Welcome, Mr. President. We have some advice. 
Fifteen of the world’s leading thinkers share their ideas. 

Plus: 
The price of tax evasion
How to convince teens to eat healthy foods
“Whether it’s a Russian oligarch or some Asian dictator—it’s like they are all going to the same hairdresser.”
Another seemingly interminable circus of a US presidential election is finally over. Now the interlude before the real challenge of governing a divided country begins.

On that front, we have some ideas. Several months before the election, we asked some of the brightest thinkers in the United States—experts in monetary policy, behavioral science, economics, accounting, and political science—for a single piece of advice for the next president. We received responses from Nobel laureates, former policy makers, and even some academics unsullied by government.

To the incoming resident of 1600 Pennsylvania Avenue: we know you have a lot on your plate, but this collective wisdom is worth reading and considering. Take the tax code—where do you start to fix such a complex beast? Our advisors have thoughts on that. They offer ideas to bring back to the US billions of dollars of corporate cash sitting overseas.

Nobel laureate Roger Myerson has advice on fighting terrorism by taking out our enemies without creating more of them. His fellow Nobelist Eugene F. Fama offers a thought on how to govern corporate America: avoid moral hazard and let failing companies fail.

The campaign was vague on details. Our advice gets down to practicalities. In response to street violence, behavioral scientist Anuj Shah advocates antiviolence programming, based on cognitive behavioral therapy, that his studies suggest cuts arrests for violent crimes in half—and that can be rolled out nationwide for just 1 percent of the total amount the US is currently spending on criminal justice.

Online, you can get more advice, and hear directly from those offering it, in a series of videos on Review.ChicagoBooth.edu. To all our readers, we want to hear what advice you would offer the president. And we invite all of you (including the president) to sign up online for our regular emails and updates. We can promise you lots more interesting ideas, now and long after the inauguration.
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**Feedback**

**The Equation**

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Movie theaters are dueling with text messages to poach each other’s customers
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Ayelet Fishbach, Jeffrey Breakenridge Keller Professor of Behavioral Science and Marketing, has spent more than 15 years researching how people make decisions and what motivates them. She has published dozens of scholarly articles, and her work has been covered widely by the mainstream press, including the New York Times and the Wall Street Journal. (Page 10)

Margarita Tsoutsoura, associate professor of finance and Charles E. Merrill Scholar, took advantage of how banks in Greece underwrite loans to estimate the magnitude of Greek tax evasion and understand how it varies across industries. Tsoutsoura and her collaborators received the 2013 Wharton School-WRDS Best Paper Award in Empirical Finance for their research. Tsoutsoura, whose other research interests include corporate finance, has taught at Chicago Booth since 2010. (Page 38)
American companies are thinking long term
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Lending market’s future: Which model will lead the way?

The two faces of the common market
By Arthur A. Shenfield

What economists think about admitting highly skilled immigrants
The IGM Panel

Canice Prendergast, W. Allen Wallis
Professor of Economics, has had his work about improving the functioning of food banks featured in Slate and the New York Times, among other outlets. In this issue, he dissect the unorthodox economic theory behind that research. Prendergast also curates Booth’s contemporary art collection. (Page 44)

James E. Schrager, clinical professor of entrepreneurship and strategic management, studies the use of strategy by executives and venture-capital partners. An active advisor to boards and CEOs, he uses some of his experiences to explain why it’s important for a start-up to recognize its “pivot point.” (Page 72)
WE WELCOME LETTERS

We welcome your comments. Send email to Review@ChicagoBooth.edu or send letters addressed to Chicago Booth Review at any of the following addresses:

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PLAYSTATION AND THE LABOR MARKET

In response to ‘Video killed the radio star’ by Erik Hurst (Fall 2016)

Video games are everywhere except in the productivity stats . . .

(seriously, I think this is scary).

–Nico Lacetera, Toronto, Ontario

Compare cost of homeownership—what is there to aspire to?

–Mark Goodfellow, West Midlands, United Kingdom

Who else was humming the tune as they read the title (or singing out loud like me)?

–Danusia Jolliffe, Surrey, United Kingdom

Worrying and, I fear, highly accurate article.

–Robert Annett, London

Thank God the E. T. Atari game sucked so badly or I’d likely be living under a bridge somewhere.

–Andy Waldron, Woodstock, Georgia

There is no inherent reason to find this terrifying. There is no inherent reason to find this terrifying.

–Justin Hendrix, New York

Technology is making leisure more attractive than work. The implications are disturbing.

–Rahul Jain, Uttar Pradesh, India

Interesting. Good thing no one looks at the effect of women buying #yarn. Sure, you’ve got jokes, but no studies . . .

–Shelley Miller, Memphis, Tennessee

Video games, iPhones, Facebook, and craft IPA made subsidized leisure more fun than taxed work.

–Alan Reynolds, Reston, Virginia

Technology is making leisure more attractive than work. The implications are disturbing.

–Rahul Jain, Uttar Pradesh, India

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–Shelley Miller, Memphis, Tennessee

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–Andy Waldron, Woodstock, Georgia

Young guys in basements. Old guys doing NYT crossword. Or in rocking chairs on deck.

–Mark O’Friel, New York

There is no inherent reason to find this terrifying. There is no inherent reason to find this terrifying.

–Justin Hendrix, New York

Video games, iPhones, Facebook, and craft IPA made subsidized leisure more fun than taxed work.

–Alan Reynolds, Reston, Virginia
WHO WON THE DEBATE?

In response to The Big Question, ‘Are markets efficient?’ (Posted online, June 2016)

Love watching these gentlemen respectfully discuss different views.
—Mark Gaffin, Washington, DC

Debating Fama is like bringing a knife to a gunfight. He owns this subject matter.
—Rick Ericson, Chicago

Are markets efficient? No. Never. No one ever has all the information. Is marriage efficient? No. No one ever tells their spouse everything and most people cheat and lie.
—Jack Goldman

SCIENCE SCORES!

In response to ‘A winning football team can improve a university’s science research’ (Published online, August 2016)

I would retweet this 1 million times for the “science funding has no ROI” people. Because this and so many other metrics tell a different story.
—Samar Kaukab, Chicago

Editors’ note: See this article in chart form on page 12 of this issue.

SHOULD THE US ALLOW IN MORE SCIENTISTS?

In response to ‘What economists think about admitting highly skilled immigrants’ (Published online, September 2016)

More labor in a market will increase income?
—Dale Jackson, Huntsville, Alabama

Frankly, we need them. Too many Americans are not going into STEM fields, which is problematic for our economy. We cannot support the economy if we do not the workforce that can meet the current needs of these fields, since many of these fields are vital to our economic and national interests. We don’t have much of a choice until we start producing enough qualified graduates domestically.
—Mark Oakley, Bentonville, Arkansas

Editors’ note: To read more about this topic, please see “What economists think about admitting highly skilled immigrants” on page 82 of this issue.
Learn how research is shaping business, policy, and markets.

May 18, 2017
Washington, DC

Nudges in practice

Richard H. Thaler, Charles R. Walgreen Distinguished Service Professor of Behavioral Science and Economics, Chicago Booth

May 24, 2017
Boston

Optimizing drug trials and medical treatment

John R. Birge, Jerry W. and Carol L. Levin Distinguished Service Professor of Operations Management, Chicago Booth

For more details, email Review@ChicagoBooth.edu or call 773-834-5863.
Slow-motion video makes juries more likely to convict

John Lewis was convicted of fatally shooting a police officer in a Philadelphia Dunkin’ Donuts in 2007. On appeal, his attorney argued that the jury had been swayed by the repeated slow-motion replay of the shooting, which gave them the impression of intent where there had only been reflex.

The appellate court rejected this rationale, but science suggests Lewis’s attorney had a point. We read more intent into a person’s actions when we see them in slow motion, according to research by Chicago Booth’s Eugene M. Caruso, University of San Francisco’s Zachary C. Burns, and University of Virginia’s Benjamin A. Converse.

“We first noticed the phenomenon in sports replays,” says Caruso. “Often a replay shown of something like a collision would seem worse in slow motion than it did in real time. We
As video slows, viewers’ perception can change

After watching video of a robbery that ended with a shooting, study participants assessed the shooter’s intentions.

How much time did the person with the gun have to assess the situation before he fired?

- Viewed at regular speed
- Viewed in slow motion

To what extent was the action willful, deliberate, and with premeditated intent to kill?

Did the person with the gun shoot with the intention to kill?

Source: Caruso et al., 2016

realized that any systematic bias that slow motion may introduce could have implications for the use of video evidence in courtrooms.”

The researchers ran a number of experiments to investigate the effect. In one study, participants watched video of a robbery that ended in a shooting. Some watched the video at regular speed, but those who watched the slow-motion version were more likely to feel that the perpetrator acted intentionally rather than reflexively.

Caruso, Burns, and Converse extrapolated the findings to see how this inclination might correspond to jury decisions. In 1,000 simulations of 12-person juries, “slow motion video quadrupled the odds that jurors would begin the deliberation phase ready to convict,” they write. Had jurors watched the video at regular speed, 39 juries would have unanimously decided to convict. But had they watched the slow-motion video, 150 juries would have made that decision, the researchers estimate.

Even when participants were told how much time had elapsed in the video, they still sensed more intent when the video was shown in slow motion. The effect attenuated, but not completely. “This reminder did not eliminate the difference in how much time participants felt the actor had,” says Caruso. “Slow-motion viewers still felt the actor had more time to act, and these perceptions translated into greater judgments of intent among slow-motion viewers—even when they knew how much time actually passed.”

Of course, video can help juries determine a timeline of events, such as when someone reached for a gun. But jurors can never be completely sure of a person’s intentions. If a jury considers video to be particularly objective, “its biasing potential may be especially pernicious,” the researchers write.—Alice G. Walton


Brexit explained:
How witch hunts create community

Chicago Booth’s Ronald S. Burt, speaking in London

“Right now, London is the hub of the world. You won’t be with Brexit. . . . People are lining up to eat your lunch.”

“The more closed the network, the more the network is like an echo chamber and people will tell you the same thing back, again and again, so that you get these extreme, polarized opinions. This is how a group can maintain a very negative opinion about a corporation and the group right next door has a very positive opinion.”
In a crisis, companies opt for shorter-term bonds

Companies actively manage their debt-maturity structure by strategically refinancing and rolling over debt. A model by Chicago Booth’s Zhiguo He and Northwestern’s Konstantin Milbradt explains the dynamics behind what many observed in the 2007-10 financial crisis: when times get tough, companies are more likely to take on shorter-term debt.

Say a company holds a lot of long-term bonds that are about to mature. It could shorten its debt-maturity structure by replacing its long-term bonds with short-term ones. Or it could lengthen its structure by refinancing.

Just like a homeowner, a company may refinance when conditions are good and rates are low. But when a company is struggling and conditions are deteriorating, it may pay more for long-term debt and take a rollover loss when refinancing.

To explain the dynamics, the researchers created a model based on a widely used framework developed in the 1990s by University of California, Berkeley’s Hayne Leland. Under that framework, when cash flow drops, companies are more likely to default. But He and Milbradt argue that a company’s debt-maturity structure is relevant to the decision of whether and when to default. In 2007 and 2008, financial firms shortened their debt maturities as the subprime-mortgage market was worsening. “If default was going to occur in the near term anyway, then bond holders gained significantly by taking possession of the collateral sooner,” write He and Milbradt.

The shorter maturity structure could help a company pretty itself up for a quick sale. It could also cause the company to default sooner, increasing the amount bondholders are able to recover. “The earlier the default, the higher the defaulting cash-flows, the higher the debt recovery value,” the researchers write.

Their model suggests that with worsening economic conditions, companies that already have short debt-maturity structures are likely to shorten them further.—Natasha Gural

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

“A GUIDE FOR MORE ACCURATE FINANCIAL REPORTING

THE ACCOUNTING profession has been gripped for decades by the debate between advocates of a regime based on rules and those who prefer principles. But according to Chicago Booth’s Pingyang Gao and Haresh Sapra and New York University’s Hao Xue, the best system would combine the two approaches.

The researchers constructed a model with an auditor, a standard setter, and investors. The model incorporates two contentious issues: managerial interference and illegal side payments.

Gao, Sapra, and Xue contend that the standard should rely more on principles when the auditor’s independence is harder to compromise, as well as when it’s costly for managers to tamper with evidence they give to the auditor. When evidence about company financial statements is weak, auditors should adopt rules-based standards to avoid manipulation by management. And in each case, standard setters should assess the strength of the evidence, and see if their professional judgment produces a decision that aligns with a rules-based approach.

—Alex Verkhivker


Go to Review.ChicagoBooth.edu to read more about this research.

“Mobbing is when people find community in the abuse of [some others]. It could be they wear something strange. It doesn’t matter what they do. In the common denunciation of this ‘witch,’ we find community.”

“The AfD in Germany, the National Front. Nationalistic organizations [say] there are enemies out there who threaten us. People sharing that story can come together . . . You don’t see it in the areas where people are cosmopolitan. You see it in areas where people are relatively cut off and need that feeling of community.”

“You can see the places where Brexit happened is where people live in these dense little communities. They’re cut off from the outside.”
Charities: Get donors to give a piece of themselves

If you’re raising support for a cause, try to get potential donors to feel that they’re giving something of themselves, suggests research by Minjung Koo of Sungkyunkwan University in South Korea and Chicago Booth’s Ayelet Fishbach.

“People who give something that represents their essence—for example, an item they owned for a while versus only briefly—feel more committed to the cause and believe they are more generous,” says Fishbach.

Fishbach and Koo tested this in five donation studies. In one, they gave each participant (a college student) a pen in return for filling out a survey. They then asked whether the student would donate the pen to a charity that provided pens for kids in Kenya and Sri Lanka. Students told at the beginning of the study that they could keep the pens, who therefore felt ownership longer, felt more generous and more committed to the charity to which they donated the pens than those who owned the pens for the shorter period.

A similar sentiment was displayed when people were asked to either sign a petition with their names or support it anonymously. Those who signed said they felt more generous and would be more committed to the cause in the future.

In another study, participants were asked to consider donating money or blood to the World Health Organization to help mothers who lost blood in childbirth. The researchers first asked them to list the amount of money they would donate that would equate to a blood donation, and then consider giving either that listed amount or blood. People who considered donating blood said they felt more invested than those who considered donating money.

“People report it’s actually easier to give blood than their listed amount of money,” says Fishbach. Yet they felt more committed and generous donating blood rather than their equivalent amount of money. Nonmonetary donations, such as blood, may cost donors less financially and better generate long-term commitment from supporters.

“This study has clear implications for organizations that solicit charitable giving: they should encourage self-giving,” Fishbach says. For example, while labeling a donation with a person’s name could appear as bragging (compared with anonymous giving), “it’s people’s way of connecting to a cause, and it’s important for long-term involvement. Those who gave the self were more likely to give again.”—Alice G. Walton


For more on this topic, read “Beyond the Ice Bucket Challenge,” Winter 2014/15.
Why markets need not fear uncertainty

Here’s a chicken-or-egg finance question: Do volatility shocks in equities markets cause business-cycle downturns, or do business-cycle downturns manifest as highly volatile stock prices?

Research by Chicago Booth’s Stefano Giglio and Northwestern’s Ian Dew-Becker and David Berger suggests that volatility is evidence of contractionary economic conditions already in place.

The study covers two types of volatility: realized and expected. Realized volatility is manifest in stock prices, and measures how much prices move around each month. Expected volatility, as measured by options prices, reflects what market participants expect the market’s realized volatility to be in future months. When expected volatility is high or rising, investors expect uncertain times in the future. In these cases, it could be that investors cause downturns through their expectations of volatility—some have argued that fear and uncertainty themselves can cause the economy to contract. For example, companies may delay making investments in times of high uncertainty.

If that were to happen, changes in expected volatility could actively cause economic downturns.

This, however, seems not to be the case, according to the researchers. Volatility does not lead to contractions; rather, contractions cause volatility. “The evidence we present favors the view that bad times are volatile times, not that volatility causes bad times,” they write.

The study focuses on S&P 500 index options, with rolling six-month measurements of expected equity-market volatility beginning in 1983.

Investors generally price options based on measurements of expected future volatility. Movements in the price of underlying equities, meanwhile, reflect current volatility.

What the study finds, which is at odds with the standard view described above, is that increases in expected volatility actually have no measurable effect on the real economy, after controlling for current volatility. In other words, increases in uncertainty have not historically been associated with future downturns—so fear itself is nothing to fear.

The findings call into question common explanations about uncertainty causing, rather than reflecting, poor economic performance. —Michael Maiello


HOW MUCH CAPITAL IS ENOUGH?

“There’s a big, complicated [regulatory] description of what’s adequate capital, and it’s expressed entirely in terms of book capital. It doesn’t have anything to do with market values of capital. It has to do with the book value of capital. If you have taken even a little bit of accounting, you know those two things are not the same. They are not designed to be the same. To the extent that the book measures of capital and book measures of asset value can be manipulated strategically, this is a difficult basis on which to found your regulatory rules.”

—Mark J. Flannery, director and chief economist of the US Securities and Exchange Commission’s Division of Economic and Risk Analysis, speaking at the Fama-Miller Center for Research in Finance in October.
A winning football team can improve a university’s science research

To study the impact of research expenditure on scientific productivity, Harvard’s Haris Tabakovic and Chicago Booth’s Thomas Wollmann look to an unlikely source: college football. A winning team, they find, predictably sells more tickets and attracts more donations, and some of that money turns into funding for scientific research. They looked at 40 teams ranked in the Associated Press’s Top 25 football poll from 1987 to 2011 to see how movement in the polls affected universities’ fundraising prospects the following year.

More government debt can make bonds a safer investment

Harvard’s Carmen Reinhart and Kenneth Rogoff famously argued in the American Economic Review that rising debt would hurt economic growth—and politicians worldwide used the argument to justify austerity measures.

