Phishing for Phools

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November 10, 2015, and March 10, 2016
Something right was happening in Canada. It’s truly a double honour to be asked to give CIFAR’s Dodge Lecture. First of all, it’s a tremendous honour to be asked by CIFAR to give this lecture because of CIFAR’s fabulous work across many, many disciplines. But second, this is a lecture in honour of David Dodge. David exemplifies what it means to be a great public servant. He has served as Deputy Minister of Finance and of Health, Governor of the Bank of Canada, Chancellor of Queen’s University and Chairman of the Board of Directors of CIFAR.

David has always selflessly done what was needed. And I’m going to give you a taste of why that matters. Compared with the U.S., the financial crisis let Canada lightly off the hook. From 2008 to 2010, the rise in the Canadian unemployment rate was 2 percentage points. In contrast, the rise in the United States was almost double that. Instead of 2 per cent, it was 3.8 per cent. That 2-percentage-point difference is hundreds of thousands of people who, in Canada, had jobs that they wouldn’t have.

Something right was happening in Canada and David Dodge, who was the Governor of the Bank of Canada from 2001 to 2008, was a significant part of what was right. As you will see, this lecture concerns why we need heroes like David.

I’ve written a book called *Phishing for Phools* with Bob Shiller. It’s meant to be a popular book, and there are two motivations for that. The first is that we’re influenced more than we think by popular books. And the public and economists have too great an acceptance of the view that whatever markets do is right. Of course, all economists would take into account standard problems such as pollution and unequal income distribution. But that does not exhaust the reasons why competitive markets yield bad outcomes.

The book explores the notion that markets deceive us and manipulate us. We call this “phishing for phools.” Every economist I know knows this. But that leads to a second very general motivation.

The rule of what can and cannot be published in economics leaves holes. There are some perfectly valid and important things to say, but there’s no way to say them that would be acceptable in any journal. For example, quite a few economists thought that financial derivatives would lead to the current crisis. But economists could not figure out a way to express those views in the form of a paper. I believe that *Phishing for Phools* happens to
We are machines that are prone to error

be one of those holes in economics, because although we all know it, it cannot be published. And because it cannot be published in journal form, it gets ignored. And because it was ignored, we had the financial crisis, the central economic event in the history of our times. That’s what I’m going to talk about today.

But the book also has a subtext, which gradually becomes increasingly important as it proceeds. That subtext concerns a principal way in which we think. And this way in which we think results in our being phished for phools. I’ll come back to that only at the very end of the talk, but I think it’s important, and I want you to see that, too.

With these prefatory notes, let me begin with the theory. The book is based on conversations with Danny Kahneman some 25 years ago. Danny told me that the basis for psychology was that humans are machines. We are machines that are prone to error. The job of the psychologist is to ferret out that error. In contrast, he said that the fundamental notion of economics is equilibrium. That equilibrium means the following: if there’s a profit left on the table, someone will take up that opportunity for profit. We see that every time we go to the supermarket. People sequentially choose what they think is the shortest line. In equilibrium, the lines are almost the same length.

You’ve probably never wondered about why it’s hard to choose the line at the supermarket; that’s an equilibrium thing. Because everybody’s chosen previously the shortest line, it’s hard to choose since you always wonder which one it is. How do we put Danny’s insight into economics? Danny’s insight says that free markets will not just provide what we really want. That’s only the case if human machines are making the right choices.

But free markets will also provide us with wrong choices, and they will do so as long as there’s a profit to be made. Let me restate: the principle means that if we have some weakness or another in the equilibrium, that weakness will be taken up if there is a profit to be made. That means, among business persons looking around and deciding where to spend their investment dollars, some will look to see if there are unusual profits from our weaknesses. And, if they see such an opportunity to profit, that will be what they choose. As a result, economies will have what we call a “phishing equilibrium.” What is a phishing equilibrium? It is an equilibrium in which every chance for profit, more than the ordinary, will be taken up.
And that will include our willingness to make the wrong choices.

Let me give you some examples. I don’t think these things are as frequent in Canada as they are in the United States, but the first example is Cinnabon. Back in 1985, a father and son, Rich and Greg Coleman of Seattle, founded Cinnabon Inc, and they had a marketing strategy. They would open outlets that baked the world’s best cinnamon roll. Cinnabon is probably not good for your diet, because it has 880 calories. “Life needs frosting” is the Cinnabon motto. The Colemans took a great deal of effort to develop their marketing strategy. Cinnamon, which they chose carefully, is said to attract humans by its smell — just the way pheromones attract moths.

