discount rate is 10 percent, so his company is worth $1 million. The interest rate goes down to 1 percent, the stock market booms, and Bob’s company is now worth $10 million. Hooray for Bob!

But wait a minute. Bob still gets income of $100,000 per year, and he still spends $100,000 per year. Absolutely nothing has changed for Bob! The value of his company is just what some call “paper wealth.”

And why care about wealth at all? Let’s compare Bob to Sally, who earns $100,000 per year in wages and has no assets. The distribution of income and of consumption between these two people is entirely flat. But the distribution of wealth was already concentrated before the interest rate dropped: Bob had $1 million of wealth, because we ignored Sally’s human wealth, the present value of her salary. After the interest-rate decline, wealth inequality is 10 times larger, because we also ignore the higher capitalized value of Sally’s human wealth.

But why should we care? Bob and Sally are both marching along unchanged.

You might object that I just assumed Bob didn’t change consumption. He should sell some stock and go on a round-the-world private jet tour. Or do what gazillionaires really do, start a foundation and give the money away. But Bob won’t do that for a simple reason: originally, he wanted to spend $100,000 per year, and if he sells his company for $1 million and invests it at 10 percent, he could spend $100,000 per year. Now, if he sells his company for $10 million, he can only invest that at 1 percent per year, so the most he can spend is still $100,000!

People don’t want to consume in one big spurt. They want to spread consumption out over their and their heirs’ lifetimes. When the interest rate goes down, it takes more wealth to finance the same consumption stream.

The present value of liabilities—consumption—rises just as much as the present value of assets. This is a rather deep point that gets lost all too often in the static Keynesian thinking about wealth effects of consumption that still pervades macroeconomics.
If the rise in asset value came because people expected the income stream to grow a lot in the future, at unchanged discount rates, indeed Bob would be more “wealthy” than before. But that is emphatically not the situation of today’s market values, at least on average. If you think internet companies have enormous stock values because their profits will continue to grow at astronomical rates, I have some 1999 dot-com stock to sell you.

(A refinement: lower real interest rates do generate a substitution effect. With lower interest rates, Bob may want to rearrange consumption to be earlier in time rather than later in time. But the central point is that the lower interest rate does not have a wealth effect. Though the asset is worth more, he cannot consume more in every year than he could before. The original flat consumption path is still just as affordable.)

There are good questions to be asked about the distribution of consumption, and in particular, lifetime consumption. If Bob averages $100,000 annual consumption over his life, and Sally only averages $10,000, that’s an interesting observation about our society, and we might want to think about the economics, politics, and justice of the situation. But why should we worry about an increase in mark-to-market “wealth” that has no implications for the overall command over resources that “wealthy” people have?

Is this a big effect? Yes. To the right, you’ll see a simple plot of real interest rates over 40-plus years, computed as the 10-year bond rate less the inflation rate, as measured by the University of Michigan inflation survey. It declines from nearly 10 percent in the 1980s to negative numbers in the past decade.

### Real interest rate’s decline

The real interest rate dropped from about 10 percent in the 1980s to negative numbers in the past decade.

### Calculation of the real interest rate

Constant-maturity rate of 10-year US Treasuries minus expected-inflation rate from the University of Michigan inflation survey

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The life of a poor kid from the south side of Chicago is completely untouched by whether a venture capitalist in Palo Alto, California, upgrades from a turboprop to a private jet.

Just why should we care about wealth inequality? Obviously, many smart people are very animated by it. Why?

According to University of California at Berkeley’s Emmanuel Saez and Gabriel Zucman, who have advised Senator Warren on her plans to tax wealth, “the public cares about the distribution of economic resources.” But the public doesn’t distinguish between wealth inequality, income inequality, and consumption inequality. And envy is a poor basis for confiscatory policies.

I think many of us, me included, worry about lack of opportunity, and the many barriers to advancement on the lower end of America’s economic spectrum. And I think society as a whole is better off if the bottom end rises. This worthy impulse is, I suspect, what many people mean when they say they worry about inequality. Perhaps the presence of wealthy people makes the struggles of the less fortunate more painful to watch.

But if you say inequality per se is a problem, the inescapable logical conclusion is that you think society as a whole is better off if you and I lose $10, and Bill Gates loses $1,000. We are then more equal. If you do not believe this, do not use the word “inequality,” or pursue destructive policies that achieve that leveling loss.