But research by Chicago Booth’s Zhiguo He, Stanford’s Arvind Krishnamurthy, and Northwestern’s Konstantin Milbradt indicates that a higher level of debt can make government bonds a safer investment.

In periods marred by financial turmoil, investors and even central banks worldwide pile into government-debt securities, particularly those issued by the United States and Germany. These safe assets serve as collateral in financial transactions, provide a reliable store of value, and perform even better when markets get jittery—features that are all enjoyed by US Treasuries.

He, Krishnamurthy, and Milbradt take a step back and ask what makes government debt a safe investment vehicle, and pose a broader question: What makes an asset safe?

The researchers consider two countries that each issue government bonds but differ in the amount of debt they issue as well as in the soundness of their bonds. “We can think of the large country as the US and the small country as Canada,” they write.

The appeal of safe assets

US government debt is the world’s premier safe asset, the researchers say, while Germany holds a similar status within Europe. During times of turmoil, the values of US and German bonds rise as central banks and other investors search for quality.

A bond becomes safe if other investors think that bond is safe and therefore invest in it. The analysis reveals a number of attributes that determine the safety of an asset, including the ability of each country to service its debt, and the risk associated with refinancing debt.

Interestingly, the model suggests that the country issuing a larger absolute amount of debt tends to earn a safety premium. Even when all investors coordinate and put their savings into one country’s debt, the country that is issuing a larger amount of debt is able to offer a higher rate of return. The US, for example, has a deep financial market of Treasuries that is better able than that of other countries to meet the coordinated demand for a safe asset. Of course, a country with more debt also takes on more rollover risk.

In a global savings glut, “US government debt is likely to continue to be the safe asset,” the researchers write, adding two caveats. First, US debt would be less attractive if US fundamentals were to deteriorate significantly relative to other countries. Second, if another country were to issue a larger amount of debt, that could cause the country’s bonds to become the dominant safe asset.—Alex Verkhivker


Keeping your spouse happy makes you healthier

If you’re married, keeping your spouse happy may have a selfish benefit: it will boost your own health. Research by William J. Chopik at Michigan State University and Chicago Booth’s Ed O’Brien finds that having a happier spouse is linked to better health in oneself, and this seems to be completely independent of how happy or unhappy one is.

A number of previous studies have linked a person’s own happiness to health and longevity, but the researchers wondered if being around “happy others” might have a similar effect. To test the theory, Chopik and O’Brien assessed the health and happiness of nearly 2,000 couples, ages 50 to 94, over a period of six years. Both partners rated their individual happiness and life satisfaction, and answered questions about their personal physical health, including their activity level and any chronic health problems.

The happiness of a person’s spouse was strongly linked to how healthy the individual was. And this seemed to work for both partners. Even more, the effects of a partner’s happiness on a person’s health were independent of the individual’s own happiness level. “The current study demonstrates that happy partners seem to substitute as proxies for a happy self,” write Chopik and O’Brien.

Spousal happiness may one day become another health marker. “It suggests a novel way to potentially detect and therefore treat declining health in an individual,” says O’Brien. “An unhappy spouse might hint at health problems in oneself.”—Alice G. Walton

WHY INVESTORS SHOULD BUY MORE OF THAT RISKY STOCK

MOST INVESTORS understand that there are different types of risk in an equity portfolio. The most severe, default risk, is that a company will go bankrupt and the value of the equity will fall to zero. A less extreme risk, market risk, is that a stock's price fluctuations will become unacceptably wide.

These risks are interrelated in any portfolio. When a stock is in danger of default, its market risk may also increase, and this may affect the volatility of other holdings.

Investors might think that the best solution would be to sell the stock with both default and market risk, and split the remaining capital between a safe money market account and an investment that is not in danger of default.

A better strategy might actually be the complete opposite, according to research by Chicago Booth’s John R. Birge, University of Science and Technology of China’s Lijun Bo, and Columbia’s Agostino Capponi.

The researchers propose that in this case the best approach would be to allocate money to the investment that will reduce overall risk to the portfolio the most. In all but the most extreme cases, this means continuing to allocate capital to the riskier investment—because a small improvement in the conditions for the riskier investment will have the largest effect on reducing risk in the portfolio overall, and the premiums earned from the risky investments will have the effect of maximizing returns.—Erik Kobayashi-Solomon


When winning $200 can feel great, or less so

S uppose that your friend visited a casino. It was a lucky trip—she won $200 at the end of the weekend. But did she win $300, and then lose $100? Or did she win $600, and then lose $400? The answer affects how she feels about her experience, even though her ultimate winnings were the same, research suggests. And understanding why could help people present trade-offs strategically, to nudge others in specific directions.

Chicago Booth’s Abigail Sussman asked study participants to imagine they had been gambling. When they won money overall, they consistently felt better about cases in which the amounts they had supposedly won and lost were smaller in magnitude, even if larger amounts added up to the same amount in the end.

This preference reversed when the gambler was unlucky. When participants instead lost money after the gambling weekend, they

Seeking to slow credit, China instead created a boom

W hen China implemented a new banking rule in 2008, officials believed that would slow the credit market. Instead, credit soared.

Chicago Booth’s Kinda Hachem and Zheng Michael Song of the Chinese University of Hong Kong have an explanation for what happened. They argue that the rules change led small Chinese banks to engage in “shadow” banking, which affected lending and the interbank loan markets.

1. Regulation hurts small banks

The Chinese banking system differs somewhat from that of Western countries. Chinese banks have traditionally faced binding ceilings on the returns they can offer depositors. This benefits banks with deeply entrenched retail networks, particularly the four banks established by the government after the Cultural Revolution. Small banks, unable to use higher interest rates to entice deposits away from larger competitors, resort to lending more aggressively.

In 2008, China began enforcing a rule that mandates banks keep at least 25 percent of deposits on hand as reserves. But that hurt small banks, which often loan as much as 90 percent of deposits. And according to Hachem and Song, those small banks turned to shadow banking.
felt better if they had won and lost larger amounts.

Organizations may be able to use this quirk of human cognition to nudge their customers and stakeholders into making decisions that are more closely aligned with their stated aims, Sussman suggests, indicating that each individual piece of information presented is likely to have an impact. For example, an online dieting site that helps customers count calories may show that a person consumed 3,000 calories in a day and burned 2,800—or could show that a person consumed 200 calories more than he burned. Sussman’s research suggests that when a dieter sees the consumed calories along with those burned, he is more likely to focus on the high-magnitude positive impact of having burned 2,800 calories than on the fact that he was 200 calories short of his goal of weight loss. To better focus him on the end result, Sussman suggests presenting the numbers instead as a single figure of net calories burned.—Erik Kobayashi-Solomon


It’s the journey, not just the outcome
Exploring situations that each ended with the same result, researchers find that a gambler’s ups and downs affected participants’ perception of the experience.

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2. Small banks create a workaround
The banks offered off-book “wealth management products” whose returns topped the ceiling on traditional deposits. They didn’t explicitly guarantee returns, but they told customers to expect a certain percentage—and they achieved these returns by loaning customers’ money to trusts. The products attracted more customer business, which created more liquidity that the banks used to arrange more loans.

“The bank-trust cooperation just described constitutes shadow banking: it achieves the same type of credit intermediation as a regular bank without appearing on a regulated balance sheet. It also achieves the same type of maturity transformation as a regular bank, with long-term assets financed by short-term liabilities,” the researchers write.

3. Large banks strike back
The four largest banks responded to the competitive threat by holding funds back from the interbank market, where small banks often turn for overnight loans to meet liquidity needs. The large banks subsequently hiked interest rates on the interbank market, creating instability to force small banks to keep more cash on hand and scale back their fast-growing shadow banking. But because big banks then made less money on the interbank market, they issued more loans of their own to compensate for the lost income.

The end result: a credit boom, and a tighter, more volatile interbank market because of, not in spite of, higher liquidity standards.—Brian Wallheimer

What does economics have to do with seat belts? You’re referring to my 1975 paper, which argued that because seat belts reduce the likelihood that drivers are harmed if they crash, they encourage more reckless driving.

So do seat belts lead to more accidents? I asked my research assistant at the time to statistically estimate the counterfactual scenario—what the death rate would be in the absence of seat belts—so we could compare it to the actual death rate and find the benefit of the regulation. He couldn’t find any benefit. Upon further investigation we found that the regulation had provoked an offsetting behavioral response. When we held other factors constant, the 1966 regulations [the first set of US auto safety regulations, which required that all vehicles be fitted with seat belts and other safety devices] caused more accidents; but the accidents tended to be less harmful, so the net number of driver fatalities was unaffected.

Subsequently, scholars have questioned your findings. Do you stand by the results? If an undergraduate handed in the seat-belt research nowadays as a term paper, I would ask her to redo it. It was a primitive piece of work; but it came up with a provocative answer to a well-posed question. My critics don’t quarrel with the basic theory of an offsetting response. There is a continuing debate about the magnitude of this response in specific cases.

Should we scrap seat belts? I never say you shouldn’t wear a seat belt. People have taken me to be anti-seat belt. That’s ridiculous. It’s a complete misunderstanding of what I was trying to do. Regulation in its essence tells you and me that we can’t do what we otherwise would want to do; but it doesn’t take the basic incentive away. So you have to understand that one effect of any regulation is going to be offsetting behavior of some kind.

Sam Peltzman thinks you should belt up

Ralph and Dorothy Keller Distinguished Service Professor of Economics Emeritus at Chicago Booth
How business leaders, policy makers, and market watchers keep up to date on the latest research.

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How business leaders, policy makers, and market watchers keep up to date on the latest research.
If you want your kids to eat healthy food, don’t tell them how nutritious it is. Instead, tell them healthy food will stick it to the man.

Chicago Booth’s Christopher J. Bryan, along with a team of researchers, used a group of eighth graders to explore the idea that rebellion and the pursuit of social justice—both natural inclinations in most teens—can be harnessed and used for good. They find that kids will eat healthy foods to rebel against Big Food companies.

The researchers had one group of eighth graders at a rural Texas middle school read standard health-class material—including tips on reading nutrition labels and the health benefits of eating well.

Another group read that Big Food companies spend millions to maximize the addictiveness of their foods, deceive customers into believing their food is healthier than it really is, and specifically target young children and the poor with marketing for the unhealthiest foods. “We cast the executives behind food marketing as controlling adult authority figures and framed the avoidance of junk food as a way to rebel against their control,” write Bryan and his co-researchers.

The next day the school principal asked students to choose snacks for an upcoming school celebration. The kids who’d read the “stick it to the man” material chose more healthy foods—fruits, carrots, or nuts—over junk food and were more likely to choose water over sugary drinks.

The differences weren’t huge but were significant. The researchers calculate that if these choices were sustained over the long run, they would equate to about a pound of fat lost per person every six to eight weeks. A sustained change of anywhere near this magnitude would put a big dent in the obesity crisis.

“If teenagers aren’t particularly motivated by long-term health,” says Bryan. “So, instead of trying to get them to care about something they don’t care about, we framed our appeal in terms of values teens do care about: they want to assert their autonomy from adults and they care about social justice. If they’re able to see healthy eating as a way to live up to those values, it’ll feel motivating and important to them.”

Alice G. Walton


**KEY INSIGHT**

**BAD CREDIT ISN’T BAD FOR YOUR RÉSUMÉ**

A bad credit report may be foreboding for your borrowing prospects, but it’s less so for your job prospects, according to research by Princeton University’s Will Dobbie, Federal Reserve Bank of New York’s Paul Goldsmith-Pinkham, Chicago Booth’s Neale Mahoney, and the US Social Security Administration’s Jae Song. The researchers set out to identify the financial- and labor-market effects of the removal of a bankruptcy flag from a credit report. They find that when bankruptcy disappears from a credit report, the removal is likely to correspond to an economically significant increase in credit limits and mortgage debt, but have no impact on employment or earnings.

Plight of border counties
Research suggests areas that rely on interstate business suffered in the wake of a 1 percent rise in a state’s taxes and spending.

WHEN THE STATE of Illinois raised taxes in 2011, neighboring state Indiana put up gleeful billboard advertisements to attract business. “Illinoyed by higher taxes?” the ads asked. “Come to Indiana, a state that works.”

But research findings have some bad news for Indiana and elsewhere: rising taxes and spending in one state can have substantial negative effects on people in neighboring states, suggests a study by Chicago Booth’s Sam Peltzman.

The results add weight to the view that when state and local governments increase spending and taxes, there are negative consequences for the economies of border areas, Peltzman says. That’s true for border counties within a state that raises taxes, and about half the effect spills over to counties on the other side of the border, he finds.

Peltzman examined economies in neighboring states from 1975 to 2012. He measured employment levels, wages, and the number of businesses established after tax and spending policies were implemented.

He studied how fiscal-expansion policies affected the counties individually—and he looked at what happened when a simultaneous fiscal expansion occurred on both sides of a state border. The data consistently suggest that the economy of a border county shrank when its state’s taxes and spending increased, and local economies also shrank when the state on the other side of the border raised taxes at the same time.

The findings tend to support the argument “that larger state and local government is purchased at the cost of a smaller private sector,” Peltzman writes. He suggests that further research will identify what types of taxes and spending matter the most and which industries and other groups are hardest hit.

—Ed Robinson


Go to Review.ChicagoBooth.edu to read more about this research.

How history shapes the outcomes of market reform

The European Union enacted a series of regulations in the early 2000s to improve the financial markets of member states. While the new regulations were the same across the EU, member countries implemented, supervised, and enforced the new rules individually, ideal conditions for researchers looking to compare the effectiveness of different approaches.

Chicago Booth’s Hans B. Christensen and Christian Leuz and Wharton’s Luzi Hail studied the liquidity effects of two of the new regulations, finding that some countries experienced big improvements, while others saw little to no benefit. A critical determining factor: the country’s regulatory history.

The researchers focused on the Market Abuse Directive and the Transparency Directive. The MAD aimed to address insider trading and market manipulation, while the TD focused on supervising and enforcing corporate reporting and mandatory disclosure rules.

The goal for both directives: give investors more and better information and harmonize regulation across the EU countries. That would increase liquidity, which could in turn lower the cost of capital, raise market valuations, and create more efficient markets.

On average, the MAD and the TD increased liquidity in European financial markets, the research finds—each by around 10 percent relative to prior liquidity. Because trading costs fall as liquidity rises, the researchers calculate that each directive led
to trading-costs savings of at least $130,000-$430,000 a year for each of the 4,846 companies in the study sample. That represents an annual benefit of between 0.1 percent and 0.2 percent of market capitalization—a benefit that compounds over time and hence is economically significant.

However, the liquidity effect varied widely with the strength of countries’ existing regulatory infrastructure. Countries with a previously solid history of implementing and enforcing financial regulations saw liquidity rise more than 20 percent, double the EU-wide average.

Countries with previously weak regulation and weak implementation of the new rules, on the other hand, saw virtually no liquidity benefits.

This disparity reflects core differences among EU countries. “A country’s past track record with respect to implementing regulation is likely revealing about its political will to put in place regulation that induces (or curbs) socially (un)desirable behavior,” the researchers note.

Rather than reconciling disparate market conditions across European countries, the harmonization of regulations actually led to larger liquidity gaps among markets by making the already strong countries stronger, whereas the weaker countries stayed the same.

“History and countries’ prior institutional conditions matter greatly for regulatory outcomes,” the researchers conclude.

“Differences in these prior conditions pose a major obstacle for regulatory harmonization.”

This is of import for both the G20 (comprising the world’s largest economies) and the European Commission, both of which have proposed or implemented regulatory reforms that essentially seek to strengthen and harmonize financial rules.

The research suggests it will take more than a few isolated regulatory changes to align market conditions across the EU.—Kate Marshall Dole


Source: World Bank Worldwide Governance Indicators

### Regulatory strength in Europe

The researchers used 2003 scores from an index measuring governments’ strength in implementing regulations as a starting point in assessing the effectiveness of new directives. Scores from 2015 show regulatory strength shifting.

*Ranges from 2.5 (strong) to -2.5 (weak)*
Extroverted CEOs don’t have the best track records

Extroverts often seem to have the upper hand in business. They’re the ones commanding a room full of eager investors, selling employees on a new strategy, or boosting manager morale during a turnaround.

Yet research suggests that the operating performance of companies with more-extroverted CEOs is worse.

Harvard’s Ian D. Gow, Chicago Booth’s Steve Kaplan and Anastasia A. Zakolyukina, and Stanford’s David F. Larcker measure CEO extroversion by categorizing the words executives use during the question-and-answer portion of conference calls. This part of the call is more likely to be unscripted and therefore more indicative of a CEO’s personality than the executive’s prepared remarks.

According to the researchers, companies run by more-extroverted CEOs have lower returns on assets and lower cash flows, as reflected both at the time of the conference call and in the period afterward.

The researchers emphasize that their study doesn’t assess whether a CEO’s extroversion causes weaker operating results. Certain personality types may be drawn to particular industries, and boards of directors may seek executives with certain traits.

Still, the researchers have some ideas about why the negative relationship between extroversion and corporate performance might exist. Extroverts like to dominate, they note, and while extroverted CEOs can be energetic and forceful in communicating their ideas, they also are more likely to expect obedience. That expectation may not help companies make the best decisions.

Further, the researchers suggest, “short-lived enthusiasm of extreme extroverts can result in aggressive strategies that tend to be prematurely terminated.”

The researchers also examine the relationship between CEO language patterns and four other personality traits. They find that CEOs who are more open to experience run companies with higher spending on research and development as a percentage of sales.

Also, CEOs who rank high in conscientiousness—those who pay careful attention to detail—are more likely to be in charge of slower-growth companies.

—Amy Merrick


View from home

Researchers find a gap between parents’ perception and children’s actual academic performance.