Most of us in the United States probably take it for granted that there just happens to be such an outlet right there where we’re waiting for our delayed flight or at the mall. But that’s no coincidence. All those outlets, and all that cinnamon, which undermines our diets, are a natural result of a free market equilibrium. That’s my first example.

The second example comes from a metaphor invented by Bob, who is a true genius. I would never have thought of this. Keith Chen, Venkat Lakshminarayanan and Laurie Santos, three researchers at Yale at the time, taught capuchin monkeys how to use money to trade. The monkeys developed an appreciation of price, they saved, and they did other transactions.

But let’s go beyond those experiments. Let’s do a thought experiment. Suppose we opened up the monkeys to trading with humans quite generally. We would give a large population of capuchins substantial incomes, and we would let them be customers of for-profit businesses run by humans without regulatory safeguard.

You can easily imagine that the free market system, with its taste for profits, would supply whatever the monkeys choose to buy. And we could expect an economic equilibrium with concoctions appealing to strange capuchin tastes. But amid this monkey cornucopia, their choices would be very different from what makes them happy. How do we know? We know from Chen, Lakshminarayanan and Santos that capuchins love sweet fruit roll-up tacos with marshmallow fluff. Capuchins have limited ability to resist temptations, and we have every expectation that they would become anxious, malnourished, exhausted, addicted, quarrelsome and sickened. Those are Bob’s words.
We now come to the thought point of this thought experiment. We shall see what it has to say about humans. Our view of the monkeys has analyzed their behaviour as if they have two types of what economists call “tastes.” The first type of taste is what the capuchins would exercise if they made decisions that are good for them. The second type of taste, their fruit roll-up taco taste, is what they actually exercise.

While humans are no doubt smarter than capuchins, we can view our behaviour in the same terms. We can imagine humans, like the capuchins, as having two different types of taste. The first concept of taste describes what’s really good for us, but, as in the case of the capuchins, that’s not always the basis for all of our decisions. The second concept of taste is a taste that determines how we really make our choices, and these choices may not in fact be good for us.

The distinction between the two types of taste and the example of the capuchins give us an image. We can think about our economy as if we all have monkeys on our shoulders when we go shopping or when we make economic decisions. Those monkeys are in the form of the weaknesses that have been exploited by marketers for ages. Because of those weaknesses, many of our choices differ from what we really want or, alternatively stated, they differ from what’s good for us. We’re not generally aware of that monkey on our shoulder. In the absence of some curbs on markets, we reach an economic equilibrium where the monkeys on our shoulders are substantially calling the shots.

That takes us to a further proposition. And this proposition is at the very basic fundamentals of economics. It goes back to Adam Smith and his statement that markets are basically benign, because they give us what we want. The modern rendition of Adam Smith’s “invisible hand” statement is that a competitive, free market equilibrium is what’s known as “Pareto optimal.” What does that mean? That means that once such an economy is in equilibrium, it’s impossible to improve the economic welfare of everyone. Any interference would make someone worse off.

The theory, of course, recognized some factors that might blemish such a competitive, free market equilibrium, such as pollution and bad distributions of income. But, with those qualifications, the result is believed to be true.
But with free markets, there’s not only freedom to choose. There is also freedom to phish. That actually is the problem. It is still true that the equilibrium would be optimal — it would be Pareto optimal — but it would be an equilibrium that is optimal not in terms of what we really want, but in terms of our monkey-on-our-shoulder tastes. And that, for the monkeys as for ourselves, would lead to manifold problems.

Why hasn’t this been seen until now, or why hasn’t it been seen in these general terms? Standard economics has ignored this obvious difference because most economists have thought that, for the most part, people do know what they want. That means that there’s nothing much to be gained from examining the differences between what we really want and what those monkeys on our shoulders are instead telling us.

But that ignores, when you think about it, the whole field of psychology, which is, for the most part, about the effects of those monkeys on our shoulders. It also ignores the fact that the competitive equilibrium involves people generating information that will lead us astray, insofar as it is legal and there’s a profit to be made by it. It ignores the fact that markets enable phishing for phools.

At this point, I’ve made a bold statement, and the onus is on Bob and me in the book to indicate that in real life, this equilibrium does affect our lives. We have four areas of NOBODY-COULD-POSSIBLY-WANTS, in which we have been seriously phished for phools.