The life of a poor kid from the south side of Chicago is completely untouched by whether a venture capitalist in Palo Alto, California, upgrades from a turboprop to a private jet. That kid will be made no better off when confiscatory wealth taxation forces the venture capitalist to drive.

If you’re worried about opportunity, mobility, left-out and left-behind people and areas, good for you. But wealth inequality is a poor phrase to describe this worry. Use better words that do not empower disastrous economic policies. —CBR

**John H. Cochrane** is a senior fellow of the Hoover Institution at Stanford University and distinguished senior fellow at Chicago Booth. This essay is adapted from two posts from a series on taxation and inequality originally published on his blog, The Grumpy Economist.
Is the cult of the founder still as strong as it has been?

Isaac: The past 15-20 years of the rise of consumer internet has been largely about getting behind the Larry Pages and Mark Zuckerberg of the world, boy geniuses who built the next consumer app in their dorm rooms and made billions of dollars. But since 2017, we’ve seen a curbing of that idea.

Now, with people such as [Uber co-founder and former CEO] Travis Kalanick and [WeWork co-founder and former CEO] Adam Neumann, we’re seeing the limits of that type of thinking. I think there’s going to be a real reckoning. Employees are pushing back. There’s been a generational change in how they’re viewing executive and company behavior. Employees want the products and the software that they’re building to live up to the ideals that they joined the company for in the first place. That’s new for the CEOs. [Facebook co-founder, chairman, and CEO] Mark Zuckerberg isn’t used to getting an
internal letter leaked to the press that pushes him to change his policy on political ads. GitHub isn’t used to having to drop contracts with US Immigration and Customs Enforcement because its employees don’t feel comfortable with that. There’s a real sea change there.

**Kaplan:** If you ask venture capitalists what they look for in an early-stage investment, a big chunk say they invest in the founder, as opposed to the business. We surveyed 600 venture capitalists and most said they bet on the jockey, not the horse. They’re looking for people who know their industry, who have passion—an ability to energize and motivate people—and who can take an idea and really push it. My research suggests that, on the margin, they might be better off prioritizing the business, because that typically changes less than the people. At Uber, Kalanick is gone, but the business is progressing. Google, Amazon, Facebook, Starbucks are essentially the same businesses they were when they started; the people sometimes change. Sometimes they don’t.

Venture capitalists do three things: First, they source the deals. Second, they evaluate and select the deals. Third, they sit on the board, where they monitor and advise the company after the investment. That’s when they’re trying to figure out if the company is doing the right thing. That is your first line of defense against bad behavior.

**Do startups need to have corporate-governance rules from day one?**

**Marcello:** The founders we work with often build an advisory board before they even create the company, and a lot of the times we’re working with young people who are starting these companies, and they need advisors who have deeper experience, who know the industry, who know the work that needs to get done to really guide them along the way. So we start talking about issues like that very early. In the cases of Uber and WeWork, one of the things that stood out to me was what happened with the voting power that Kalanick and Neumann had, which made it harder for the board to make changes at the CEO level. That’s something to think about as we broaden the discussion around culture and responsibility among startups.

**Kaplan:** What’s puzzling about this is that the venture model really is to have good governance, where they have the board, and if things don’t go well, they [the investors] get control. These situations where the founders retain control, which happened at Google, and Facebook as well, are really not the typical model.

**Isaac:** One of my sources keeps telling me that you have to play the game that’s on the field, meaning the control that the venture capitalists are giving up is part of a wider trend, especially given the wealth of capital flowing into Silicon Valley. There’s a ton of different family offices, Fidelity is investing, and all this money is moving down to as early as they can get in, because companies are staying private longer. What do you have to do to get into that deal? I think this is going to shift, but right now there’s just so much money in there that they [the investors] have to continue giving up that control.

**How much do founders and funders think about what a company’s culture will be like if it grows very fast?**

**Marcello:** We do have that conversation with the founders, so that they think about the future and what their venture will look like as a big company. For example, one thing we talk about during the growth stage is when to bring in a human-resources person, which seems simple, but in Uber’s case, it waited a long time to do that. We talk about some of those structural things you can do with a company to try to keep people on their best behavior and to establish practices and protocols, so that as you scale up, you have systems in place.