Average absolute value of gap, in standard deviations of the performance distribution

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<thead>
<tr>
<th>Group with least education</th>
<th>Group with most education</th>
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Source: Dizon-Ross, 2016

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Real-time gambling odds have predictive power

Betting on sports is big business worldwide: betting expert Patrick Jay, speaking to the United Nations, estimated the global sports-gambling industry to be worth between $1 trillion and $3 trillion in 2015. And new technologies are helping bettors find new ways of placing their wagers: around the world, online bookmakers are able to offer their clients real-time betting markets with continuously updated odds that facilitate betting throughout the duration of matches.

The odds for the outcome of a sporting match change in response to events within the match. As a result, research indicates, it is possible to use betting-market information to predict game outcomes. Chicago Booth’s Nicholas Polson, Chicago Booth PhD candidate Guanhao Feng, and University of Chicago graduate student Jianeng Xu examined the betting market for soccer matches in the English Premier League (EPL) and find that it’s possible to use real-time market odds data to determine probabilities for various margins of victory.

The researchers’ model relies on the market efficiency of the betting-odds market for its predictive power. It begins by calibrating two opposing teams’ average levels of strength and expected scoring rates by using the initial odds set for a win, loss, or draw. It then uses odds data updated throughout the match to calculate, as the match progresses, the probabilities of various final score differences.

The model makes it possible to follow the implied volatility of the outcome throughout the match and demonstrates how the market forecast adapts to game events.

The researchers illustrate their findings with betting data for a March 2016 match between Everton and West Ham of the EPL. The market-implied probabilities for three different outcomes—a West Ham win, an Everton win, or a draw—vary throughout the game in response to major match events, such as goals or red-card penalties.

The model measures the effect of game events on the market probabilities of different outcomes. The researchers find the model fits the dynamics of the EPL within a game, but they note that it can also be applied to other sports, such as baseball and hockey.—Alex Verkhivker


An underdog’s chances change by the minute

As each significant event took place during a March 5, 2016, match between Everton and West Ham of the English Premier League, betting markets reacted, quickly adjusting each team’s chance of winning.

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An underdog’s chances change by the minute

As each significant event took place during a March 5, 2016, match between Everton and West Ham of the English Premier League, betting markets reacted, quickly adjusting each team’s chance of winning.
Investors have been wary of India’s restrictive labor laws, which grant a number of protections to workers when businesses close operations. High costs associated with the country’s Industrial Disputes Act (IDA) of 1947 have caused economists and financial-media pundits to argue that India’s labor laws have hindered economic growth.

But the IDA doesn’t apply to contract workers, and employers are relying more on staffing agencies and contractual work to avoid labor restrictions, according to research by Chicago Booth’s Marianne Bertrand, Chang-Tai Hsieh, and Nick Tsivanidis, a PhD candidate. As companies have increased their use of temporary workers, the contract-labor industry has become an important gauge of economic activity.

Using data on Indian manufacturers, Bertrand, Hsieh, and Tsivanidis find that at companies with more than 100 workers, which are the companies most affected by the IDA, the share of contract workers increased from under 30 percent to almost 60 percent between 1990 and 2011. The same data provide evidence that large manufacturing organizations that use contract labor are more likely to pursue risky investments because contract workers can be laid off at essentially no cost.

More broadly, the researchers set out to estimate the effect of contract labor’s rise—to 1.3 million contract workers in 2014—on the Indian economy. They used the locations of staffing-agency hubs as a proxy for measuring the growth in contract-labor employment, using the initial location of staffing companies in 1998 to predict the growth of contract labor in manufacturing. They conclude contract labor provided India’s economy with much-needed stimulus.

The data suggest that large companies find contract work particularly helpful, as they are disproportionately able to work around India’s restrictive labor laws. —Alex Verkhivker
January 20 offers the United States an opportunity for a fresh start. A new president brings new policy ideas, a new team, and a new store of political capital. But America’s slate is anything but blank. The list of concerns facing the country’s new chief executive—old and new, chronic and acute, social, economic, military, and geopolitical—is dwarfed only by the universe of ideas about how to address them.

We’ve asked some of America’s foremost academic social scientists for the one piece of advice they’d most like to offer the White House. Our group of advisors, who hail from some of the country’s most elite universities, includes Nobel laureates and former senior-level policy makers. Their suggestions range from how to deter terrorists to how to end political gridlock, from ways to reduce poverty to ways to spur new-business growth.

All advice was solicited and received before the outcome of the election was decided. Our object in this project was to collect advice to the office of the president, rather than to any particular occupant. It reflects, then, not the commotion and controversies of the campaign, but rather the most promising solutions to America’s most pressing problems, as identified by some of its brightest minds.

Advice for the Next President
Fifteen of America’s top thinkers offer their ideas for how America can grow faster, stay safer, and work better
I'd like to offer two pieces of advice to the next president. One is to find wise trades. The other is to stop what I would call parasitic integration. Let me explain what I mean by those terms, and how they’re related.

Wise trades sound like a broad idea, but I mean something very specific. Columbia’s Joseph Stiglitz referred to near-Pareto improvements, which describe trades that allow...
My general advice for the next president of the United States is that less government is better than more. Regulation of almost everything, at the federal, state, and local levels, is choking the economy. It’s choking business formation, and it’s choking listings of stocks on stock exchanges. The number of listed stocks has dropped by about 30 percent since 2000. All regulation should have an expiration date, so Congress can judge from experience whether the costs justify the benefits. And why stop there? Perhaps all or at least most laws should have expiration dates, and exceptions should be rare.

I would like taxpayers to have more direct say (i.e., a menu of choices) in allocating how their tax dollars are spent. Lest this seem silly, we do it now, at least in part, with the charitable tax deduction. I think of that deduction as the Feds allowing me to allocate the tax I would otherwise be paying them to my favorite charities instead. This is better than raising taxes and having the Feds allocate the tax dollars to their choice of charities, which is basically the system in Europe.

“Too big to fail” is an abomination. We should increase the capital requirements of large financial companies so they can absorb the losses they might incur. If they nevertheless fail, trust the FDIC (Federal Deposit Insurance Corporation) to liquidate them in an orderly way. The FDIC liquidates small banks that fail, and we should let it handle big banks.

To understand wise trades, imagine a situation where Spouse A and Spouse B are going to dinner and a movie. Being perfectly nice people, they compromise on the dinner choice, and then over dinner they compromise over the movie choice. Later on, they find out that there was a trade to be made: Spouse A cared more about dinner choice, and Spouse B cared more about movie choice. If we let each dominate on the issue that he or she cared about, both would have ended up being happier.

We’ve now been through two different presidential administrations where the ability to reach across parties to actually make wise decisions has been very, very limited. But if we go back to the 1990s, we had something called a Habitat Conservation Plan, which provided a means to make trades between land rights and environmental concerns so that land owners could potentially violate the Endangered Species Act while in pursuit of a broader plan that would make the environment and the economy better off. Similarly, in the Environmental Protection Agency we had something called Project Excel, which had the same object with this question in mind: How do you relax some regulations in the pursuit of wiser agreements for the overall society, on both economic and environmental grounds?

It need not just be environmental issues. We were on the verge of a grand deal to solve our debt crisis, but that fell apart due to extremists on both sides of the aisle.

What the next president should do is to figure out how to harness a bipartisan set of wise legislators who could craft a series of wise trades across domains so that we could have wiser policies. Then legislators could resume their partisan differences, but on a more Pareto-improved set of options that they would be looking at.

The idea of wise trades is not compromising, and we’re not just looking for the center. We’re looking for wise legislators who realize that there are trades to be made, legislators who actually want to make the world a better place as opposed to clobbering the other side.

But making the world a better place doesn’t just entail wise trades. My other piece of advice is that there’s a moral imperative to stop parasitic integration. Integration, or value creation, is something we teach in negotiation classes; parasitic integration refers to situations where two parties come up with trades by stealing from people who aren’t at the table.

Growing the debt so that we can spend more without increasing taxes is parasitically integrating across those issues while dumping the debt on future generations. Similarly, overharvesting our forests and overharvesting our seas provides the means for current society to be better off largely because we’re stealing from future generations. I think the next president should abide by the imperative to stop stealing from future generations, and that certainly includes a major focus on reducing climate change, which is an enormous threat to the earth’s future residents.
Stop subsidizing the wrong things

Anat R. Admati
Stanford

My advice for the next president of the United States is to take a close look at bad policies we have regarding certain subsidies—specifically, subsidies that completely distort the economy and do us harm. We subsidize harmful things, and as a result, many of us are suffering the consequences of things that can easily be fixed.

One of the big distortions in the economy is that we have policies—tax rules, for example—that encourage and subsidize the use of debt in certain situations. For example, housing. We subsidize the purchase of houses, but only if the buyers borrow. If they borrow, they get to deduct the interest on the mortgage. They don’t get a subsidy if they don’t borrow. And the more you borrow, the more you’re subsidized.

That subsidy doesn’t make sense. It doesn’t do what we want it to do; but what it does do is make people use a lot of debt when buying houses. That subsidy can inflate housing prices and actually add to inequality and other distortions. If we want to subsidize housing, if we want people to own houses, we have to find a different way to deliver those subsidies to the people who deserve them.

Similarly, we subsidize, through the tax code and otherwise, corporate debt. In other words, we encourage corporations to finance with debt rather than financing with equity. That is an incredible distortion, and it does nothing for the economy except to encourage corporations to use more debt than is efficient. As a result, we get distortions in investments, we get an incredibly fragile financial system that we have a lot of trouble regulating, and all because of a policy that can be quite easily changed.

We also subsidize, for example, sugar and do almost nothing to subsidize vegetables. The sugar industry loves and promotes their subsidy. But we could subsidize something healthier instead. We don’t subsidize pollution. We don’t subsidize smoking. But we have policies that subsidize similarly harmful things.

Some of these subsidies, such as the corporate debt subsidies, started almost as an accident. They were put in place 100 years ago temporarily, maybe to help indebted railroads. But we seem to be stuck with them. It seems difficult to change a tax code—people tell you it’s a sacred thing, as though it’s from the Bible. Once a subsidy is in place, the people who benefit most from it hate to lose it, and then it becomes a political issue. It becomes lobbying for certain loopholes or preferential treatment.

We have to stop subsidizing harmful addictions, such as addictions to debt or addictions to sugar, and start crafting better policy. Use subsidies instead to address the things that we know are wrong but are difficult to tackle, such as inequality.

Improve health-care metrics

Dan Adelman
Chicago Booth

Today 30 percent of all Medicare payments are tied to payment models that have a quality-metric component to them. That’s expected to move to 50 percent over the next couple of years.
The act has created a number of programs focused on quality metrics—for example, the Hospital Value-Based Purchasing Program, the Hospital Readmissions Reduction Program, and the Medicare Shared Savings Program. As a result, today 30 percent of all Medicare payments are tied to payment models that have a quality-metric component to them. That’s expected to move to 50 percent over the next couple of years.

The metrics we’re talking about are ones such as mortality, readmissions, and patient safety. In addition, these metrics are also being publicly recorded, so now the Centers for Medicare & Medicaid Services publish figures allowing people to compare various hospitals across metrics. Soon they plan to do the same for physicians. In addition, you have U.S. News & World Report, which has its own quality metrics that it publishes, and other agencies, such as the nonprofit ProPublica.

Consequently, quality metrics are tied not only to dollars but reputation. In the Healthcare Analytics Laboratory at Chicago Booth, we collaborate on lots of projects with hospitals all around Chicago, and we’re seeing hospitals working hard to improve their quality. These are good reasons to keep the patient-protection component of the act in place.

However, there’s a crisis brewing. The quality metrics that are being calculated are inaccurate. And as a consequence, some good hospitals are being penalized, and some bad hospitals are being rewarded. Patients are also being directed, in some cases, to providers that are not giving the best care.

Why are the metrics inaccurate? There are two primary reasons. One has to do with data integrity, and especially with internal controls. We lack national standards for how hospitals should control, internally, the collection and maintenance of data. For example, on the death of a patient, some hospitals make sure that conditions such as obesity and diabetes are properly coded, while others don’t. Those that do have seen increases in their mortality quality metric without having necessarily made an actual quality improvement. Differences in internal controls can make hospitals look better or worse than they really are.

There are also data-integrity problems with how quality metrics are externally reported. Some of my collaborators at Rush University Medical Center just published an article demonstrating that the patient-safety indices calculated by U.S. News & World Report have, in the past, suffered from a data-integrity issue.* U.S. News & World Report has actually changed its methodology for how it calculates these scores, and in 2016 there have been some reversals, with formerly high-ranking hospitals now near the bottom along some metrics.

The second major problem with quality metrics involves methodology.

A couple of years ago the Institute of Medicine published a report saying that hospitals should begin to collect data on social and behavioral determinants of health. It’s been well understood that these determinants actually have significant impact on readmission rates, mortality, and other things. But they aren’t being accurately captured right now, and so it is believed that safety-net hospitals in particular are being unfairly penalized.

Similarly, ProPublica has begun ranking surgeons across the nation, and the methodology they’re using for risk adjustment, while sophisticated, was not properly vetted in the medical community before their rankings were released.* Nonetheless, their ranking affects where the public gets its care.

As a result of all this, my second piece of advice to the president is that the government should set up for health care something similar to the Financial Accounting Standards Board.* We need a nonprofit, independent authority to serve two basic roles. One is setting standards for the internal controls of hospitals around data collection and data integrity, as well as standards for external reporting of quality metrics, much as the National Quality Forum does today. Its second role should be as an auditor. It should be able to go into hospitals and verify that the standards established for internal controls are in fact being followed. In addition, any agency, governmental or private, that’s involved in rating hospitals should be subject to audit to make sure it’s following proper methodological standards and being transparent.

What I’m describing is not a small job. But taking these steps would allow us to build on the strides we’ve already made toward better quality and patient protection in health care.

*Visit Review.ChicagoBooth.edu to see citations for research mentioned in this essay.
Employment and real wages for low-skilled workers have been falling during the past 15 years. The Earned Income Tax Credit (EITC) provides a tax credit to low-wage workers, and thus both redistributes income and promotes employment. However, only single mothers significantly benefit from this policy—the level of the EITC for childless adults is negligible. To help low-skilled workers out of poverty, we should increase the level of the EITC for childless adults. Economic studies have shown that the EITC has increased employment among single mothers; expanding it for childless adults with low wages would likely also encourage employment for this disadvantaged population.

Not only would increasing the EITC for childless workers help reduce poverty and boost employment, the idea has bipartisan support, according to a report by the Center on Budget and Policy Priorities. This proposal would therefore be a good place to start effectively helping the low-skilled workers who have been falling behind in American society.

It is time to take a new and clear-sighted look at direct income support for poor and lower-income families. My advice to the next president of the United States is to reach beyond the tired politics of welfare bashing and reconsider policies of income assistance that can help struggling households make ends meet.

The US has now had two decades of experience in cutting its income safety net, dramatically reducing public welfare and, in many states, eliminating general assistance to the poor. This period has also witnessed growing inequality and relatively high levels of poverty (and deep poverty) even as the economy recovered from recession. Although there are many factors accounting for these developments, it seems reasonable to consider whether ending income support has made things worse. While we experiment with other ideas that may open a path to greater equality over the long run, it is time to consider restoring and upgrading our income support system to meet both the short- and longer-term challenges we face.

Consider that advanced market democracies, especially the Nordic states, have achieved relatively high levels of economic equality and low levels of poverty due, among other things, to a combination of social welfare and labor market arrangements. Admittedly, the US is unlikely to replicate these arrangements for reasons that are both political and historical. But a modest lesson that might be drawn from the Nordic experience is the importance of a basic income safety net.

There are a number of ways to provide direct cash assistance, some more efficient than others. For example, proponents of a “citizens wage” make the case for a basic income that frees its recipients from bureaucratic oversight and supports individual autonomy. More often, US income-transfer policies introduce bureaucratic complexity by attaching work and other requirements, as is the case for the Temporary Assistance for Needy Families (TANF) program, but somewhat less so for the Supplemental Nutrition Assistance Program (SNAP) and the Earned Income Tax Credit (EITC).

The case of TANF may be particularly instructive. TANF is the name for the “reformed” welfare system, created in 1997 with the idea of reducing poverty by increasing work. But this did not happen. In the 15 years after TANF, many poor adults worked more hours and received less cash assistance, but without corresponding declines in poverty. In fact, many households found themselves with no work and no welfare.

Nor did TANF result in reduced federal spending. Instead, it shifted spending from direct cash aid to the poor to funding for social services. Although many social-service
programs are valuable, they do not directly put money in people’s pockets to help put food on the table, pay the rent, buy clothes, and ride the bus.

US and international experience suggest that there is no obvious substitute for direct income assistance. Income support not only has benefits for poor and lower-income households, but, by underwriting consumption, it can have broader benefits for economic and community development as well as health and well-being. Yet concerns about moral hazard have bedeviled efforts to build and sustain a system of income support for the nonelderly in the US, despite considerable evidence that these concerns are overstated.

Over the long run, other policy initiatives will be required to address the complex challenges posed by poverty and inequality. However, until other alternatives prove workable, it is possible to act directly and quickly to have an impact on poverty in America by providing money to people who need it and don’t have it. Cash assistance is a means to that end.

My advice for the next president of the United States would be to focus on studying and expanding antiviolence programming for young people across the country.

In research I’ve conducted with other investigators, we’ve seen promising results from a particular type of antiviolence programming—for people who have been through these programs, arrests for all crimes dropped by about 35 percent, arrests for violent crimes dropped by 50 percent, recidivism rates dropped, and graduation rates went up. The programs are loosely based on principles of cognitive behavioral therapy, or CBT, which at its core basically says, “Everybody acts automatically from time to time. We all respond to situations quickly or interpret them or make assumptions about them quickly.”