The first one is personal financial insecurity. A fundamental fact of economic life has never made it into the economics textbooks. Most adults, even in rich countries, go to bed at night worried about how to pay the bills. Economists think that it’s easy for people to spend according to a budget. But we shall see later that it just isn’t. No one wants to go to bed at night worried about the bills, and yet most people do.

Area two of NOBODY-COULD-POSSIBLY-WANTS is financial and macroeconomic instability. Phishing for phools in financial markets is the leading cause of the financial crises that lead to the deepest recessions. Every time it is different: the stories are different; the entrepreneurs are different, their offerings are different. But, also, every time it is the same. There are the phishermen and there are the phools. And when the built-up stock of undiscovered phishes (named “the bezzle” by John Kenneth Galbraith)
gets discovered, asset prices crash. In the last crisis, the investment managers who had purchased the overrated securities could not possibly have wanted them.

Area three of NOBODY-COULD-POSSIBLY-WANTs is ill health. Here we discuss how the pharmaceuticals do their phishing and how the “phood” industry fills us with sugar, salt and fat. I’ll give you one example. In its five-year career, Vioxx is estimated to cause 26,000 to 56,000 cardiovascular deaths in the United States alone. No one wants bad medicine. About 69 per cent of American adults are overweight — that’s Cinnabons again. And more than half of them, 35 per cent, are furthermore obese. Yet nobody wants to be obese. And then there is tobacco…

Area four of NOBODY-COULD-POSSIBLY-WANTs is bad government. Just as free markets work at least tolerably well under ideal conditions, so does democracy. Politics is vulnerable to the simplest phish, which we see especially in the United States, whereby politicians silently gather money from the interests and use that money to show that they are just one of the folks.

Our later chapter describes what we think is probably a pretty typical campaign, a campaign by Charles Grassley of Iowa. Grassley, in order to win, gathered a multimillion-dollar war chest and then showered the state with the most beautiful TV ads you’ve ever seen where he’s just “one of us” back home. He rides his tractor lawnmower around, and Iowa grass is unbelievably beautiful. You see these emerging ellipses of grass, of cut grass, and he’s saying: “Grassley, Grassley, I like my job in Washington, but what I really like is to come home and be just like one of you and mow my lawn.” Almost no one wants a democracy where elections have to be bought in this way.

That’s the introduction to the book. I only have time to give you the taste of one chapter.

Suze Orman is a popular U.S. TV figure. She gives very loud and shrill financial advice. But the curious thing is that her audience seems to adore her and lap up her every word. When I asked an economist friend about her, he had the predictable reaction. He had watched her for only 10 seconds and could not stand her “Mommy-knows-best” voice. Furthermore, he found her investment advice simplistic. But that does not explain why Orman’s audiences are lapping her up.
Her most popular book is *The 9 Steps to Financial Freedom: Practical and Spiritual Steps So You Can Stop Worrying*. Let’s contrast what she tells us there with a portrait given of consumer spending in the economics textbooks. According to the textbooks, we decide on our demand for the proverbial apples and oranges by having a budget for our spending. Then we choose the combination of apples and oranges that we can buy that maximizes our happiness. That’s the way economics is taught.

But Suze Orman’s financial advice books tell us that consumers do not follow such a textbook protocol in their purchases. How could consumers do anything other than what the textbooks describe? I’m an economist, and I probably actually do somewhat act that way. But Orman tells us that people have emotional hang-ups with regard to money and to spending it. She says they’re not honest with themselves and, as a consequence, they do not engage in rational budgeting. How could she know? She’s a financial advisor, and she has a test.

What she does is ask her advisees to add up their expenditures. They’re coming to her because they’re in trouble. Of course they’re going to do their best at it. But when they add up those expenditures, they all but invariably fall short of what a documented accounting from the record later shows up. Figuratively, relative to the proverbial trip to the supermarket to buy apples and oranges, it’s as if her advisees are spending too much in the fruit section and, by the time they reach dairy products, there’s nothing left over for the eggs and milk.

In real life, such budgetary failure translates into having nothing left over for savings. This failure to deal cognitively and emotionally with money, says Orman, leads to those unpaid bills. It’s her mission to keep those bills down so that her readers and her clients will no longer worry at night. That’s the role of Mommy and why those audiences are excusing that “Mommy-knows-best” voice.

