Can the Free Market Protect Consumers?

November 17, 2015

by Michael Edesess

The evolution of economic theory has gone something like this: First set up a nice target, and then line up Nobel-prizewinning economists to shoot it down.

The target is the assumption that economic agents (people, consumers) are rational, that they reveal their rationally determined preferences through their economic actions and that this produces an optimal equilibrium.

Economists load their weapons with ammunition to shoot these targets down. That ammunition has been multiverse: externalities and “market failure”; “animal spirits;” “irrational exuberance”; the principal-agent problem; regulatory capture; information asymmetry and the market for lemons; then finally, behavioral economics.

And now, a new book, Phishing for Phools, by Nobelists George Akerlof and Robert Shiller – respectively, authors of the phrases “market for lemons” and “irrational exuberance” – says that all of these should have been central to economic theory in the first place.

Why? Because the exact same free-market process that Adam Smith lauded for doing a great job of satisfying mutual self-interests, also incentivizes scamming. It is not possible to separate the two; they must be part and parcel of the same economic theory.

Watch out for the “ph”

Akerlof and Shiller take their title from the word “phish,” which, according to the Oxford English Dictionary, was coined in 1996. It originally meant, “To perpetrate a fraud on the Internet in order to glean personal information from individuals.” They generalize this term by saying, “It is about getting people to do things that are in the interest of the phisherman, but not in the interest of the target.”

If you are successfully phished, you are a phool. There are two types of phools: psychological and informational.

Psychological phools are people who have an urge to do things that they know are not in their own best interest. All of us are psychological phools from time to time. Akerlof and Shiller refer to psychological phools as people who exhibit – occasionally or incessantly – “monkey-on-the-shoulder” tastes. There are plenty of examples of this: people who can’t stop smoking, gambling addicts, alcoholics and so on.

Sellers of cigarettes, casino gambling, and alcoholic beverages willingly and eagerly take advantage of these monkey-on-the-shoulder inclinations, tailoring their marketing to, and generally aiding and abetting their customers' self-victimizing tastes.

Information phools are different. They are presumed to know what they want, but they don't know that the product or service they are being sold won't give them what they want because the seller is, in one way or another, either distorting the facts or not revealing them.

Akerlof and Shiller cutely substitute the "ph" for "f" in any word starting with "f", to indicate that someone is phishing and making a phool out of you. They provide interesting historical information on several industries to show how common phishing and phoolery are. There's no problem, of course, about the spelling when it comes to the pharmaceutical industry. They describe how Big Pharma inveigles doctors into recommending their medications, even when they may have flaws in them or their efficacy hasn't been proven. But they also cover the phood industry, in which obese-making phoods are peddled to Americans, 69% of whom are overweight, according to the U.S. Centers for Disease Control and Prevention. Their monkey-on-the-shoulder lack of resistance to these phoods makes them easy marks, even if they know that the phoods aren't what they "rationally" want or should have.

An engaging history of phishing expeditions

This is the place to get a good summary of the history of the sales of cigarettes, the discovery that cigarettes were causing cancer and the campaign against the acceptance of that fact by the tobacco industry. We learn, for example, that before the 1880s, tobacco was mainly chewed and spit out. But then the cigarette-rolling machine was invented. Say Akerlof and Shiller, "In 1900 the cigarette was no more than a dot in the tobacco industry landscape, with annual US per capita consumption of just 49. By 1930 that number had increased to 1,365; and by 1950 to 3,322.5. This increase was coincidental with an epidemic of lung cancer."

The history of smoking in the United States forms a major thread in the annals of epidemiology. But although most of us know the rough outlines, few of us know the details. Akerlof and Shiller provide an excellent summary.

They also provide a good outline of the story of the Merck Corporation and its vaunted, and then disgraced arthritis medication Vioxx, after it was revealed that taking Vioxx increased the risk of heart attacks. I had read that Merck knew but suppressed that information, but I didn't know the details. Again, the authors provide a good summary. They further explain how requirements that doctors attend continuing education classes provide opportunities for drug companies to phish doctors – or doctors to phish their patients – by sponsoring symposia.

An account of the Savings and Loan crisis of the late 1980s sheds new light on that episode – including how savings and loan executives deployed the "Texas strategy," whereby they colluded to trade land back and forth at increasingly higher prices. Based on those elevated prices, they got friendly appraisals that enabled them to get development loans. These loans facilitated the payment of generous fees to the developers and their friends.

Unsurprisingly, the financial industry bears the brunt of the obloquy. The authors present information, much of it now familiar, about the enormous size and influence of the industry, especially compared with the minuscule budgets of its regulators, and how the political clout of industry – with more than 20 lobbyists for each member of Congress – keeps it that way.

Reputation mining

One phishing technique that Akerlof and Shiller highlight is "reputation mining." This is the practice of mining a reputation for providing good products, the better to sell customers bad products. This is a practice that can produce astonishingly shocking results in many cases. It can continue for a long time. Take the case of Merrill Lynch. This is my own example, not Akerlof and Shiller's. Merrill Lynch may have had an exalted mission around its inception 100 years ago (for a good account, read Joe Nocera's excellent book A Piece of the Action: How the Middle Class Joined the Money Class), but it has now racked up a record of appalling errors and misdeeds, ending finally with its own self-destruction and forced purchase by the Bank of America. Despite this fact, it paid out $3.6 billion in bonuses to top executives after its acquisition, adhering to prior agreements apparently secretly authorized by Bank of America.