Bringing this to every at-risk young person in the country would cost about $2 billion per year—a pretty small fraction of the $200 billion per year that we spend on criminal justice already.

Usually our automaticity is well adapted or well tuned to the environments or situations we’re in. Every once in a while we do things automatically that are not well matched to the situations we’re in. For example, sometimes we might escalate a conflict when in fact it might have made more sense to walk away from it. CBT-based programming spends time teaching people to reflect on the situations they’re in and to think about those situations from various angles so that they come up with appropriate responses.

The challenge of scaling these interventions right now is that we’re not sure of the best ways to adapt them to local contexts. What does this kind of program look like in Houston as opposed to Chicago? We’re not 100 percent sure. We don’t know the exact ingredients that are most effective in these different contexts.

Consider, then, a five-year plan wherein the Coordinating Council on Juvenile Justice and Delinquency Prevention would lead a multiagency effort to study and evaluate programs to see which are the most effective. In years one and two they might field and act on proposals from organizations providing CBT-based programming. They can evaluate, say, 40 cities with 40 programs. Through the variation in those programs, you’ll better understand the common components of the programs that work.

In years three through five, they’d scale up that evaluation and demonstration approach to more cities, but also in different contexts. For instance, in-school programming versus after-school programming versus juvenile-justice settings. We estimate that once we better understand the most effective components and contexts, bringing this to every at-risk young person in the country would cost about $2 billion per year—a pretty small fraction of the $200 billion per year that we spend on criminal justice already.
The next president must maintain and expand efforts to improve the lives of young children because they are our future. Research shows that what happens early in life sets a pattern for child development. Children who are healthy, well nourished, and cared for in safe and stimulating environments grow up to be happier, healthier, better-educated, and higher-earning adults.

Federal programs that have made a difference for children include the Earned Income Tax Credit, Medicaid (and SCHIP, the State Children’s Health Insurance Program), WIC (the Special Supplemental Nutrition Program for Women, Infants, and Children), SNAP (the Supplemental Nutrition Assistance Program, formerly the Food Stamp Program), and Head Start, among others. Children in the US today have lower mortality, higher educational attainment, and less risky behaviors because of these programs.

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average about 4 percent on the state level, for a total of 39 percent. We are one of the highest corporate tax regions on the planet. The rest of the world is moving toward lower rates and, of course, attracting capital and investment and creating jobs.

In addition, much of the rest of the world is on a so-called territorial tax system, wherein corporations with operations in different countries pay taxes on earnings in those countries, but they can repatriate, or bring back, any of the profits to their home countries without paying additional taxes. The US has a simple worldwide system, so you pay tax locally in whatever country you have revenue in, and then you'll pay more tax if the funds are repatriated to the US. There's been one recent proposal to have a significantly lower tax rate, in the 12–14 percent range, on repatriated earnings. That would certainly give more of an incentive to bring that money back.

Another key reform would be to lower tax rates more generally but broaden the tax base by eliminating a lot of loopholes and special deductions, so that you can lower rates without actually reducing revenues. An added benefit of that is by eliminating the distortions that come with loopholes, you're using the market rather than the tax code to establish incentives for allocating investment, and that will likely lead to more-efficient allocation of funds and a somewhat higher growth rate.

Ireland is an example of how powerful tax reforms can be. It has a low corporate tax rate, about 12.5 percent, which is lower than the rest of the European Union and relatively low in the developed world. The American Chamber of Commerce in Ireland estimates that about 700 US companies have opened up operations in Ireland, and they've created about 140,000 jobs there. The business-friendly policy environment has fostered high job growth and an economic boom in Ireland while the rest of Europe stagnates.

Not only is tax reform important; it's something that's politically feasible. I don’t think anyone believes that giving strong incentives for US corporations not to invest in the US makes any sense at all, and hence we've had House Speaker Paul Ryan (Rep.), Senator Charles Schumer (Dem.), and presidential candidates Hillary Clinton and Donald Trump talk about these kinds of things. It's one of those rare issues that both sides of the aisle can agree on.

“The American Chamber of Commerce in Ireland estimates that about 700 US companies have opened up operations in Ireland, and they've created about 140,000 jobs there. The business-friendly policy environment has fostered high job growth and an economic boom in Ireland while the rest of Europe stagnates.”
I think the most important task for the next president is to deal with climate change. The Paris Agreement was an important first step in getting the countries of the world to reduce carbon emissions. But almost all experts agree that it is not nearly enough. The US president must be a leader in negotiating more effective agreements.

Tackle global warming

Eric S. Maskin
Harvard

Clean the house, mind the store, heal the world

John H. Cochrane
Chicago Booth and Hoover Institution, Stanford

My advice to the next president: mind the store.
I know, every president dreams of repeating Roosevelt: a 100-day flurry of new legislation, orders, and agencies, dramatically changing the country and cementing his or her place in history.

But it’s not 1932. We’re not in the middle of a national emergency. You (likely) don’t have a compliant Congress. Our country does not need a massive dose of new laws, new regulations, new agencies. It has lots of laws, regulations, and agencies that aren’t working. We need to clean up the mess.

Yes, your team has 100 policy ideas ready to go, with new regulations and policies and tax credits and executive orders for everything from child care to traffic jams at intermodal transfer facilities (I’m not making this up) to crabgrass removal (I am making that one up, I hope) to new restrictions on trade and immigration.

It won’t work. Congress will block you, executive orders will wind up in court, partisan polarization will increase, your opponents will fight back with ethics probes, and the economy will continue at its sclerotic pace.

It’s not the moment.
First, appoint good people. Get management of the country out of the White House and to the agencies where it belongs. The president’s major job is to appoint good people to work for him or her.

Throw away your long list of new policies. Read House Speaker Paul Ryan’s “A Better Way,” the detailed legislative plan that the House wants to follow. Find the simple things in there you can agree on. Sit down with him and get them done.


Simplify the gross complexity. Fight hard against pervasive cronyism, not with more rules but with less temptation.

If you just got that done—clean up the house and mind the store, get the things the government is already trying to do to work with modest competence—the economy would take off like a rocket. You would go down in history as the country’s great healer. Future presidents would emulate your first term, not Roosevelt’s.

Then, go on a tour. Start with our friends, not on big negotiations with our enemies. Quietly, with no public statement, no spin doctors, go reassure our allies that America stands with her friends and means what she says. No more lines in the sand, constant spin, empty threats, empty guarantees, and needless public insults. Speak softly, carry a big stick, and stop promising never to use it. Our enemies will retreat, and you will go down in history as the great healer of the world, too.

Yes, that will require that you throw away all your campaign promises and plans and disappoint so many of your supporters. But think what historians will say of your deep character, when they describe how you arrived at the battle, recognized everything you had planned was not going to work, and took up the simple mind-the-store, faithfully-execute-the-laws task that the current moment, true wisdom,
Perhaps the biggest concern that economists talk about today—related to the issue of low or even negative interest rates—is how to stimulate economic growth. My advice has to do with an important driver of growth, which is how to encourage companies to increase their levels of investment—that is, to spend more on plant, machinery, equipment, and R&D, investments that ultimately will generate future profits, increase employment, and drive economic growth.

If you look at the largest public companies in the US, you will find that this type of investment expenditure—capex and R&D spending—has grown very modestly since the 2007-10 financial crisis. There are two culprits for this. First, as some of my research shows, nonfinancial public companies are returning cash to shareholders—through both dividends and repurchases—at record levels (both in absolute-dollar terms and relative to their earnings). There isn’t much the president can (or should) do about this.

In spite of these large payouts, the cash held on corporate balance sheets is also at record levels. Apple, Microsoft, Google, and other large tech companies have received a lot of attention here: Apple, for example, is holding well in excess of $200 billion in cash (really, cash and marketable securities) on its balance sheet. Moody’s reported that US nonfinancial companies held a record $1.7 trillion in cash at the end of 2015.

This is the where the next president can help. A big reason these companies are holding so much cash is the US tax system, which is urgently in need of reform. Not only is the corporate tax rate, at 35 percent, one of the highest among developed economies, but—even more important—the US taxes the foreign earnings of US multinationals. This means that if a US multinational, such as Apple or Microsoft, earns $100 in another country and pays $20 in taxes in that country, it owes an additional $15 in taxes to the US government (bringing the total up to the 35 percent liability imposed by the US). This $15 can be deferred indefinitely if the money is not brought home (or, repatriated), which provides a strong incentive for these companies to keep the cash offshore.

Remarkably, of the $216 billion in cash on Apple’s balance sheet, $200 billion (93 percent) is held offshore and is not being spent. Microsoft holds around $103 billion in cash, of which $96 billion sits outside the US.

Reforming US tax code—both lowering the corporate rate and eliminating taxation of foreign earnings—could bring a lot of cash back to the US and be a big boost to investment. Furthermore, it would remove the incentive for US companies to opt for tax-motivated inversions, which move US businesses (and the associated employment and investment, not to mention tax revenues) to lower tax regimes. The Obama administration has been trying to stamp out such inversions almost on a deal-by-deal basis by thinking up rules to block individual transactions; well thought-out tax reform would remove the incentive underlying them in one fell swoop.

I think everyone agrees that our tax system is overly complex, that the tax rate is too high, and that this has created structural disadvantages for US companies. Reforming the tax system could go a long way toward stimulating corporate investment and driving economic growth. This seems like a no-brainer for the next president.
M y advice to the next president of the United States is this: although we’ve had some failures in state building, and although it’s popular for politicians today to say “America should not engage in state building,” in fact the US’s national-security interests really depend on this nation developing an effective capacity for postconflict political follow-through for future military interventions.

Don’t run away from state building—recognize that the failures of the past mean that we need to invest more in it. The cost will be significantly less than the cost of any number of new weapon systems that military contractors are currently talking about, and its impact on our ability to deter international terrorism will be far greater.

Terrorism is first and foremost a political tactic. The basic goal of terrorist violence is to provoke a violent response. Because terrorists hide within larger populations of people, governments that respond to terrorist acts often do so to the detriment of large subsets of those populations. The effect is to cause people in those populations to start viewing the governments in question as their enemies. It enables the terrorists to say, “Well, we’re the ones who have been fighting this dangerous enemy all along.”

Our response, they hope, will create political opportunities for them. Almost all of the discussion we hear this election year about how to respond to international terrorism in the Middle East and elsewhere in the world is, “When they attack, we’re going to just bomb them. Don’t try to do state building; don’t occupy anything. Just go in with destruction.”

Destruction creates chaos. It creates hardship for the populations around where the terrorists are operating. And that is exactly what terrorists want. When we face, as we do today, enemies such as ISIS, who actually think that any American military operation would simply create new political opportunities for them, that means our military threats have failed to act as deterrents.

So what can we do that terrorists would truly hate? The answer is to build up political alternatives to them. And the way to do that is to develop a balanced sharing of power between national, provincial, and municipal governments.

If you look through the history of what happened in Iraq and Afghanistan after our military interventions there, you’ll find that where we had frustration and failures, it was almost always because we didn’t insist on a proper balance between local and national politics in the formation of the government. This is not some theoretical abstraction. This is exactly the kind of political principal that meant the most to America in its own state-building process.

It has been said by many that Americans have overestimated the degree to which people around the world desire or are ready for democracy. I think democracy is a pretty good sell. I think people all around the world, if they don’t have a democratic government, appreciate the idea that the national leadership ought to be accountable to a broad popular approval, and don’t want leaders who can’t win popular approval in something such as an election.

Far from overestimating the appeal of democracy, I think we underestimate the extent to which other countries are exactly like the US in having local politics that mean as much to them as national politics. Far from overestimating the appeal of democracy, I think we underestimate the extent to which other countries are exactly like the US in having local politics that mean as much to them as national politics.

For example: ISIS in 2014 conquered the Sunni third of Iraq very quickly because of an alienation of the Sunni population. That area had legitimately elected provincial governments in the three Sunni-majority provinces. If the US
My advice to the next president is to look at the evidence from the past and recognize that presidents have a very limited ability to change public opinion.

Most new presidents are, of course, coming off a successful election campaign. Often there are new communications technologies that have been involved in their winning the election. They’re surrounded by people who are telling them that they are particularly good at connecting with the public and at using these technologies, and so presidents tend to perceive that they will be capable of molding public opinion on the issues that they care a lot about. Yet time and time again, we see presidents getting burned on those issues.

That doesn’t mean that if there’s an issue on which the public is already behind the president and Congress is blocking it, the president can’t use public communications to try to pressure Congress. But if there’s an issue on which the president is trying to actually move public preferences, presidents fail over and over again. They waste a lot of time, and they expend a lot of capital.

The exception is security. On something like a national security matter, the public tends to defer to the president and rally around the flag, so to speak. The president has a big informational advantage in those cases, and the public knows that. The same isn’t true, however, of other policy areas, where access to information is more balanced.

Not that the president should shut down the communications office. You wouldn’t want your opposition to go out and be on the airwaves while you sit back and do nothing. But when presidents find themselves surrounded by people who have every incentive to tell them that they are great at molding public opinion, by policy advisors who are working to get certain policies passed, I would say prioritize those policies on which you already have the public behind you. -CBR
Who’s most likely to dodge taxes?

The Panama Papers leaked the names of tax avoiders, but they’re only part of the problem. Researchers are on the case.

BY ALINA DIZIK  ILLUSTRATIONS BY KYLE PLATTS
The reason: Greek citizens understate their earnings to tax authorities, but tell banks a more realistic income. Armed with that knowledge, UMass Amherst’s Nikolaos Artavanis, University of California at Berkeley’s Adair Morse, and Chicago Booth’s Margarita Tsoutsoura used bank figures to back out how much money is going unreported to Greece’s tax authorities. They estimate that the country had €28 billion in unreported income in 2009, which added up to 31 percent of the annual deficit, and an additional €11.2 billion that could have been collected to offset the deficit.

Welcome to the murky world of tax evasion and avoidance, where the amount people avoid in taxes is hard to track because, after all, “it’s an activity that’s meant to be hidden,” says Tsoutsoura. In the past seven years, she and other researchers in academia and in the government and nonprofit sectors have been on a global hunt to document what individuals and companies are evading—or legally avoiding paying.

Eschewing official tax returns, researchers are calculating missing taxes by creatively slicing data and working with third-party sources to cross-reference information. The end goal is to push governments to change complicated and often-ineffective tax systems.

The Panama Papers

On a global scale, the amount of capital floating out of regulators’ sights is staggeringly large, says Copenhagen Business School’s Brooke Harrington, author of Capital without Borders: Wealth Managers and the One Percent.

Some of that is due to tax avoidance practiced by the very rich, which the “Panama Papers” have helped corroborate. In the Panama Papers, the names of 140 officials from 50 countries were leaked from a single wealth-management firm, Mossack Fonseca. “We don’t appreciate how much they have in common with each other—whether it’s a Russian oligarch or some Asian dictator—it’s like they are all going to the same hairdresser,” says Harrington, who has studied the professionals who create tax-avoidance strategies.

Many wealth managers, including those at Mossack Fonseca, work with the world’s 168,000 ultra-high-net-worth individuals, who have at least $30 million. Most practices of wealth-management firms are legal and make use of offshore legislation to pursue tax avoidance—sometimes in countries that are not known as tax havens. “Wealth managers are like hackers,” Harrington says. “They are hacking the legal systems of other countries.”

This year, several EU member states have put more pressure on tax havens to encourage transparency by creating a blacklist of territories with weak banking laws that don’t comply with the Organisation for Economic Co-operation and Development’s (OECD) Automatic Exchange of Information standard, says Vanessa Mock, European Commission spokesperson for the Taxation and Customs Union. Because being listed as a tax haven can affect long-term investment in a country, Panama, Lebanon, and the South Pacific island nation of Vanuatu have all recently signed up to implement international tax standards.

While avoidance is legal, evasion is not. And the price of evasion is high. The United States alone had an average $458 billion gross tax gap annually for the 2008-10 tax years, with $319 billion of that due to individuals, according to the Internal Revenue Service. Evasion can be particularly problematic for developing countries. About $1 trillion illicitly leaves developing countries every year, according to Global Financial Integrity (GFI), a Washington-based nonprofit. “A good chunk of [illicit financial flows] is likely related to tax evasion, but we don’t have the resources here to go further to determine how much,” says Matthew Salomon, a senior economist at GFI.

Besides draining government coffers and inhibiting development, “evasion leads to distortions in the economy between activities that are taxed, and others that are not,” says Harvard’s Dina Pomeranz. “It can push people into activities that are easier because of evasion but economically inefficient.” For example, smaller companies—not obligated to track their revenues or spending in much detail—may stay purposely small to evade tax collectors.

Take a peek at the tax returns of Greece’s self-employed, and many of the people who filed those returns will seem like poor contenders for a loan. On paper, Greece’s lawyers, doctors, and accountants are struggling, yet banks continue to take a chance on lending to them at interest rates that don’t appear to reflect the risk of default implied by the tax returns.
Tax evasion across industries

In a study of the magnitude of tax evasion in Greece, researchers developed a measure of how well income can be traced from industry to industry. They find a weaker paper trail in many industries that see higher amounts of tax-evaded income.

Source: Artavanis et al., 2015
But despite the problems caused by tax nonpayment, “there’s hesitation on the part of some political elites to look at this,” says Gail Hurley, a New York–based policy specialist for development finance at the United Nations Development Programme (UNDP). “Governments are wary if you start digging into these activities.”

**Follow the paper trail**

But researchers are digging anyway as they attempt to quantify the problem.

Traditionally, authorities have attempted to track tax evasion through random auditing, but private-sector data are allowing a new approach. “Because the private sector adapts to a culture of tax evasion, private sector data offer a window into the magnitude of, distribution of, and motivation for tax evasion,” Artavanis, Morse, and Tsoutsoura write.