And it’s also worrying — and this is worth noting more than parenthetically — that worries, as noted in Orman’s subtitle, are central concerns of the financial advice books. But you do not find them in books on economics. I’ve looked in many indexes, and I’ve never found this word “worries.” We can paint a statistical portrait that shows that this is a serious concern. This poses a problem. The Suze Orman view of the world suggests that people are spending too much and they are worried as a result.
That leads to the question of why. There’s another perspective. What’s the reason for it?

In the United States and Canada and everywhere else, the goal of almost every business person is to get you to spend your money. Life in a capitalist economy is a continual temptation. Think about it. Walk down a city street like King Street. The shop windows are literally there to make you come in and buy.

In the old days, in the United States, pet shops in nice suburban neighborhoods placed puppies in the window, and there was even a popular song about it. The singer Patty Page was coming down the street. She sees such a puppy and bursts into song. Her song is: “How much is that doggie in the window?/The one with the waggly tail/How much is that doggie in the window?/I do hope that doggie’s for sale.”

I think some people know the first verse. But probably almost nobody here knows the next verse. The next verse says: “I must take a trip to California/And leave my poor sweetheart alone/If he has a dog, he won’t be lonesome/And the doggie will have a good home.”

That second verse is the point of our whole book. Markets have a good side and give us this wonderful cornucopia, but they also have this bad side. Think about that song and what it means. You have this young woman, and she’s going in to buy this doggie and give it to her boyfriend, and then she’s leaving for California.

Every time that doggie wags its tail, the boyfriend’s going to think of her. This could be the best thing that ever happened to that boyfriend. They had this wonderful romance, and she has to leave for California. We don’t know for what reason. He’s going to have this reminder of this wonderful thing. That’s one possibility.

But there’s another possibility: there’s a scatterbrained young woman; the romance has been utterly disastrous; she’s going to buy this puppy; the boyfriend is there having to take care of it in the middle of the night and all the other times. Every time that doggie wags his tail, he thinks about this romance and girlfriend and how terrible everything is. But that’s exactly the point. This doggie for sale, this ad, and this puppy in the window may induce her to do something that’s utterly wonderful on the one side. But
there’s also a downside. It may get her to do something that’s a curse for this poor young man who’s waiting at home.

That’s the point of our whole book. You get the good side and you get the bad side. In the shopping mall, one does not literally walk down the street looking in the windows, but temptation is there asking you to buy. In the supermarket, the temptation is there on either side of the aisle. These invitations attempt to lure us. They simply are pervasive. The idea of tempting the consumer to buy, to spend her money, is at the very heart of free market capitalism.

I’ve given you a taste of what this book’s all about. There’s a lot more. I’ll give you some idea of the chapters I haven’t covered here: the financial crisis, the role of advertising, buying cars and housing, credit cards, lobbying and politics, food and drugs, inventions, tobacco and alcohol, more on the looting of the S & Ls and the financial crisis, and then the conclusion and where it fits.

What I’ve done is describe the very beginning of the book. Importantly, what emerges is a new concept. The book gives a picture of perhaps the major reason regarding why and how we’re phished for phools. That introduces a new variable into economics, which is the stories that people are telling themselves when they make their decisions.

Almost all of us, when we make our decisions, are embedding ourselves in a story. Think about us here today. We’re here at this wonderful lunch for David Dodge, and we’re part of the CIFAR story. Each and every one of us has his or her story as to what we’re doing here at this lunch. As soon as we leave here, we’re going to have other business, and we’re going to change our story.

But the decisions we make depend upon the stories that we’re telling ourselves — a new variable that changes both how we think about economics and economic policy. A great deal of economic policy is about the stories that we’re telling ourselves. The work of the politician is to tell a story as to what that politician is or does and why they’re doing it.

We saw this in rudimentary form in the Orman example, because Sue and Tim, when they go to the supermarket, are telling themselves a very different story than what’s imposed on them by standard economics. And that’s why they’re going to bed worried at night.
In the concluding chapter, we tell how a wrong U.S. national story has resulted in systematic bad policy. This is also a book about morals. And, of course, this social science part of CIFAR is also about morals, because exploration of this downside to free markets shows that pure self-interest leads to many poor outcomes.

One result of that, which I started with at the beginning and with which I’m going to end, is that we need heroes. I began with describing one of those heroes: David. And I end with my thanks for him, for everything that he has done, and also my thanks for who David Dodge is, the person that he is. Thank you very much. And thank you, David.