Wouldn't you think that after this whole string of black marks against Merrill Lynch, the Bank of America would change the name of its new subsidiary to something not so tarnished? No, they kept it – because the phoolish investing public still believes that Merrill Lynch provides wise financial advice. This reputation mining can continue for an indefinite period.

Another example is that of the French company LVMH, which made a fortune by acquiring a number of luxury brands like Louis Vuitton, then trumpeted the brands by emblazoning their names and logos on all of their products, while cutting costs and reducing the brands' actual quality. Again, this is my own example, based on a reading of the book Deluxe: How Luxury Lost Its Luster by Dana Thomas.

These examples of reputation mining stand in stark contrast to the beliefs of economist Milton Friedman. In a video titled "Who Protects the Consumer?" Friedman said, "Consumers don't have to be hemmed in by rules and regulations. They're protected by the market itself. They want the best possible products at the lowest price. And the self-interest of the producer leaves him to provide those products in order to keep customers satisfied. After all, if they bring goods of low quality here, you're not going to keep coming back to buy. If they bring goods that don't serve your needs, you're not going to buy them. And therefore, they search out all over the world, the products that might meet your needs and might appeal to you. And they stand in back of them because if they don't they're going to go out of business."

This is a very optimistic and, frankly, naïve view of the motives of producers. It assumes that they never engage in reputation mining and get away with it.

Meanwhile reputations have been mined on Wall Street to near-depletion. In the late 1970s, as Akerlof and Shiller relate, Goldman Sachs co-senior partner John Whitehead, concerned that Goldman Sachs would lose its "Trusted-Friend ethics," set forth the 14 principles of the partnership, beginning with "Our clients' interests always come first."

But by the late 2000s, Goldman's reputation – and that of most of Wall Street – as "Trusted-Friend" had deteriorated so much that money manager Seth Klarman could *defend* Goldman by saying, "I know Wall Street will always try to rip our eyeballs out." In other words if you don't know that, you're a phool, and whatever happens to you is your own damn phault.

The real message

In their Conclusion and Afterword, Akerlof and Shiller purportedly attempt to explain why their book is a contribution to economic theory, or to reconcile it with economic theory.

But this is where the real story comes out.

The authors identify the competing economic doctrines they call Old Story and New Story. Old Story is that "with externalities, with an unfair distribution of income, and with phishing for phools, markets do not work perfectly. In that case, there is a potential role for government."

New Story began with these words of Ronald Reagan in his First Inaugural Address in 1981: "In this present crisis, government is not the solution to our problem; government is the problem." Akerlof and Shiller point out, not so incidentally, that these words are usually quoted without the qualifier "in this present crisis."

What was the present crisis? The 1970s had been a time of economic tumult in the United States, largely initiated by enormous hikes in the price of oil, on which the gas-guzzling country was crucially dependent. Oil prices leaped from 1973 to 1974 from $3 a barrel to $12 a barrel after the embargo imposed by the Organization of Petroleum Exporting Countries during the 1973 Arab-Israeli war, and more than doubled again in 1979 from $15.85 to $39.50.

The government's response, beginning under Republican president Richard Nixon, was disastrous price controls on oil and gasoline. This made things worse. Long lines formed at gas stations, and fistfights broke out in the lines. The stock market and the economy plummeted in 1973-74. Inflation soared, yet employment was stagnant – a condition dubbed "stagflation." The 70s generally were an age of "malaise" – an attitude attributed to President Jimmy Carter after a televised speech he gave in 1979 in which he counseled energy conservation (and did not actually use the word "malaise").

It was explicitly in the context of "this present crisis" – the handling of which had been mangled by government – that Reagan delivered his message. The message was that government is not always right; it can mess things up very badly sometimes. But New Story then took on a life of its own, beyond what Reagan ever meant. It became the story that government always makes things worse.

Akerlof and Shiller definitively state that the "New Story is wrong: because its characterization of the economy is wrong." Then they add that the "New Story – that government is always the problem – is itself a phish for phools."

This is the message they are conveying. The idea that free, unfettered and unregulated markets can produce ideal results and that government action is always detrimental has gone way overboard – way more than Adam Smith ever intended, and probably way more than Ronald Reagan intended. Economists like Milton Friedman naively added power to this pendulum over-swing.

It's not that Akerlof and Shiller are anti-market. They are only saying that free markets will inherently deliver I-win-you-lose results as well as we-all-win results; some external protection is necessary against the I-win-you-lose results. This has become lost in the swinging of the pendulum, away from the pro-government responses after the Great Depression, which reached their apogee in the U.S. and the U.K. in the 1970s.

It's long past time for the apogee of this wild reverse pendulum swing to have been reached. Let us hope that Akerlof's and Shiller's message, together with many others like them that have been published recently, will be heard.

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