One of the first studies to use private data was conducted in 2010 by Carnegie Mellon University’s Serguey Braguinsky (currently at the University of Maryland), Clemson University’s Sergey Mityakov, and then–Harvard PhD candidate Andrey Liscovich, and compared car registries in Moscow with car owners’ salary records. By looking at the price of the car, the researchers could detect unreported income. This kind of data provides the ability to cross-check official sources of income with private, and perhaps unexpected, data sources.

Not all the activity that turns up in cross-checking is nefarious. In a 2012 study, Chicago Booth’s Erik Hurst sought to determine whether researchers could trust household data. In comparing spending data to reported income data for self-employed Americans, he finds that the self-employed generally underreported income by 25 percent; but he doesn’t assume that’s due to evasion, which implies intentionally either understating your income or overstating your deductions.

Computing the incomes of self-employed workers gets complicated, as they or their accountants have to identify business and personal expenses. Income-computing mistakes in this group often result in lower taxes. “Given the complexity, errors tend to accrue in a way that leads income to be underreported,” says Hurst. “Some of it may be nefarious, while some of it may be just systematic errors when income is being reported. My data does not allow me to distinguish between the two. Given this, I cannot conclude that explicit evasion is taking place.”

Hurst finds that privately collected data about how the self-employed spend their money are more accurate than government data. “People don’t skew their expenditure data,” he says. “They eat a certain amount of food, drive a certain car, and [from that] I can infer their income.”

Artavanis, Morse, and Tsoutsoura collected private banking data about people who applied for credit. The anonymized data included incomes, debts, occupations, and more.

They saw that professions that generated the least amount of data—leaving little in the way of paper trails—had the highest incidence of evasion. That was particularly true for the self-employed. Self-employed doctors, engineers, and educators generated relatively few receipts and documents, and were more likely to evade taxes. People working in the pharmacy and transport industries, meanwhile, had naturally higher paper trails and were less likely to evade taxes.

The likelihood of evasion increased alongside wealth. Of the professions studied, doctors, private tutors, engineers, lawyers, accountants, and financial-service agents had the highest likelihood of evasion, with an average €24,000–€30,000 evaded per person.

Researchers can also cross-check information using other government data, even taxation data. Harvard’s Pomeranz studied Chile’s valued-added tax (VAT), paid by more than 400,000 local companies and assessed on products depending on their stage of production and sale. VAT, she finds, is part of a long-established tax system that generates more information than a retail sales tax, making it harder to game. The structure of the VAT is such that it leaves more of a paper trail. Because input costs are tax deductible, companies have an incentive to request receipts from suppliers.

GFI looks at trade between countries, and in particular at aggregate merchandise trade numbers, to draw conclusions
about illicit financial flows. In ongoing analysis, it finds that in some cases, companies underreport imports to evade import duties, while at other times they inflate imports and pay more duties in order to depress income. For example, to avoid export duties, a company may underreport the number of pairs of socks it exports. Another company, to lower domestic revenue and associated taxes, might overreport the number of socks it exports. Tracking trade is “a very gross, crude way of coming up with a snapshot” but does not account for the sizable evasion that happens, for example through cryptocurrencies including bitcoin, or the simple smuggling of cash, says GFI’s Salomon.

Changing policy in Greece and beyond
While the growing body of data is helping policy makers create deterrents to tax evasion, those hoping to evade taxes are continuously seeking new ways to escape their financial obligations. For researchers and government officials, the result can feel a little like an ongoing game of cat and mouse. “When you start cross-checking, companies in particular move to other, less monitored forms of evasion,” says Tsoutsoura. If one country uses third-party data to find tax evaders, that can encourage individuals and companies to find better places and ways to cheat.

In 2011 and 2012, George Washington University’s Paul Carrillo, Harvard’s Pomeranz, and University of California Davis’s Monica Singhal studied 8,000 companies in Ecuador that were notified by the country’s Servicio de Rentas Internas about tax discrepancies between previously filed returns and third-party sources such as credit-card sales or exports. The government hoped to get companies to pay up, but the plan didn’t work as intended. When companies received notices about discrepancies, some did at first declare higher income in subsequent returns. But they then found another loophole. “They offset much of this higher declared revenue by an increase in declared costs, resulting in only small changes in their reported profits,” the researchers find. For every dollar in tax revenue adjustment, companies in question increased their reported costs by 96 cents, and thus avoided raising their tax bills.

But tougher economic times have inspired governments around the world to push harder to track lost revenue, feeding a growing movement to crack down. In the past two years, there has been more interest in tracking how money flows out of the least-developed economies in parts of sub-Saharan Africa, says UNDP’s Hurley. “Civil society has mobilized quite strongly around tax evasion because damages are more severe when the countries are poorest,” she says.

In 2015, member states at the UN’s Third International Conference on Financing for Development, in Addis Ababa, Ethiopia, publicly agreed that agencies should focus on stopping illicit financial flows, especially from the world’s poorest economies. The UNDP paired with the OECD to start a Tax Inspectors Without Borders program, which works with academics and tax specialists around the world to help developing countries build out their ability to effectively collect taxes and audit multinational companies.

Greece lost $261 billion in illicit financial flows between 2003 and 2011, according to GFI. Tsoutsoura’s research has gotten what she says is a surprising amount of publicity and resulted in collaboration with government officials. The data popped up in parliamentary tax-policy deliberations and have played a role in tax-related reforms as the Greek government-debt crisis unfolds. Greeks are no longer turning their backs on tax evasion as they did prior to 2009, she adds. “In the past it was much more acceptable if you were underreporting; now people realize that it should not be acceptable.”

In the past year, the government has started using third-party banking data to uncover potential forms of tax evasion, says Tsoutsoura, a native of Greece who travels between there and the US throughout the year. Recent regulatory changes have made it easier for authorities to access this type of financial data, she adds.

Greece’s self-employed citizens now need to pay taxes on their entire income—unlike wage workers, who still get €9,000 tax free. Still, there’s plenty of room for improvement. The research suggests that professions with the highest rates of tax evasion are aligned with the occupations of parliamentarians, who may not want to pass more stringent laws because of personal conflicts of interest.

The emerging body of research is encouraging governments, including Greece, to create better policing strategies. Many of the results from tracking Greece’s self-employed may be applicable elsewhere, Tsoutsoura says, especially in countries with pervasive tax evasion—such as Italy, Turkey, and parts of Latin America. “The more we have research that brings numbers to the table, the more people realize that this aggregates to a large amount.”

“In the past it was much more acceptable if you were underreporting; now people realize that it should not be acceptable.”

—MARGARITA TSOUTSOURA

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Why fake money is better than real money at feeding the hungry

An esoteric market idea revolutionized food banks. What else could it do?

BY DEE GILL   PHOTO ILLUSTRATION BY GLEN GYSSLER
If you love markets, it’s a good time to be alive. Almost everything you could ever need is on sale in online marketplaces. The sharing economy has extended existing markets for hotels and taxis: if you are traveling, you can book a room in someone’s home, and be driven there by someone you hailed on Uber or Lyft. Markets govern financial trading, ad rates, and the amount you pay for jeans.

In most cases, these markets run on currency—if you want something, use money to pay for it. Alternative markets are relegated to neighborhood babysitting co-ops and barter exchanges. And fake-money markets sound like they belong in the board game Monopoly.

But a study of an established fake-money market has Chicago Booth’s Canice Prendergast rethinking the possibilities for these unorthodox systems.

Prendergast analyzed data from a fake-money market he helped establish for Chicago-based Feeding America, a nationwide nonprofit that matches food from manufacturers with food banks that need it.

The benefits of the market far exceeded his expectations. “It was a bit of an eye-opener to me to see how big the gains were,” says Prendergast, who studied the market’s operations between 2005 and 2011, totaling about 65,000 transactions. “I knew things seemed to be going well, but I didn’t realize quite the extent to which they were going well.”

The market, which Feeding America calls the Choice System, greatly increased the amount of food collected by the food banks. Within seven months of implementation in 2005, Feeding America’s food supply increased roughly 36 percent. Between 2006 and 2011, its annual supply of food to give away rose to 340 million pounds, from 220 million. “To put this from the perspective of another lens,” Prendergast writes, “an increase in supply of 100 million pounds a year is equivalent to providing a full day’s food for roughly an extra 60,000 people every day.”

With the magnitude of the market’s success, Prendergast says, “I can see this being replicated.” In fact, it’s being replicated, in and out of Feeding America.

**Fake money promotes fairness**

Money works fine in most markets. Buyers and sellers bring money, goods, and information to a marketplace, and then haggle, deal, or trade their way to a price. Markets are adept at making needs visible when consumers have equal resources. Market prices, and the incentive for consumers to conserve currency for future purchases, ensure that goods go to the buyers who need them most.

A fake-money market works exactly the same way as a real market, but uses a play-money substitute for real currency. Typically the organization holding the goods to distribute sets up a market where those goods are auctioned off on a regular schedule. The bidders use points or shares that are distributed to them equally (or the fair equivalent of equally) in advance.

Fake-money markets are best suited for situations where people want the benefits of a market but have a compelling reason to think that a real-money market wouldn’t be fair, explains Chicago Booth’s Eric Budish, who recently revamped a fake-money market for Wharton. People may want the efficiency a market can bring but also want participants involved to be armed with a defined amount of “money.”

For example, at Booth and other graduate schools, some courses are more popular than others. Schools could allocate seats using a conventional market, by ramping up prices for the most-popular courses. But to ensure that rich students don’t have an unfair advantage, some schools instead use fake-money markets—they give first-year students a certain number of points they can use through their graduate careers to bid on seats in courses they want. Popular courses require the most points, rather than the most cash. (See “How a fake-money market helped MBA students,” page 48.)

Course-allocation auctions are a textbook example of fake-money markets, largely because few other examples exist. There are neighborhood babysitting co-ops that use points, and there are barter systems that swap one good or skill for another. Some hospitals are using fake-money markets to schedule emergency-room nurses. But fake-money markets are otherwise little used because, as Budish points out, real-money markets typically solve most allocation problems.

Some employers do auction off in-demand vacation days, but more probably offer overtime pay for holiday work, and employees who need the extra money will choose to work those days.

Many employers do the latter, but that leaves hanging the issue of fairness: people who have enough money have a better chance of taking holidays off. Fake-money markets aren’t a replacement for using money; they offer something different. They are, says Budish, “a way of realizing the benefits of using markets in corners of the economy where that didn’t seem possible.” Prendergast’s research, as well as Budish’s study of Wharton’s system, suggests that in the right circumstances, fake-money markets can provide extraordinary benefits.
Fake money meets food banks
For Feeding America, the fake-money market resolved distribution problems that real money never could. A decade ago, Feeding America (then called America’s Second Harvest) approached four faculty at Chicago Booth—Harry L. Davis, Robert S. Hamada, Donald D. Eisenstein, and Prendergast—to join a task force working to solve several issues. Feeding America wanted a more efficient and transparent way of distributing donations to member food banks around the country.

Feeding America acts as a remote clearinghouse for food donations from big businesses such as Tyson, Kraft, ConAgra, and Wal-Mart, which donate surplus food. When Tyson has a truckload of chicken on offer in Little Rock, Arkansas, Feeding America contacts a food bank to go get it—or at least that’s how it used to work.

Traditionally, Feeding America assigned these truckloads, without much consideration of content, on a sort of rotation system. The food banks could accept the food and pay transport costs to receive it, or they could decline it. In an attempt to get the biggest share to places with the biggest needs, the organization set allocation amounts for each food bank based on the bank’s size and the poverty level of the population it served. It also took into consideration proximity. The organization tried to figure out who needed what, in part by guessing.

But Feeding America recognized it had several problems with this system. Food banks often accepted food that they did not want. Idaho banks were offered potatoes they did not need, while others took in sodas, which were both expensive to transport and low in nutritional value. If a food bank declined a donation, the food it declined counted against its future allocations, plus it created potentially awkward situations with donors that Feeding America wanted to keep happy. Meanwhile, a food bank desperate for protein, or hitting a dry spell with local donors, had no efficient way of finding out which nearby sources had excess. Feeding America wanted to send the most food to the neediest places, but it didn’t know where those needs lay on any given day.

A traditional market wouldn’t have worked—taking the food banks’ money would have run counter to Feeding America’s mission. The task force proposed a different system, the fake-money market. Feeding America gave each food bank an allocation of shares (the fake money) based on the same size and poverty-level criteria. Descriptions and locations of every truckload of food the organization sourced were entered into a website, where auctions went live twice a day. At each auction, food banks used their fake money to bid on what they wanted.

Feeding America found that it could quickly match corporate donations to the food banks that needed them most. Because it knew placement had become more efficient, it accepted more donations, thereby increasing food supply. Food banks in turn added their own overstocks of locally sourced goods to the market.

The fake-money market turned out to be a tool that improved both efficiency and fairness relative to Feeding America’s old system of assigning donations. The food banks reported greater satisfaction with the Choice System, even though a quarter of them collected half as many pounds of food as they would have under the old allocations. In a demonstration of efficiency, they saved their fake money to buy the higher-quality, more-expensive goods that they needed most.

A market fueled by fake money
Feeding America, a nonprofit that routes donations to a network of food banks, devised a free system in which food banks can prioritize their needs.

1. **Fake money to work with:**
Local food banks start the day with an allotment dictated by a formula that grants needier locations more than others.

2. **Online auctions:**
Feeding America runs them twice a day as donations come in. Food banks target what they need the most, and the highest bids win.

3. **Level playing field:**
At the end of the day, any fake money spent is split up among all of the food banks, regardless of who won today’s auctions.
How a fake-money market helped MBA students

In theory, fake-money auctions are straightforward copies of traditional markets, with points replacing cash for transactions. But creating a successful one in real life is tricky. These markets typically break down quickly, undercut by myriad unpredictable, situation-specific issues of efficiency and fairness. In fact, creating an efficient fake-money market for a real-world problem is so difficult that there are few exemplary models to follow.

Chicago Booth’s Eric Budish and Wharton’s Judd B. Kessler touch on some of these design issues in a study of one of the more successful fake-money auctions, a 20-year-old course matching system at the Wharton School of the University of Pennsylvania. Traditionally, some top schools, including Harvard, Wharton, and Chicago Booth, used fake money in what’s called a bidding points auction. Each school followed the same basic system: a multiround auction gave seats to the highest bidders, ostensibly ensuring that students who needed the course most got spots. But students could easily find themselves outbid on every course they selected, and some found ways to game the system.

In research published in 2011, Budish proposed that schools could improve their ability to give students the schedules they wanted with several tweaks to the auction process and the sorting that followed. A school would give all students similar budgets of artificial currency, and instead of “bidding” on courses in an auction, students could instead report their preferences for courses. A computer would find the market cost of each course based on the bids and determine the most preferred schedule each student could afford.

Budish says the outcome is efficient, because each student gets the schedule she likes best out of the affordable options—and fair, because each student starts with approximately the same budget. Those budgets are similar rather than exactly equal in order to break ties. Say every student were originally given 10,000 points, and they all wanted to take the same course. In that case, it wouldn’t be possible to establish a market price for that class. But when the school varies budgets by even a handful of points, some students spend all their points on that one in-demand class, and others who can’t afford to do so spend their budgets on other classes they still want to take. “So the outcome is as fair as you can get,” Budish says. “That’s the beauty of the market.”

“Also it aligns incentives,” says Budish, who claims that students have an incentive to honestly report the courses they want to take, rather than bid strategically as they did with a bidding points auction. Computers evaluate millions of possibilities when doing the tough computational work that students used to have to do as part of strategizing.

Budish and Kessler tested the updated market design in a lab, and Wharton decided to implement the new system in 2013. In a study of the results, the researchers find evidence that suggests the changes are working as intended. The Financial Times and Bloomberg Businessweek reported that Wharton’s new Course Match was a success that vastly increased the chances that a second-year student could enroll in a popular course. Other schools, including Booth, continue to use a bidding points auction.

The market accurately priced goods to reflect demand from its consumers, whose concerns for spoilage and nutrition make them distinct from most grocery shoppers. In Feeding America’s market, peanut butter and noodles were the most desired foods. Truckloads of pasta and rice were expensive, while milk and cheese were relatively cheap. A single pound of cereal sold for more shares than 120 pounds of produce. In fact produce often traded at negative values. If Feeding America received a donation of broccoli, say, and the demand for that was low, Feeding America gave food banks points to take the broccoli.

How to make fake-money markets work

The consistency of the Feeding America auction is crucial, says Prendergast. Fake-money markets require busy and ongoing trading that participants trust will continue day in and day out, with more good spending options consistently coming to auction. Consumers and food banks must have that faith, he explains, or they would have every incentive to immediately spend their entire account, regardless of need. When that happens, market efficiencies are lost as bidders dump soon-to-be worthless points, or attempt to game the system. Feeding America’s Choice System works because members have opportunities to spend their shares on 50 or so truckloads of food twice daily—today, tomorrow, and for pretty much every workday to come.

But attention to detail in the market’s set-up—in Feeding America’s case, dozens of details specific to the project—is particularly critical. “It may be that it is not the broad match of the concept of fake currency to the problem that generated its likely success, but rather the myriad of small details that got it over the line,” Prendergast says.

Budish came to the same conclusion when revising Wharton’s course- allocation market. There’s no one-size template for establishing a fake-money market that will work. “In market design,” he says, “tiny details make a huge difference.”

For Feeding America, an important wrinkle was a clause that redistributed to all members the sales proceeds at the end of each day. At midnight, any fake money spent on a given day was split up and returned to food banks. That went a long way toward assuaging disappointment a food bank might have felt after losing out to a higher bidder, as everyone benefited from the higher price paid.

Also crucial were provisions for splitting bids, buying on credit, and collecting shares for hard-to-move goods. The details included a fairness committee, set up to handle any grievances with the system. So far the committee has not been tapped, but it nevertheless helped gain member trust, which in part led to the success of the system.