**Kaplan:** It’s tricky, because the culture that gets you started and makes you successful can at some point get outgrown. More than half of venture investments lose money, so having a
successful venture investment is hard. Venture capitalists make more than 60 percent of their returns on the 10 percent of deals that earn more than five times their money. So venture capitalists make their big money on investments like Uber and Slack. And so what happens when these things start scaling and going really well? Everybody’s drinking the Kool-Aid. It’s very hard to go from being a scrappy startup to where you’re getting bigger and you have to put in some of the structures that Starr mentioned. And if the board pushes on it and the founder pushes back, the founder has a lot of power because the company just skyrocketed. That dynamic makes it hard.

Isaac: The problem for Kalanick was that he wanted to keep that startup feel even when Uber was at global scale and had hired more than 10,000 people. The best CEOs know that you can’t operate the same way when you’re in a garage or with 50 people, and there’s a point at which you bring in more experienced hands or people who have run global businesses with tens of thousands of people around the world.

Truly disruptive startups often have to operate in legally murky areas, because they are challenging rules that have been shaped by big incumbent companies. How should disruptive startups navigate this gray area?

Kaplan: That’s a risk-return question, and each person answers that differently. In the past several years, we’ve had a number of students who wanted to start cannabis companies. That was risky. But because the regulation and the law went their way, some of those people did extremely well. The one thing I do tell them is never to do anything that is going to send you to jail.

Marcello: In that case, regulatory hasn’t caught up yet. Many entrepreneurs see an opportunity in that gray area. There’ll be a period of time when there is this opportunity, and then regulators will catch up, and the circumstances will change. This is the concept of the entrepreneur as disruptor, and the issue of what’s allowable with the disruptor title on. We talk a lot with students about coachability, and I was thinking about marrying that with the concept of the disruptor. When you’ve worked for years with entrepreneurs, you see coachability as a signal for whether they will be the persuasive successful founder. Do they take advice? Do they listen to feedback? What are they like to work with? We can often correlate those factors to people who are able to raise money, find a cofounder, and hire people. The entrepreneur as disruptor would speak against that; it would say that it’s OK to not be coachable, to be a maverick, or not necessarily to take all the advice.

How has the entry of large international funders such as SoftBank and Saudi Arabia’s Public Investment Fund changed the startup funding formula?

Isaac: The SoftBank phenomenon has been the most fascinating shift in dynamics in Silicon Valley over the past few years. They have this $100 billion fund that they have to invest within five years. That means parking enormous amounts of capital into a number of startups, and they can’t do small strategic investments. That means they plunk $1 billion into WeWork or DoorDash or other companies. That has repercussions in a number of ways. It creates a level of indiscipline because when you have unlimited money, you don’t have to worry about building a business. You can always go back to the capital faucets, and SoftBank seems to be pouring it out. [SoftBank founder and CEO] Masayoshi Son is hailed as a visionary, but the big question for me has been, is he a genius or totally nuts? I honestly don’t know.

Kaplan: This was something where it’s closer to totally crazy than visionary. If you look at the amount of money going into VC funds every year in the United States, it’s $40 billion. So a $100 billion fund—$20 billion a year, over five years—increases the amount of venture money by 50 percent in one fell swoop. It didn’t make sense when he raised it, and you’re seeing the fruits of that. It’s a little bit like what happened in the dot-com boom. There was more money then—it was worse—but you still have a destabilizing force with the Vision Fund. The Vison Fund raised the valuations on those companies and others. The companies then spent a lot of—too much—money. It’s actually great for the consumer: they get free delivery. But at some point, it is not sustainable and it breaks down. And the really good news is that it has broken down. The Vison Fund will take a huge loss on WeWork, which is terrific. Uber is a little different. It’s a real company. I’m somewhat optimistic that it will be cash-flow positive someday.

“[SoftBank founder] Masayoshi Son is hailed as a visionary, but the big question for me has been, is he a genius or totally nuts? I honestly don’t know.”

— MIKE ISAAC
But is it worth $45 billion? We don’t know. Lyft is actually about cash-flow neutral now, so I’m sure the potential is there. But the point is that the Vision Fund inflated the private-company valuations, and the other venture capitalists felt they had to follow. And so you created an unhealthy treadmill. I think now it’s been broken. You’ll have more sanity, which is a very healthy thing.