What else fake money could do

Nonprofits and similar institutions tend to determine need and then use centralized systems to allocate the goods and services they offer. Prendergast’s work offers a way to judge
Feeding America’s supply
Prices and amount of items, 2005–11

Key

- **Cereal:** 382.4% of the median price of all items
- **Diapers:** 354.7%
- **Pasta:** 315.7%
- **Paper plates, utensils:** 299.3%
- **Meals:** 279.1%
- **Rice:** 270.4%
- **Meat:** 193%
- **Baby food products:** 155.4%
- **Cleaning products:** 150.6%
- **Other protein:** 139.6%
- **Nuts:** 120.4%
- **Canned fruit:** 117.3%
- **Condiments:** 90.6%
- **Snacks:** 89.8%
- **Health, beauty items:** 88.7%
- **Canned vegetables:** 84.2%
- **Vitamins:** 66.5%
- **Baby products:** 51.5%
- **Dairy:** 45.3%
- **Juice:** 41.3%
- **Beverages:** 11.6%
- **Produce:** 7.7%
- **Other items:** 66.5%

Median price of all items (100%)

Price, relative to median

Share of all items by weight (Total: 100%)

Go to Review.ChicagoBooth.edu to see citations for research in this article.
Inside a movie theater, management has a monopoly on films and refreshment. But outside, the competition for moviegoers' business is intense.

Movie theaters can use cell phones to learn where potential customers are, a process known as geolocating.

You've turned every cell phone in Gotham into a microphone...

The Dark Knight (2008) come with me if you want to live.

It's OK, Mom. He's here to help!

Theaters can also use geolocating to target customers in areas near other theaters and attract them with coupons and discounts, a tactic called geoconquering.
But the competition doesn’t have to sit idly by as their customers are poached via geotargeting.

I’m as mad as hell, and I’m not going to take this anymore!

Theaters can respond with “defensive promotions.” Instead of targeting customers near their competitors, they can offer deals to cell phone users in their area and combat geotargeting.

The call is coming from inside the house!

When a stranger calls (1979)

Chicago Booth’s Jean-Pierre Dubé teamed up with Zheng Fang, Nathan Fong, and Xueming Luo to quantify how effective each strategy was.

Their research indicates that a theater can profit by offering deep discounts to customers near rival theaters.

You don’t understand the power of the dark side!

The Empire Strikes Back (1980)
However, even modest defensive offers can convince customers to stay.

**You failed, Your Highness. I am a Jedi, like my father before me!**

When both theaters offer deals via geolocating, they sometimes enter a war of attrition. They both offer discounts, but the defensive offers negate the offensive offers. So why do they do this?

**I did lose a million dollars last year. I expect to lose a million dollars this year. You know, Mr. Thatcher, at the rate of a million dollars a year, I'll have to close this place in . . . 60 years!**

It's similar to the prisoner's dilemma: theaters realize that if their competitors do not offer geolocated ads, they can do so and poach customers.

**I drink your milkshake! I drink it up!**

**There will be blood (2007)**
AND IF THE COMPETITORS DO USE GEOLOCATING TO TARGET CUSTOMERS, THEY HAVE TO ALSO OFFER DISCOUNTS TO DEFEND THEMSELVES.

THERE'S SOMETHING I OUGHT TO TELL YOU.

TELL ME!

I AM NOT LEFT HANDED EITHER.

THE PRINCESS BRIDE (1987)

BECAUSE PILOT TESTS FOR DISCOUNTS DON'T FACTOR COMPETITORS' RESPONSES, THIS RESEARCH SUGGESTS THAT THEY MAY OVERESTIMATE THE EFFICACY OF THE PROGRAM.

I COULDA BEEN A CONTENDER! I COULDA BEEN SOMEONE!

ON THE WATERFRONT (1954)

THE RESEARCH ALSO SUGGESTS THAT WHEN THEATERS OVERESTIMATE THE EFFICACY OF DISCOUNTS—WHEN THEY OFFER DISCOUNTS BASED ON HOW RECENTLY A CUSTOMER HAS BOUGHT A TICKET RATHER THAN WHERE SHE IS—THEY TARGET THEATER JUNKIES WHO WOULD HAVE SEEN THE FILM ANYWAY!

THAT WAS A WEIRD MOVIE.

VERY ECLECTIC.

TOO REFERENTIAL.

IT WOULD HAVE WORKED BETTER AS A COMIC.

SHALL WE SEE ANOTHER?

I'VE GOT TIME.
DIGITAL MARKETING FOR EXECUTIVES

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Almost every day, US companies are criticized for focusing too much on the short run and not enough on the long run. Laurence Fink, the CEO of BlackRock, one of the largest money managers, recently wrote that . . . the effects of the short-termist phenomenon are troubling. . . . more and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth.

In other words, US companies are destroying value by not investing for the long run. Poor corporate governance and overly generous pay plans for CEOs that reward short-term behavior are often cited as accomplices to short-termism. And politicians have taken notice. On her presidential campaign website, Hillary Clinton vowed to halt “quarterly capitalism,” saying, “We need an economy where companies plan for the long run.” She promised to change the tax code, curb shareholder activism, and restrain executive pay with the goal of refocusing corporations on long-term growth. Outgoing vice president Joe Biden weighed in with similar sentiments in a Wall Street Journal op-ed in September.
FOOTNOTES

At the same time, US companies are criticized for being very (and even, perhaps, too) successful. Corporate profits (after executive pay) in the United States are at historically high levels and at historically high proportions of GDP (see "A new wave of profitability began in the 1980s," page 57). And the trend of increasing profits has not been a short-term one. US corporate profits have increased steadily since bottoming in the early 1980s. US companies arguably have taken advantage of technology and globalization to become increasingly profitable and efficient in the intervening period.

The early 1980s is precisely the time that most observers believe finance and shareholder value maximization became ascendant. It is also the time that Wall Street and the financial sector began to grow substantially—both in the US and internationally. The early 1980s also coincided with the rise of management consultants who spread techniques across US firms and across the world. In 1980, consulting firms were relatively new and relatively small. Today, McKinsey & Company has offices in more than 60 countries, Boston Consulting Group in more than 40.

Although many would think the results achieved by US companies have been tremendous, the efficiency and profitability of those companies are perceived to have contributed to the increase in income inequality by benefiting those at the top of the income distribution while keeping wages lower for the rest. In other words, the fact that the great success of US companies has not been distributed uniformly has created political challenges.

You may have noticed that there is a conflict. How can US companies excel at generating increasing profits over a 30-year period and, at the same time, be mortgaging the future for the short run? The only way to reconcile the two arguments is to believe that US companies are short-termists. “The short run” is normally defined as a period of years, at most five years. It’s been more than 35 years since the publication of the Hayes and Abernathy article, and almost 25 years since the appearance of Porter’s. By any measure, today is the long run.

The implication of the short-termism argument is that in the longer run, because of a lack of investment, corporate profits will wither, things will go wrong, and poor management will be shown to have failed. So today—according to the short-term perspective—US corporations should be in dire straits.

But that is unequivocally not the case. The trend line has been unmistakably up. The uptrend began just around the time of Hayes and Abernathy and has continued since. This is evidence that the short-termists cannot explain. Nevertheless, short-termists such as Fink continue to repeat the mantras of the 1980s and 1990s.

Clearly, there’s an incongruity in claiming that US companies are both poorly governed and overly successful. And in fact, almost four decades after Hayes and Abernathy’s complaint, the data strongly suggest that concerns about short-termism and poor governance are overblown. The aggregate evidence is much more favorable for the efficiency argument. Rather than being criticized, US corporations should be congratulated.

And the shareholders of US companies have not been the only beneficiaries. As US corporations have taken advantage of technology and globalization, the global outcomes have been impressive. According to the World Bank, in 1980 the number of people living in extreme poverty globally was around 2 billion, some 44 percent of the world’s population, which numbered about 4.5 billion. By 2012, that figure had fallen to less than 900 million, or about 13 percent of the global population of 7 billion. The World Bank projected last year that for the first time the number of people living in extreme poverty around the globe was expected to have fallen below 10 percent.

While causality is hard to prove and many factors have contributed to this result, US companies have played an important role in these outcomes.

So why is there criticism for success and short-termism? While the success and efficiency of US corporations have been good for the people at the top and for people in developing countries such as China and India, they have not been so good for the people in the middle in developed economies. That has fueled frustration and anger, which helps explain the Donald Trump and Bernie Sanders phenomena, Jeremy Corbyn’s election as leader of the UK Labour party, the UK’s
A new wave of profitability began in the 1980s

The trend of increasing corporate profits goes back to the early 1980s, a time that saw the rise of Wall Street, management consultants, and globalization in the financial sector.

vote to leave the European Union, and the rise of populist politics more generally.

In addition to the anger, other pieces of evidence encourage the short-termists. For example, a 2005 academic paper surveying 401 financial executives found that 78 percent would sacrifice long-term value to smooth earnings. I have no reason to doubt that result. Corporate leaders face strong pressures, some of which may lead them to take actions that flatter the short run at the expense of the longer run. However, it is also clear that some of the same short-term pressures can actually prompt companies to become more efficient. It is not at all clear which of these effects dominates. Again, the trend line suggests that even if some companies are obsessing over the short run, the long run is taking care of itself.

Another argument that is regularly used by those who lament short-termism relates to buybacks. This group contends that companies buy back their own stock to boost their share prices in the short run, regardless of the long-term impact. This argument is something of a *non sequitur*. It suggests that in a buyback, the money simply disappears rather than going to investors who spend it or use it to make other investments. It also suggests that companies that don’t need money should invest it anyway, rather than give it back to shareholders.

For observers such as my colleague Luigi Zingales at Chicago Booth, part of the explanation is crony capitalism, in which incumbent corporate giants use their political connections to shape the system in their favor. There may be industries that fit that description—telecoms being one possible example—but they are the exception rather than the rule. The US’s biggest, most valuable companies are Apple, Google, Amazon, Facebook, and the like. They have used market forces to their advantage, are profitable as a result, and certainly now enjoy some market power. But they didn’t attain that position through the machinations of some corporate *illuminati*. They have gotten to where they are in part because they are operating in sectors where there are network effects.

At the same time, the short-termers ignore a lot of evidence that defies their position and their fears. Amazon has been highly valued for many years despite the fact that it was losing money for much of that time. Amazon invested for the long run and has been richly rewarded for doing so. Similarly, US biotechnology companies, which have made huge progress in innovation and push the boundaries of science, are routinely valued in the billions of dollars often before they actually have any drugs for sale. If the market were really as short-termist as critics claim, that industry would not exist.

So short-termism is not the bogeyman it is often made out to be. The argument does not fit the evidence. And it is the same evidence that leads to the second, converse, criticism made of corporate America: that rather than being poorly governed, companies have been relentlessly and successfully efficient. While that efficiency has contributed to tensions in the developed world, the global effect has been overwhelmingly positive.

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Most of the tools that corporate decision makers employ to validate ideas are based on predictive logic—the idea that if A leads to B leads to C, then in order to validate C, we look for A and B. This is the logical framework used by young entrepreneurs when they approach an opportunity by setting a goal, C, and then try to find A and B—the market demand, technical feasibility, competitive landscape, required resources, etc.—to predict the chances of C’s success. They use surveys, focus groups, expert interviews, analogue analysis, trial balloons, and other tools with which corporate decision makers are familiar.

But are there other ways of thinking about problems and opportunities that corporations can leverage? I was asked to participate in CEO Perspectives, a joint program between Chicago Booth, Northwestern’s Kellogg School of Management, and the Corporate Leadership Center, which brings together the most successful experts rely on five principles of effectual logic to solve problems.
talented top executives of Fortune 1000–sized organizations in Chicago. This event attracts people headed for their company’s C-suite, perhaps even to the CEO role. I asked the organizers why they wanted me, an entrepreneurship professor, in this program. Their response: executives want to know what they can learn from the way entrepreneurs innovate.

What I talk to those executives about is effectual logic. When a concept is truly innovative, there’s no research that can effectively predict a market for it. One of the most-often-cited quotes on this subject comes from entrepreneur extraordinaire Steve Jobs, who said: “People don’t know what they want until you show it to them. That’s why I never rely on market research. Our task is to read things that are not yet on the page.” It is important to note that Jobs didn’t say he didn’t do market research. He said he didn’t rely on it. He instead showed people things and got their reactions, feedback, likes, and dislikes. He didn’t use market research to predict; he used it to create a market and to improve what he offered to the market. This is where effectual logic comes in. Effectual logic leverages assets on hand, existing expertise, a network of stakeholders, and experimentation to create opportunities rather than discover or predict them.

Saras D. Sarasvathy of the University of Virginia coined the phrase “effectual logic” to describe a way of thinking that expert entrepreneurs rely on to create their ventures. Sarasvathy asked super-successful entrepreneurs—those with 15-plus years of start-up experience, multiple ventures both successful and failed, and at least one IPO—to solve the kinds of problems entrepreneurs face in bringing something new to market. She learned they relied heavily on their power to engage a single customer, experiment until they found the best solution for a problem, and drive that solution into the market they created for it.
The five principles of effectual logic
From her research with these expert entrepreneurs, Sarasvathy derived five working principles of effectual logic. Corporations can and do exhibit these effectual-logic behaviors in launching truly innovative initiatives, but examples are not easy to find and too often come largely out of the technology industry.

**1 Bird-in-hand principle—start with your means.** Expert entrepreneurs approach opportunity on the basis of who they are, what they know, and whom they know. They work from competence, expertise, and their network to envision possibilities, rather than target opportunities according to the market size or expected returns.

A corporate example of using the bird-in-hand principle dates to 1996, when W. W. Grainger became the first major business-to-business firm to invest heavily in the internet as a sales engine. In 1996 the internet had only 70 million users, or nearly 2 percent of the world’s population. Just a year before, Forrester Research had written a report in which 50 percent of Fortune 1000 CIOs stated unequivocally that the internet had no applicability to business and, as nothing more than a consumer time sink and security risk, would never be enabled behind their firewalls.

Grainger took a different look at the internet and decided that what it was really good for was information. Amazon.com had launched in 1995 with the vision of making a vast catalog of books, too numerous to house in a store, accessible to anyone, anywhere. What Grainger had was the world’s largest catalog of maintenance, repair, and operations products. Why not put that catalog online and see if customers would use that information source to discover and buy more Grainger products? Despite a complete lack of data about the channel conflict this would create, the willingness of customers to adopt this solution, or the impact on business operations, Grainger forged ahead. Starting with its asset base of information, salespeople, and relationships, Grainger pioneered business-to-business e-commerce.

**2 Affordable-loss principle—focus on the downside risk.** A common stereotype is that entrepreneurs are risk takers, but entrepreneurs don’t see themselves that way. They say they manage or limit risk. One way expert entrepreneurs do this is by investing, at each step of the entrepreneurial journey, only the time, energy, and resources they can afford to lose. They choose actions and goals in order to learn specific things about their business opportunities, and they pivot, adapt, or cut bait on the basis of what they learn. They find the upside in their experiments, even when those experiments don’t end up becoming booming businesses.

3M is famously known for allowing engineers to spend 15 percent of their time on their own projects, just exploring ideas, whether or not those ideas are in line with the company’s mission. 3M’s management is betting that any loss of productivity is worth the potential gain of supporting ideas in their nascent stages. And that bet has paid off with products including Post-it notes, ScotchBlue painter’s tape, and a lens-manufacturing process that generates more than $100 million in annual revenue.

Google lives the affordable-loss principle by making frequent forays into the market with products that often seem well outside its core business model and retreating just as quickly if the market rejects them. For Google, the concept of affordable loss can involve an awful lot of money. If you google “Google’s biggest failures,” you will find myriad articles on the subject citing dozens of flops—among them Google Wave, Notebook, and Nexus Q, a spherical digital media player. But in every case, Google keeps whatever works from the failure while jettisoning the product itself. Aspects of Google Wave are found in Gmail; Notebook features infuse the very successful Google Docs product; and even Nexus Q, which was Google’s first foray into hardware, helped with the design and launch of Chromecast.

**3 Lemonade principle—leverage contingencies.** Corporate managers are often obsessed with “what if” scenarios, trying to create plans and define outcomes for every eventuality. Entrepreneurs instead embrace the fact that they have no idea what will happen next, and their very business models could have to change and adapt as they learn from the marketplace. As a result, entrepreneurs view surprises, both good and bad, as ways to make their business cases stronger. In its launch year, Cranium, the game company, missed the annual Toy Fair, where the vast majority of new toys and games are introduced to the market. It mitigated that bad luck by getting into a completely different go-to-market channel: Starbucks. Cranium became the fastest-selling independent board game in US history.

In the corporate world, Pfizer created the category of erectile dysfunction drugs when Viagra failed to treat blood pressure and angina, the conditions for which it was being tested. It was during those tests that volunteers reported significantly more and longer erections when taking the medication, and Pfizer decided to launch trials in that area.

Three quarters of a century earlier, conservative paper-product company Kimberly-Clark found itself with warehouses full of Cellucotton and no market for it. During World War I, Kimberly-Clark had developed Cellucotton as an inexpensive, soft, absorbent wood-based replacement for cotton bandages, but when the war ended, the company had no idea what to do with the stuff until they discovered that nurses in the field had used the Cellucotton to replace sanitary rags. Working with their marketing agency, Kimberly-Clark branded the new product Kotex—short for “cotton textile”—and the disposable-sanitary-products market was born.

**4 Patchwork-quilt principle—form partnerships.** Entrepreneurs face a lot of nos, especially when bringing really innovative solutions to market. Rather than try to convert the nos to yeses, expert entrepreneurs seek out the subject citing dozens of flops—among them Google Wave, Notebook, and Nexus Q, a spherical digital media player. But in every case, Google keeps whatever works from the failure while jettisoning the product itself. Aspects of Google Wave are found in Gmail; Notebook features infuse the very successful Google Docs product; and even Nexus Q, which was Google’s first foray into hardware, helped with the design and launch of Chromecast.