**Marcello:** Some startups may be focused on getting a huge, no-strings cash injection, but what our founders think of as success and what inspires them is building something real, having it have an impact and actually touch people’s lives and solve whatever problem they’re trying to solve.

**Isaac:** Ship some of those [founders] out to San Francisco, please. That is not the mentality out west.

**Kaplan:** We had two startups in the New Venture Challenge competition at Booth at about the same time that had very different outcomes. One was Grubhub, in 2006. They started and stayed in Chicago, they tried to find business and revenue models that made money, they grew, and they became cash-flow positive—which they still are. At last count, Grubhub was worth almost $4 billion. The second example is Bump, which won our competition in 2009. Bump was one of the top-10 iPhone downloads in the world in 2009. They went to the Bay Area and they were not encouraged to make money; they were encouraged to get users. They ended up selling to Google for a modest amount, and they never earned a dollar of revenue. So those are two extremes. You can do the west-coast model, but at some point you have to make money. In the midwest, startups tend to focus on making money earlier. They’re very different philosophies.

**Is profitability becoming a more important criterion for startup investors?**

**Kaplan:** I always tell my students “CIMITYM—cash is more important than your mother.” If it doesn’t produce cash, your business will fail. At some point, you have to make money. Sometimes it takes a long time—as with Amazon, but it always had that path to profitability. Lyft is reporting that it’s going to go cash-flow positive in the next year or two. Uber has a different business model. It’s broader, so it’s a bit more ambitious and it’s going to be losing money for longer. So that’s what you have to decide as an investor: Does the company have that path?

**Marcello:** When you teach entrepreneurship, you have a lot of students who see these models that get talked a lot about in the media: startups in Silicon Valley, where you don’t have to make money right away if you get enough users and build your base. Every year, we see a number of business ventures with that model saying, “I’m going to be the one who makes it.” But it’s really hard to do. It’s hard to find investors, in the midwest at least, who have seen a lot of those types of startups be successful here. Often we will advise them to talk to investors in Silicon Valley or on the east coast to get other perspectives. It is really hard to build a business that way—to hope at some point in the future that revenue will be generated.

**Kaplan:** That’s why people look at indicators such as the lifetime value of a customer relative to the customer acquisition cost. These metrics give you a sense of whether you will make money over time on each customer. If you do, it is OK to pump a lot of money into getting customers today. That type of analysis is true here in Chicago and on the west coast.

**Isaac:** In Silicon Valley, a path to profitability is looking more attractive than it probably was before, particularly because everyone looked at Uber’s initial public offering and saw the very grim reality that this was not a $120 billion company—the valuation was way out of whack with what the public markets thought it was. Those days of tech-company public overvaluations are coming to an end, or at least tamping down—not at the earliest stages, but once you get to the D round or later-stage capital, when they start to think about going public. And that’s probably a good thing. But it will be hard to get around the idea that new startups should chase users first, and money will come after that. You can’t really beat that out of the heads of people in Silicon Valley, because that’s going to be what [cofounder of Silicon Valley VC firm Andreessen Horowitz] Marc Andreessen says; it’s going to be what the Zuckerbergs of the world say: it works for their businesses so it can work for you—*end*
DO LOTTERIES DO MORE HARM THAN GOOD?

If revenues are any barometer, state-run lotteries are among the most popular forms of entertainment in the United States. Such lotteries brought in more than $83 billion in the US in fiscal 2019, according to the North American Association of State and Provincial Lotteries—dwarfing, for example, the $11.4 billion North American moviegoers spent at the box office. Lotteries generate significant sums for public-sector priorities such as education and health care. But they are also a form of legalized gambling, which means they could do disproportionate harm to people with gambling addictions or few resources. So do state-run lotteries improve social welfare on balance? Chicago Booth’s Initiative on Global Markets put that question to its US Economic Experts Panel, and finds that a plurality of panelists are uncertain (meaning they believe that the evidence is ambiguous), with a significant minority on either end arguing for or against lotteries as a prosocial force.

About the IGM 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 economists, all senior faculty at the most elite research universities in the United States and Europe. The panels include Nobel laureates and John Bates Clark medalists, among others. Polls are emailed individually to the panel members, and panelists may consult whatever resources they like before answering. Members of the public are free to suggest questions.
Statement: Taking into account the revenues, consumer surplus, purchasing patterns by income, and possible consumer biases, state-run lotteries (such as Powerball and scratch-off games) increase social welfare.