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**5 Expert entrepreneurs might even create partnerships with organizations that could, from a traditional perspective, be seen as competition.**
people who buy into their vision and gather them into a self-selected network of stakeholders who cocreate an opportunity. This might even involve partnerships with organizations that could, from a traditional perspective, be seen as competition.

In 1953, two men sitting on a plane got to talking after they discovered they shared the last name Smith. One was a salesman from IBM, and the other was the president of American Airlines. American was, at the time, struggling with managing reservations, since each flight’s seats were represented by cards in a rotating file that airline employees would mark when a seat sold. When travel agents called in, operators would find a file to see if the flight had sold out. The company was rolling out an electromechanical computer system to track the seats so more operators could quickly learn whether a seat was available, but the system still required a person on either end of a phone line. Meanwhile IBM was experimenting with a communications system for the US Air Force that used computers and teleprinters to input information into a database system.

This conversation could have been dropped and forgotten; but, instead, the president of American invited the IBM salesman to see their reservation system in action to determine if the two organizations could benefit by partnering on a new solution. This is how SABRE (semi-automated business research environment) was born. Launched in 1960, it took over all bookings for American four years later. To increase the value of the solution, American opened it up to travel agents in 1976, which paved the way for the online travel industry. Travelocity spun out of the SABRE initiative in 1996.

**5 Pilot-in-the-plane principle—control the future.** Expert entrepreneurs don’t see the market as an inevitable tide in which they must catch the wave just right or be dashed on shore. Rather, they believe that the future is created by people, and they have a fundamental faith in their ability to control that future.

Anyone could have told Steve Jobs that there was no market for tablet computers beyond a few forms-based applications such as medical checklists or ruggedized field tablets for oil-rig and construction-site inspections. The technology for tablet computers had been on and off in the market since 1987, when the GRiDPad launched. That was followed in 1991 by the NCR 3125 Notepad. Microsoft got in the game in 1992 when it created Windows for Pen Computing, an operating system specifically designed for tablets. IBM tried with the ThinkPad 700T in 1992, and Apple made its big play with the Newton MessagePad in 1993, only to discontinue it in 1998. Through the early 2000s, products kept coming and going. There was no big market for tablet computers.

But Steve Jobs didn’t care. He decided to show the market something it never thought it wanted. Using Apple's superior design expertise and massive marketing machine, Jobs brought iPad to the world. The reaction was mixed. Apple devotees lined up to buy it, while Windows proponents scoffed. Some reviewers said it was nothing more than a big, heavy iPhone that couldn’t make phone calls and didn’t have a camera. But it sold 3 million units in 80 days, and it wasn’t long before developers began to turn out new and interesting applications by the thousands for this “new” computing format. The Apple App Store now boasts more than 1 million apps specifically designed for the iPad.

Corporate innovation is hard. Corporations have to deal with competing projects and priorities, budgeting nightmares, existing products and customers, and the ever-present pressure from Wall Street to make the quarterly numbers. Yet, the imperative is there. In a 2013 PwC Pulse Survey of 246 CEOs worldwide, 97 percent of survey participants indicated that innovation was a top priority for their company. Patrick Whitney, design guru and dean of Illinois Institute of Technology’s Institute of Design, says corporate innovation requires three things: first, managers who know when their customers’ needs are not being served; second, fear or pain that drives urgency; and third, executive leaders who are willing to go down a path without knowing exactly where they will end up. Perhaps the tools of effectual logic and its framework of principles, used so frequently by the most successful serial entrepreneurs, can help these leaders overcome some of the obstacles to building innovation into their corporate practice.

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Six ways to apply the creative process to business

Dancers and managers have significant common ground

1 Creativity isn’t reserved for the arts. We tend to think of an artistic pursuit as only happening in an artistic medium, but I no longer think that. I spent 17 years dancing professionally and became an executive and entrepreneur in the arts; since then I’ve been working as a management consultant. Over time, a lot of my preconceived notions about how to apply creativity have evolved.

The creative process is developed on an individual level, but there is a role that an artist or someone employing the creative process can play in team building and corporate leadership. I see that there’s a need for this creative process when I’m helping companies through team-building exercises or when I’m coaching executives on decision making. We are all constantly wading into the unknown and making sense of stimuli, data sets, and intuitions. We use different words and metaphors in the business and art worlds, but we are essentially getting at the same thing: how to find maximum presence and value.

The creative process involves finding the balance between objective and subjective in order to get work done in a way that’s both efficient and innovative. You can spend too much time overthinking problems or not enough time coming up with solutions.

2 Some job skills are truly universal. Some specialty skills, such as those acquired by dancers, apply to one domain and are not transferable. But that’s not to say that the sweat, rigor, and artistry required of a professional dancer go to waste. The ability to adapt, remain agile, innovate, empathize with colleagues, and create new systems is transferable.

Dancers are very aware of the physical spaces in which they work. They are highly adept at reading the room. Dancers hone their muscle memory to store great amounts of detail and data. They read nonverbal body language and help facilitate a more cohesive environment through their behaviors. In the business world, people would call this expert level of nonverbal awareness a “high emotional intelligence,” and the ability to follow and lead simultaneously “emergent leadership.”

During a Booth presentation in London last December, Harry L. Davis mentioned that perhaps the leaders of the future need more breadth in addition to depth. I believe he is right. We need to train more generalists alongside the plethora of specialists coming out of business schools. Someone who has achieved great mastery in her field—whether it is finance or ballet—has potentially honed a set of adaptive skills that will serve her well in a variety of contexts. The ability to achieve this type of mastery over and over again can make it easier for executives, or anyone, to confidently move from one role to the next. You have to explain transferable skills to an executive differently than you would explain them to a dancer, but the idea of transferring skills is common to both.

3 Seek independence. Past experiences gave me mastery and purpose, but not the free passage to create new ideas and work with a variety of colleagues across multiple sectors. I developed that independence in thought by choosing to follow disparate fields of study and audit a number of courses at Booth. I also developed that independence in time by creating a personal scheduling system better attuned to my organizational rhythms and work flow.

I spend weekends and Mondays researching ideas, reading, and writing. I spend Tuesdays, Wednesdays, and Thursdays lecturing, presenting, and holding meetings or workshops. I spend evenings and Fridays primarily reconnecting with my artistic self and having roundtable discussions about the creative process with all kinds of people. Doing this has allowed me to reinvent how I work, spend my time, focus and organize my thoughts, and open myself up to new ideas and influences.

Leaders often feel pressure to focus on the short run, and they end up ignoring their intuitions. Autonomy is a growing trend, but it does not necessitate distancing yourself from others—rather the trend seems propelled by the discovery that we can sometimes be most present and collaborative with others when we license ourselves to act autonomously and entrepreneurially, to make our own decisions about how to act and react. Autonomy is about intuition, and about finding a place where you have a lot more freedom. Ultimately, we need to bring into the corporate environment the permission to tap into this kind of independence. It’s part of the role that the qualitative and artistic approach plays in the business world.

4 Get comfortable with being uncomfortable. A big part of creativity is tapping into what you don’t know. It’s looking into that white space that’s not yet explored and organizing kernels of information to be examined and burnished by the stores of information you do possess. I’ve learned how to better understand the creative process through that kind of uncertainty. Most systems teach how to maximize efficiency when going from Point A to Point B. When endeavoring in a creative process, you are going from Point A to Point B while creating Point B along the way. That idea is from Amy Whitaker, author of Art Thinking, a book that takes on the importance of finding the time to explore without the pressure of success. There is no manual or best-practices playbook to deploy, which can feel risky.
This so-called sitting with discomfort allows someone to stay in an unformed state for a longer period and to learn to disregard any preconceived notions. At Booth, I was able to mine larger amounts of data from colleagues, students, staff, and alumni by exploring ideas and having challenging conversations. Sitting with discomfort means remaining open to what is possible, instead of deploying a set methodology where, because of biases, one can miss bigger truths.

Rigid frameworks don’t work. Frameworks are essential for communicating ideas. But frameworks are not universal and need to be adapted depending on the audience. I became more adept at learning about my audience and translating frameworks, but the content and integrity of the message remained consistent through evolutions.

There are differences, but also similarities, between the scientific method and the creative process. Learning about the scientific method from Chicago Booth’s Heather M. Caruso was instrumental to my understanding the benefit of a framework. Like the artist’s creative process, the scientific method allows you to combine form and feeling at the same time. I would propose blending the two into the “creative method,” to create a comprehensive, robust, transparent, and recognized process that captures the creative approach.

Creative thinking can lead to purpose. Executives and managers have long been perfectionists when it comes to their strengths and abilities, but many are now looking for something more to feel successful. Essentially, they are looking for a sense of purpose alongside the more traditional markers of success. Many professionals are becoming interested in how to have a sense of purpose, within what entrepreneur Aaron Hurst has called “the purpose economy.” Both are impossible to find without deploying creative thinking and uncertainty, or without locating intrinsic motivation and filtering it through extrinsic demands. The creative process that is used to make a work of art has great utility, but people are using the creative process all the time, regardless of their pursuit. Learning how to implement creative choice making is essential.

When it comes to finding purpose within day-to-day work, there’s greater possibility than before to maneuver in order to find real influence. Executives have more capacity to be agile and fluid, and to deal with uncertainty. There’s now a critical mass of people for whom the ability to deal with the unexpected is crucial to succeeding. The creative process can enable a large portion of the workforce to derive a sense of purpose.

The creative process can happen on an individual, internal level; but to scale and reach broader networks, teams and entire organizations need to work and create cohesively. In order for that to happen, members of teams, multiple teams, and even multiple organizations need to collaborate by merging their shared interests and equally partaking in the risks. The creative process can enable a large portion of the workforce to derive a sense of purpose.

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John Michael Schert danced for New York’s American Ballet Theatre and San Francisco’s Alonzo King LINES Ballet and cofounded the Trey McIntyre Project, an international touring dance company based in Boise, Idaho. For the past three years, he has been the inaugural visiting artist and social entrepreneur at Chicago Booth. Schert now works with companies including Google and McKinsey to help them approach problem solving creatively.
Six months of xenophobic political bloviation do not overturn centuries of experience. Trade and immigration are good for the US economy.

As Adam Smith and David Ricardo explained two centuries ago, it is better for England to make wool and Portugal to make wine, and to trade, than for each country to do both. English winemakers likely disagreed.

The founders understood the benefits of immigration, complaining in the Declaration of Independence that “[King George] has endeavored to prevent the population of these States; for that purpose obstructing the Laws for Naturalization of Foreigners; refusing to pass others to encourage their migrations hither, . . .”

Their Constitution brilliantly forbids internal protectionism against the movement of goods and people, setting up the world’s largest free trade and free migration zone and, not coincidentally, what became the wealthiest nation on Earth.

Two centuries of economic scholarship have only deepened and reinforced these lessons. We now recognize that much trade occurs among similar countries: the United States and Canada, not England and Portugal. This fact tells us that specialization of production and knowledge, the dizzying variety of goods a modern economy produces, and increasing returns are deeper sources of trade patterns than simple facts like British versus Portuguese weather.

But the fact that your car—even an “American” one—is produced from parts made in a hundred countries remains vital to the low cost and high quality of the car you buy today.

Much trade also now travels on wires, not on boats, in the form of specialized services. Yet trading the best and most efficiently provided services from around the world—Hollywood movies and Silicon Valley software for Indian call centers and radiology readings, for example—is just as important to our economy as trading wine for wool.

Trade is already pretty free. The challenge is mostly to preserve and extend what we have and to avoid one of those periodic global disasters such as the 1930s, when the world slid into trade barriers, or occasional national disasters of isolationism,
protectionism, and *Juche* (the term for self-reliance in North Korea).

Immigration is largely not free, so many of its potential benefits remain unrealized. Michael Clemens, reviewing current scholarship in the *Journal of Economic Perspectives*, summarizes current knowledge with the ballpark estimate that reducing barriers to immigration could double world income per capita.

In the last few decades, economists have also come to a much better understanding of the sources of long-term growth. This understanding only reinforces the importance of trade and openness. Economic growth itself depends on globalization, expanding the number of people with whom we trade ideas, skills, and goods. If you live in a village of 100, or even a small country of 10 million, inventing an iPhone makes no sense. You’ll never sell enough to recoup the costs. It only makes sense to innovate if you can sell it in a global market of billions of people. Growth comes from ideas, ideas are hard to come by, and expertise is specialized. The more people you are connected with, the more you grow. “The division of labor is limited by the extent of the market,” noted Adam Smith, and 250 years of work have fleshed out just how deep that observation is.

Against this backdrop, the economic and political discussion surrounding trade and migration remains stubbornly protectionist, mercantilist, and xenophobic.

In response to such forces, invoking study after study will do as much good as invoking a thousand scientific articles supporting Darwin at a revival meeting. The most good one can do is to point out the many simple logical fallacies adduced in the cause of restricting people’s rights to buy and sell what they want, to hire whom they want, and to move, produce, and live where they want. You’re being sold a bill of goods by people who want to use the power of the government to pick your pocket. At least recognize the snake oil.

It is perhaps understandable that the average person falls for economic fallacies. Individual experience as a worker or businessperson is a poor guide to the workings of an economy. We call this the fallacy of composition in economics. Each of us individually can get ahead if the government will force our neighbors to buy from us. But the country as a whole cannot get ahead by this means—though, heaven knows, our government tries.

But these traps are not an excuse for political leaders to ignore hundreds of years of solid knowledge and experience. The laws of physics are counterintuitive too. Everyday experience suggests that the earth is
The process of economic growth is painful. New, more efficient businesses come in and displace old, less efficient ones.

flat. Advocating flat-earth public policy in search of votes is not excusable. The major objections to free trade and more open immigration are that they will cost American jobs. To a lesser extent, trade is also about defending the profits of American exporting companies, which happily fund lobbying for protectionism. But they defend their actions in the name of jobs.

The logic that isolation will create more American jobs is false. But it is so pervasive we must dissect its fallacies.

*Follow the money.* When a Chinese company sells a product in America, we send money to China. The Chinese do not sit on the money. They use a lot of the money to quickly turn around and buy American goods. To the extent that they do not, they use the money to buy things from other countries—iron ore from Australia, oil from the Middle East, food, and an increasing amount of low-wage manufactured items and parts for its own manufacturing. The recipients of these dollars then turn around and spend them on goods from the US.

To the extent that all the dollars don’t end up buying American goods, foreigners end up buying assets in America, investing in our businesses. To the extent they do not buy private assets, they invest in our government bonds, financing deficits and US government spending that would otherwise vanish.

*Every dollar comes back.* This isn’t theory. It isn’t an “on the other hand” proposition. It’s simple arithmetic. And it doesn’t just come out even. Since, pretty much by definition, the foreign goods we buy are better or cheaper, and our goods better or cheaper there, each country is better off.

As often in economics, the problem is that of the seen and unseen. We see and hear from the worker who loses his job due to competition from abroad or to a new immigrant. We do not hear from and see the new job or business created by the foreign worker’s expenditure or the low-cost product enhancing the lives of widely dispersed American consumers. The politician can campaign on the doorstep of the “saved” factory. But it’s hard for him or her to take credit for nebulous increases in demand and employment spread throughout the economy or the appearance of an even cheaper jar of pickles at Walmart.

When you follow the money, it becomes clear that even tax benefits and subsidies enjoyed by foreign industries cannot make America worse off, as a whole. Sure, the industry in the US that must compete with a subsidized foreigner does worse. But the subsidized foreigner sells to us in exchange for money, and the money must come back. The foreign subsidy ends up distorting American output, but does not lower output or jobs overall. If the foreign country subsidizes all of its industries, the exchange rate must rise, undoing the subsidy.

Arguments against trade and immigration apply domestically too. If it is wise for the US to protect a job or business in New York from a cheaper competitor in Beijing, an immigrant from Poland, or a machine made in the United Kingdom, why is it not wise for the state of New York to protect that same job or business from a cheaper competitor in South Carolina, an immigrant from Louisiana, or a machine made in Santa Clara, California? The person losing the job or the lost business doesn’t care where the competitors come from.

Most Americans understand that free movement of people and goods between states benefits all of the states’ economies, and sniff the fallacy of local protectionism. Economics does not know national boundaries, so there is no argument for international protection that would not apply to national protection also.

The process of economic growth is painful. New, more efficient businesses come in and displace old, less efficient ones. In a competitive economy, anyone earning rents—extra compensation and an easy life—is a target for growth-producing disruption. Southwest and JetBlue disrupted United, TWA, and Pan Am (remember them?) and their employee unions. A&P put mom and pop out of business, Walmart destroyed A&P, and Amazon.com may displace Walmart. Uber is upending the taxi businesses. And we’re all getting cheaper and better goods and services as a result. Lots of people are doing well working for the new businesses. You might argue against “better” in the case of air travel. But that’s your choice: 1970 air travel at 1970 prices is still available. It’s called business class. The free market gives you better choices.

People who lose jobs or businesses to foreign competition are hurt—just as people who lose jobs and businesses to domestic competition and innovation are hurt. But as I hope these examples emphasize, the churn due to foreign competition is a lot lower than the churn due to domestic competition. It just comes from foreigners, who are easier to demonize.

*The lump-of-labor fallacy.* Adam Davidson, writing in the *New York Times,*
explains a central misconception: “The chief logical mistake we make is something called the Lump of Labor Fallacy: the erroneous notion that there is only so much work to be done and that no one can get a job without taking one from someone else. . . . This argument is wrong.”

The lump-of-labor fallacy pervades thinking about trade and immigration, as well as many other misguided laws and policies. In the popular imagination, there are only so many jobs to be had. There are more people who want to work than there are jobs. Unemployment consists of people waiting around for a job to be “created,” especially by a politician hungry for a moment on camera.