Robert Hall, Stanford
“I’m inclined to think that government should not exploit the public’s vulnerability to gambling, but I’m also aware of counter-arguments.”
Response: Uncertain

William Nordhaus, Yale
“Among the worst of social policies.”
Response: Strongly disagree

Robert Shimer, University of Chicago
“If there were no state-run lotteries, more private institutions would enable possibly biased consumers to gamble.”
Response: Agree

Richard H. Thaler, Chicago Booth
“States giving themselves a monopoly in this business is bad for sure, but if the alternative is prohibition, is that better?”
Response: Uncertain
Five skills of good managers
Avoid making specific statements, for starters
BY H. EDWARD WRAPP

The upper reaches of management are a land of mystery and intrigue. Very few have ever been there, and the present inhabitants frequently send back messages, incoherent both to other levels of management and to the world in general.

The fragmentary reports from the world of the top manager often produce caricatures of the hardy types who reach for the general management rungs on the ladder. For example, the literature on management produces such widely held notions as these: That life gets less complicated as you reach the top of the pyramid. The manager at that level knows everything that’s going on in the organization, can command whatever resources he needs, and therefore can be more decisive. Another description pictures the general manager’s day taken up with making broad policy decisions; a related version is that he spends most of his time formulating objectives. Still another identifies his primary activity as conceptualizing long-range plans; or, in a large company, he may be seen meditating about the role of his organization in society.

I suggest that none of these versions alone, or in combination, is an accurate portrayal of what the general manager does. Perhaps students of the management process have been overly eager to develop a theory and a discipline. As one executive puts it, “I guess I do some of the things described in the books and articles, but the descriptions are lifeless, and my job isn’t.”

My definition of a good manager is a simple one. Under competitive industry conditions, he is able to move his organization significantly toward the goals he has set, whether measured by higher return on investment, product improvement, development of management talent, faster growth in sales and earnings, or whatever.
Remember, this definition does not refer to the administrator whose principal role is to maintain the status quo in a company or in a department. Keeping the wheels turning in a direction already set is a relatively simple task compared to that of refereeing the introduction of a continuing flow of changes and innovations, and preventing the organization from flying apart under the pressure.

Considering this group of managers in action, on the job, what common characteristics do the successful ones exhibit? Do patterns seem to recur? Let me try to identify five skills or characteristics that seem to me significant:

**Keeps informed**
First, each of my heroes has a special talent for keeping himself informed about a wide range of operating decisions being made at different levels in the company. As he moves up the ladder, he develops a network of information sources in many different departments. He cultivates these sources and keeps them open no matter how high he rises in the organization. When the need arises, he bypasses the lines on the organization chart to seek more than one version of a situation.

In some instances, especially when they suspect he would not be in total agreement with their decision, his subordinates will elect to inform him in advance, before a decision is announced. In these circumstances, he is in a position to defer the decision, or redirect it, or even block any further action. On another kind of problem, the general manager may learn after the fact that some decision has been made and implemented. The skillful manager will ordinarily leave to members of his organization the judgment to decide at what stage they inform him.

Top-level managers are frequently criticized by lower levels of management, writers, and consultants because after promotion they continue to enmesh themselves in operating problems rather than withdraw to the “big picture.” Without any doubt, some managers do get lost in a welter of detail. Not only do they dig into detail, but they insist that they make all the decisions. Superficially, the good manager may seem to be caught in the same web, but his purposes are different. He knows that only by keeping well informed about the decisions being made can he avoid the sterility so often found in those who isolate themselves from operations. Many top executives who follow the advice to free themselves from operations soon find themselves subsisting on a diet of abstractions with the choice of what they eat in the hands of their subordinates.

As [economist] Kenneth Boulding puts it, “The very purpose of a hierarchy is to prevent information from reaching higher layers. It operates as an information filter, and there are little wastebaskets all along the way.”

A real-life example illustrating skillful management is that of one company president who sensed that his vice presidents were insulating him from some of the vital issues being discussed at lower levels. He accepted a proposal for a formal management development program primarily because it afforded him an opportunity to discuss company problems with middle managers several layers removed from him in the organization. By meeting with small groups in an academic setting, he learned much about their preoccupations, and also those of his vice presidents. And in this instance, he accomplished his purposes without undermining line authority.

Certain managers seem to be able to respond almost immediately with a well-reasoned position on most of the problems and proposals coming to them. The explanation may rest not so much with a superior intellect as with a well-cultivated information network that gives an early warning and permits advance preparation.

**Choosing the issues**
The second characteristic or skill of the good manager is an ability to save his energy and hours for those few particular issues, decisions, or problems to which he should give his personal attention. There is a fine and subtle distinction between keeping fully informed about operating decisions and allowing the organization to force you into participating in them, or even worse, making them.

The good manager knows that he can bring his special talents to bear on a limited number of matters. He therefore chooses those that he believes will have the greatest long-term impact and those where his own special talents can be most productive. Under ordinary circumstances, he will limit himself to three or four major objectives during any single time period.

As he spots certain situations emerging from the organization, he will elect to become involved in the decision-making process. On the others, he will assure that the organization keeps him informed at various stages, but he will refrain from
active participation. Unless this skill is exercised with great expertise, he may be accused of indifference to those issues that he keeps at arm’s length. He trains his subordinates not to bring matters to him for decisions. The communication to him from below is essentially one of “here is our sizeup and here’s what we propose to do.”

The manager is in a position to delay a course of action when he is informed prior to action, but in practice he seldom does hold up what his subordinates propose to do. His hearty encouragement is reserved for those projects that hold superior promise of a contribution to total corporate strategy. He simply acknowledges receipt of information on most matters. When he sees a problem where the organization needs his help, he finds ways to transmit his know-how short of giving orders, usually by asking perceptive questions.

Power structure
The third skill is the manager’s sensitivity to the power structure in the organization. In considering any one of the major and current proposals, he can plot the position of the various individuals and units in the organization on a scale ranging from complete, outspoken support down to determined, sometimes bitter, and oftentimes well-cloaked opposition. In the middle of the scale is an area of comparative indifference. Usually, several aspects of a proposal will fall into this area, and here is the area where the manager can operate. He assesses the depth and nature of the blocs in the organization. His perception permits him to move through what I call corridors of comparative indifference. He seldom challenges when a corridor is blocked, preferring to pause until it has opened up.

Related to this particular skill is the good manager’s recognition of the need for a few trial balloon launchers in the organization. He knows that the organization will tolerate only a certain number of proposals that emanate from the apex of the pyramid. No matter how sorely he may be tempted to stimulate the organization with a flow of his own ideas, he recognizes the advantages of cultivating trial balloon launchers or idea men in different parts of the organization. As he studies the reactions of key individuals and groups to the balloons these men send up, he is able to make a better assessment of how to limit the emasculation of the various proposals.

Why does the good manager shy away from precise statements of his objectives for the organization? There are many good reasons for not being more precise.

Seldom, too, does he find a proposal that is supported by all quarters of the organization. The emergence of strong support in certain quarters is almost certain to evoke strong opposition in others.

Avoiding specifics
The fourth skill is the ability of the manager to satisfy the organization that it has a sense of direction, but without ever getting himself committed publicly to a specific set of objectives. This is not to say that the good manager does not have objectives, both personal and corporate, long term and short term. They are significant guides to his thinking, and he modifies them continually as he better understands the resources he is working with, the competition, and the changing market demands.

But as the organization clamors for statement of objectives, these are samples of what they get back: “Our company aims to be No. 1 in its industry.” “Our objective is growth with profit.” “We seek the maximum return on investment.” “Management’s goal is to meet its responsibilities to stockholders, employees, and the public.”

In my opinion, statements such as these provide almost no guidance to the various levels of management, and yet they are quite readily accepted as objectives by large numbers of intelligent people.

Why does the good manager shy away from precise statements of his objectives for the organization? There are many good reasons for not being more precise. The main reason is that he finds it impossible to set down specific objectives that will be relevant for any reasonable period into the future. Conditions in business change continually and rapidly, and corporate strategy must be revised to take the changes into account. The more definite the statement of strategy for the organization, the more difficult it becomes to persuade the organization to turn to different goals. Even if management were capable of this kind of master planning, before it could get the objectives comprehended by the organization, the targets would have shifted.

The public and the stockholders must perceive the organization as having a well-defined set of objectives and a clear sense of direction. But in reality, the good top manager is seldom so certain of the direction in which he should take the organization. Better than anyone else, he senses the many, many threats to his company, threats that lie in the
Communication by consistency
The skillful manager also knows that objectives are impossible to state clearly enough so that everyone in the organization understands what they mean. They get communicated only over time by a consistency or pattern in operating decisions. In instances where precise objectives are spelled out, the organization interprets them so they fit its own needs.

The subordinates who keep pressing for more precise objectives are in truth working against their own best interests. Each time the objectives are stated more specifically, the subordinate’s range of possibilities for operating is reduced. The narrower field means less room to roam and to accommodate the flow of ideas coming up from his part of the organization.

The good manager’s reluctance extends into the area of policy decisions. He seldom makes a forthright statement of policy. Some executives spend more time in arbitrating disputes caused by stated policies than in moving the company forward. The management textbooks contend that well-defined policies are the sine qua non of a well-managed company. My research does not bear out this contention. The president of one company deliberately leaves the assignments of his top officers vague and refuses to define policies for them. He passes out new assignments with seemingly no pattern in mind and consciously sets up competitive ventures among his subordinates. His methods, though they would never be sanctioned by a classical organization planner, are deliberate and, incidentally, quite effective.

Evolving policies
Since good managers don’t make policy decisions, does this mean that well-managed companies operate without policies? Certainly not, but the policies are those that evolve over time from an indescribable mix of operating decisions. From any single operating decision might have come a very minor dimension of the policy as the organization now understands it. It’s the patterns as they emerge from a series of decisions that set up guidelines for various levels of the organization.

If the manager has built a solid organization, it will be difficult for him to come up with an idea that no one in the organization has ever thought of before.

The skillful manager resists the urge to write a company creed or to compile a policy manual. Preoccupation with detailed statements of corporate objectives and departmental goals, comprehensive organization charts and job descriptions—this is often the first symptom of an organization in the early stages of atrophy.

The “management by objectives” school, so widely heralded in recent years, suggests that detailed objectives be spelled out at all levels in the organization. This method is feasible at lower levels of management, but it becomes unworkable at the upper levels. In his own mind, the good top manager must think out objectives in detail, but ordinarily some of the objectives must be withheld, or at least communicated to the organization in modest doses. A conditioning process, which may stretch over months or years, is necessary in order to prepare the organization for radical departures from what it is already striving to attain.

The good manager then, avoiding debates on principles, tries to piece together particles, which may appear to be incidentals, into a program that moves at least partially toward his objectives. His attitude is based upon optimism and persistence. Over and over, he says to himself, “there must be some parts of this proposal on which we can capitalize.”

Whenever the manager identifies relationships among the different proposals before him, he knows that they present opportunities for combination and restructuring. It follows that the good manager is a man of wide-ranging interests and curiosities. The more things he knows about, the more opportunities he will have to discover parts that are related. This process does not require great intellectual brilliance or unusual creativity. The wider ranging his interests, the more likely he will be able to tie together several unrelated proposals. He is skilled as an analyst, but even more talented as a conceptualizer.

If the manager has built a solid organization, it will be difficult for him to come up with an idea that no one in the organization has ever thought of before. His most significant contribution may be that he can see relationships that no one else has seen.

H. Edward Wrapp was professor of business policy, associate dean for management programs, and director of the Executive MBA Program at Chicago Booth. He died in 2009.
How a segregated city can worsen inequality

A family’s decision to live in a nicer part of a city can yield many desirable spillovers for their children. Better public schools and amenities and positive peer effects encourage children’s academic and future career success. These spillovers become even more important when technological progress raises the skill premium, because they can amplify the difference in quality between rich and poor neighborhoods and worsen income inequality, according to the Minneapolis Fed’s Alessandra Fogli and Chicago Booth’s Veronica Guerrieri. Inequality grows in response to a skill premium shock—such as an influx of high-end jobs—not only because high-skill workers become even richer, but also because richer families are now willing to invest even more in their children’s education. This also means they can afford to pay even higher housing prices to expose their children to neighborhoods with better schools and more lucrative networks, pushing out poorer families who cannot afford it. To learn more about this research, turn to page 16.
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MANY RETAILERS ARE MAKING
A BASIC PRICING MISTAKE
Page 24