This vision has nothing to do with reality. In the end, the number of jobs in the US is the number of people scaled by the fraction who want to work. China has 764 million jobs, while America has 159 million. China didn’t take 700 million jobs from the US—we don’t have that many people. China simply has a much larger population.

“Jobs” is a nonsense argument. Economists who defend or attack trade on the basis of “jobs” are pandering to fallacious political rhetoric.

It is more reasonable to worry that trade and immigration affect wages, not numbers employed. But follow the money again. If by protecting an industry, the government can raise wages or profits in that industry, the money must come from somewhere. Where? Higher prices paid by consumers. When the government deliberately hobbles the productivity of the American economy, by skewing employment to less-productive industries, we can only lower wages overall.

We can see direct evidence against the lump-of-labor fallacy in our own history. One of the greatest job invasions in all US history was the increase in women working. Women’s labor-force participation rose from 32 percent to 60 percent from 1950 to 2000. But 27 percent of men are not permanently out of work now as a result. In the “great migration,” about 6 million African Americans moved from the rural southern part of the US to northern cities. Despite widespread fears, riots, and shameful efforts to exclude these newcomers, 6 million whites did not suffer permanent unemployment as a result.

There has also been huge resistance to national free trade—mills moving from New England to the south, car companies relocating from Detroit to

If by protecting an industry, the government can raise wages or profits in that industry, the money must come from somewhere. Where? Higher prices paid by consumers.

Indiana and Tennessee. Our state and local governments compete to waste taxpayer money on special deals for large employers. That political resistance doesn’t make the economics any more logical.

The great churn. The great churn of the US labor force most clearly belies the lump-of-labor fallacy, together with trade protectionism, anti-immigrant protectionism, and all sorts of political efforts to subsidize specific industries in the name of “jobs.”

In the single month of January 2016, 4.9 million people in the US lost their jobs, out of a labor force of 159 million. At that rate, 60 million people, 40 percent of the labor force, will be out of a job by the end of the year. Why is this not a catastrophe? Because in the same month, 5 million people in the US got new jobs.

The 100,000 new jobs “created” in that month, and bandied in the press, are not a 100,000 expansion in the lump of labor; they are the net difference of a great churn.

For this reason, net employment in the US is essentially unaffected by protection. If a political intervention could create 100,000 new jobs (if!), that is a drop in the bucket of an economy that creates 5 million new jobs a month.

The utter incoherence of trade and immigration policy is a good sign of its dysfunction. Trade and immigration policy is mostly about labor protection. Republicans are against immigration, and are turning against trade, all under the banner of protecting American jobs. But why are they then against unions, minimum wages, the Equal Employment Opportunity Commission and the National Labor Relations Board, occupational licensing, and all the rest of the government’s misguided job- and business-protection efforts? Democrats are for all those labor protections, but then soft on immigration. The inevitable conclusion: most policy discussion favoring trade and immigration restrictions has other objectives.

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The savage ethics of American Psycho

What Bret Easton Ellis’s novel teaches us about capitalism

As trigger warnings go, it’s hard to imagine what more an author might do than title his book American Psycho. And yet, the advance notice didn’t prevent the controversy surrounding Bret Easton Ellis’s infamous novel from blossoming into full-blown outrage when it was published in the spring of 1991. The previous fall, Simon & Schuster told the hotshot author he could keep his $300,000 advance for a book they absolutely refused to publish. By the time the novel finally arrived in bookstores after Vintage Books, a division of Random House, brazenly purchased the rights, bootleg copies of the manuscript had been floating around for months, filling the news with snippets of the sadistic behavior of the book’s protagonist (and said psycho), Patrick Bateman.

The publication of the novel did not immediately provoke sweet vindication for Ellis. As a literary offering, American Psycho found few defenders—most notably Norman Mailer, a man who had made a fine career courting controversy—but Roger Rosenblatt of The New York Times spoke for most critics when he called the book “the most loathsome offering of the season.” As a cultural referendum, the decision was even more decisive. The National Organization for Women threatened a boycott of Random House, at least one executive at Vintage Books received death threats, and Germany banned the work outright. Ellis himself became the most divisive figure in the literary world this side of Salman Rushdie.

Time has proven a better friend to the book. Twenty-five years after it was first published, American Psycho is now a canonical work of social satire, widely regarded by gender theorists and feminist critics alike as a scabrous assessment of modern masculinity run amok. It has sold over 1 million copies, been successfully adapted for the big screen and Broadway (as a musical, no less), and, in an achievement shared by only a handful of American authors, bequeathed a character of such salience that he has been thoroughly appropriated by popular culture. As Ellis told Rolling Stone in 2011, “I cannot tell you how many times young men have come up to me and showed me on their phones pictures of them dressed as Patrick Bateman for Halloween.” One wonders if the same may be said for Huck Finn and Captain Ahab.

American Psycho also remains, to my mind, the single most damning critique of the cultural consequences of contemporary capitalism. By drawing a parallel between the ritualistic displays of domination on Wall Street and the predations of an actual psychopath, Ellis not only shows how soft sadism shades into truly violent behavior, he suggests that the peculiar customs of the commercial elite can blind us to the difference.

What is striking about the young men of Ellis’s world is less that they are superficial, per se, than that they are strictly conformist in their superficiality.

Ellis didn’t set out to write a satirical cri de coeur. By 1987, the 23-year-old author had already published two novels about the carnal recreations of spoiled college students, and in search of a third storyline with something of an adult setting, he found himself drawn to the gold-plated phantasmagoria of the go-go 1980s financial sector. Initially, Ellis said in a recent interview, he envisioned “a much more earnest and straightforward novel, akin to what the movie Wall Street became with the Bud Fox character being seduced by Gordon Gekko.” His time among the legion of young bankers who arrived in lower Manhattan each fall changed this ambition. “[H]e longer I hung out with these guys that I was researching to write the book,” he said, “the more the aspect of the serial killer came into view. I don’t know why; I just suddenly thought, ‘Oh, my God. He’s going to be a serial killer.’” He, of course, is Patrick Bateman, “Mr. Wall Street” as one character dubs him, though on the surface he doesn’t seem any different from the other bankers around him. In fact, throughout the novel it’s a running joke that all of the 20-something professionals so closely adhere to the same lifestyle aesthetic that they are constantly mistaken for one another. “[H]e looks nothing like the other men in the room,” Bateman sniffs early on in the book, noting an artist who has invaded a social gathering. “[H]is hair isn’t slicked back, no suspenders, no horn-rimmed glasses, the clothes black and ill-fitting, no urge to light and suck on a cigar, probably unable to secure a table at Camols, his net worth a pittance.”

The pathological obsessiveness of Bateman and his ilk with a gilded persona (and, given their affinity for tanning beds, a bronzed bottom) reaffirms Ellis’s stated aim of describing “a society in which the surface became the thing only.” And yet, the author goes above and beyond a satire of simple narcissism or even consumerism in the extreme by the straitjacketed quality of the young men’s commercial proclivities. They all favor the same high-end designer labels (“Price is wearing a six-button wool and silk suit by Ermenegildo Zegna, a cotton...
To demonstrate your superiority was the motivating force of modern capitalism, and the opportunities that provided for it might be sportive in nature or something more ominous.

wheels of capitalism turning (think God helps those who help themselves as the lynchpin of a complex social theory), that force had ebbed over the course of the 19th century. What replaced it? “In the field of [capitalism’s] highest development,” Weber wrote, “in the United States, the pursuit of wealth, stripped of its religious and ethical meaning, tends to become associated with purely mundane passions, which often actually give it the character of sport.”

The iconoclastic economist Thorstein Veblen had reached something of a similar conclusion not long before Weber. For him, however, rather than replacing a divine injunction, the sporting quality of contemporary capitalism had more to do with a vacuum left by a world that was no longer characterized by the barbaric practices of pillage and plunder. When those undertakings gave way to the hustle and bustle of business, he said, the predatory instinct was turned into pecuniary drive.

Veblen described this transformation in his foremost book, *The Theory of the Leisure Class*. “Gradually, as industrial activity further displaces predatory activity in the community’s everyday life,” he said, “accumulated property more and more replaces trophies of predatory exploit as the conventional exponent of prepotence and success.” For Veblen, even if the trophies themselves changed over time, in their social significance, they were no less essential to the quartered precipices of Palo Alto than they once had been in the fashionable farmsteads of a Viking village.

Accordingly, throughout the book, Veblen conjures the constellation of contemporary practices, which, like a peacock’s plumage, signal unmistakably an individual’s financial fitness. Importantly for him, the semaphore of elite social standing was not merely a by-product of commercial accomplishment, it was the very aim of such striving. The claim to dominance in the modern world did not reside in having money, but in making that fact widely known by means of (Veblen’s most abiding expression) conspicuous consumption.

Nevertheless, such command was not established simply by the ability to consume, but to consume nicely. The wealthy man, Veblen notes, assisted by an education in refinement and the opportunity for leisure, “becomes a connoisseur,” exercising his purchasing potential with an exhaustive knowledge “in credible viands of various degrees of merit, in many beverages and trinkets, in seemly apparel and architecture, in weapons, games, dancers, and narcotics”—a list, like so many of those in Ellis’s book, that brings to mind the late French philosopher Henri Bergson’s quip that the only cure for vanity is laughter.

Less laughable, no doubt, is the green-eyed monster that inflames the acquisitive instinct even when it is placated by garish excess. Jealousy is the consequence of domination as well as the spur to its achievement. For Veblen most certainly, and for Weber in his own way, to demonstrate your superiority was the motivating force of modern capitalism, and the opportunities that provided for it might be sportive in nature or something more ominous.

Journalist Michael Lewis described the latter possibility in his memoir, *Liar’s Poker*, when he introduced his readers to the trading floor of Salomon Brothers, where he worked as a fresh-faced kid from Princeton in the mid-1980s. The “chosen home of the firm’s most ambitious people,” the trading floor was “governed” by a simple belief: “Eat or be eaten.” As such, it was a work environment with “no rules governing the pursuit of profit and glory,” one
in which savage expressions, which always accompany even the most staid visions of social Darwinism, were wholeheartedly welcome. To be on the losing side of some transaction, Lewis soon learned, was to have your “face ripped off”; to get the better end of some deal, especially a big one, was to “blow up” a customer.

Released just two years before American Psycho, Liar’s Poker reads something like a sly sociological study to Ellis’s social satire, and it substantiates the psychological predicates of the latter’s character study: captive ambition (“I narrowly escaped imprisonment myself”), overwhelming cupidity (“I was largely unaware how heavily influenced I was by the money belief until it had vanished”), and crippling jealousy (“‘You don’t get rich in this business,’ said Alexander when I complained privately to him [about the size of my bonus]. ‘You only attain new levels of relative poverty’”). In the voice of Patrick Bateman, Ellis’s diagnosis is far more succinct: “There wasn’t a clear, identifiable emotion within me, except for greed and, possibly, disgust.”

Applied to any actual person, such a judgment would be highly simplistic, but Ellis is a novelist, and he freely typifies in service of his creative aims. In their gourmandizing, determined drug use, sartorial self-indulgence, addiction to high-tech knickknacks and “for-men” frippery, and in all their libidinal excess, to say nothing of their scorn for penury and perceived weaknesses (a favorite game involves dangling a dollar bill before a homeless person before gleefully snatching it back), the satellite characters of Ellis’s novel seem merely the mundane fulfillment of Weber’s prophecy, that modern capitalism would nurture a generation of “sensualists without heart.”

Patrick Bateman, of course, is a breed apart from his fellow bankers, but (and this is the novel’s most haunting suggestion) only by evolutionary degrees. When the mayhem begins, it is presented as nothing more than another instance of sybaritic excess. “I feel heady, ravenous, pumped up,” Bateman says after slicing up a homeless man. “As if I’d just worked out and endorphins are flooding my nervous system, or just embraced that first line of cocaine, inhaled the first puff of a fine cigar, sipped that first glass of Cristal.” Ultimately, the act of murder is merely an exercise in the most self-indulgent display of all, savage dominance, and if it steadily becomes more elaborate and ornate (which it notoriously does), that is because, like ambition, the thrill lies not in the act itself but in the knowledge that it doesn’t suffer by comparison.

It needn’t be said that physical violence occupies a separate moral plane from the mischief of Liar’s Poker. Having your “face ripped off” and having your face ripped off are certainly not identical. Still, the celebration of unabashed sadism in service of superiority and personal success, a spirit that contemporary capitalism seems to tolerate and even abet, is what unites the two books, and one might be forgiven for wondering the degree to which it has contaminated the broader culture. In The Big Short, Lewis says that, while he had always viewed Liar’s Poker as a cautionary tale, not long after it was published he began receiving fan mail from college boys who had read the book as “a how-to manual,” and between them and the aforementioned Halloween revelers, one suspects more than a little overlap.

If the first wave of readers missed the moral conundrums of American Psycho, it may be because, like Lewis’s pen pals, they mistook a catalogue of outrage, excruciating in detail and description, for an endorsement of carnal extravagance. If so, it is a tribute to the salacious subtlety of Ellis’s novel, which, like Liar’s Poker or, for that matter The Great Gatsby, blinds more than a few readers by its meretricious glint.

Such subtlety, substantial not stylistic, is a hallmark of exceptional imaginative literature, which so often contributes to ethics by making everyday discernments seem slightly more ambiguous. The enduring significance of American Psycho is not that it demonstrates the obvious, namely that between the casual cruelty of the Salomon trading floor and the extravagant barbarity of Patrick Bateman there is a point at which the sadism stops being funny. (This should be clear, and clearly felt, to anyone who is not an actual psycho.) The achievement is simpler and more straightforward, and ultimately sharp as a stiletto. To ask, as a matter of moral reckoning: Between the two, what’s the difference?

If the first wave of readers missed the moral conundrums of American Psycho, it may be because they mistook a catalogue of outrage for an endorsement.

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John Paul Rollert is an adjunct assistant professor of behavioral science at Chicago Booth.
At launch, Jet.com was billed as the buzziest new e-commerce site since Amazon.com, being able to raise $225 million from top-tier investors such as Goldman Sachs and Google Ventures. An online timer counted down the seconds to the July 2015 launch. “More than just about any other current startup, Jet seems reminiscent of the dot-com boom era,” wrote Rolfe Winkler in the Wall Street Journal that month.

Jet’s big idea was to combine the Price Club with Amazon. Shoppers would pay $50 up front and in return receive the lowest prices on the web. But as is so often true, the plan didn’t quite work as envisioned.

Many new business ventures, even those that succeed, lurch into failure along the way. For some, that is the end, yet others move forward despite setbacks. To survive opening stumbles and emerge stronger requires an awareness of the “pivot point,” which is an objective measurement around which your business-plan numbers revolve.

Consider a medical-device start-up. In this case, the pivot point is based on the initial clinical trials, where we can see if the device is going to work as intended—or not. How many resources, in terms of money and time, must the company spend to pass that first trial? That’s the money we are betting. And the pivot point? The effectiveness of the device in those trials.

Take Facebook, or eBay: How big could these businesses get without advertising? The pivot point: How fast, without any advertising spending, would it take to load a critical mass of users into their network?

Jet’s initial pivot point was based on marketing spend. How many dollars would it take to get a defined number of people to pay the up-front membership fee? Jet could interact with potential customers in many ways, from banner ads, to targeted promotions and emails, to traditional advertising, and, of course, through prelaunch press buzz. Would the $225 million it raised buy it enough active customers?

Jet got its answer, but not the one it expected. Just a few months after going live, the company announced sales weren’t growing fast enough and waived the membership fee. Jet had missed its pivot point.
Why more than a Plan B?
From afar, it may seem that all a company needs to avoid collapse is to have a Plan B in case things go wrong, and in hindsight, it may appear that Jet had such a plan. But in the thick of the battle, failing to hit your pivot point means that your team had it wrong, that your plan, for now, has failed. How you react to this event will determine if you get a second chance at success—or not.

Jet decided to waive its fee, which may seem like an obvious Plan B. But dropping the fee invalidated everything the company was built on. Jet’s premise was that people would come in droves to pay $50 up front to save on everyday essentials. Without the fee, none of the projected numbers worked without raising prices. You see, Jet’s plan had been to sell everything at true cost, with profits based solely on the $50 annual fee, so no fee, no profits.

Consider how another business reacted when failing to meet its pivot point. A start-up I’ve worked with designs and manufactures a high-tech product for the bicycle market. Its product won rave reviews from experts, but, when placed in stores, it didn’t sell. The entrepreneur reacted by starting to develop a different product instead.

That may sound reasonable, but it’s not a good move. For one thing, new products often have long development times. This company needed sales now, not another long product development and testing delay.

Rather than build something new, the founder needed to spend time understanding what had gone wrong. Why wasn’t the current product selling well? Was the price too high? Was the brand not powerful enough? Had others caught up with the product’s innovation? To fix what had gone wrong, our entrepreneur needed to first figure out why the product wasn’t selling—whether it was due to the product, marketing, competition, or other forces.

Here’s an example of a company that reacted better after failing to meet its pivot point: a start-up pharmaceutical company I have been involved with began with a well-proven clinical concept. The company’s first test of efficacy failed badly. As a result, an important initial investor lost faith in the concept and pulled funding.

But the CEO of the company reacted well. She was quite shaken and questioned whether the concept for the product could ever work, telling her board, “We have done something very wrong. I don’t know what it is. We are going to do nothing from this point forward until I discover why we have failed; we will not start another trial until I find out why this one failed.”

That reaction is anathema to most venture capitalists and management teams, whose mantra is “go faster.” In this case, the CEO chose to stop and understand rather than rush forward. It was exactly the right approach.

The CEO thoroughly analyzed why the tests failed. Her business plan had set forth the scientific reasons the projected dosage regimen would work, with data to back up her approach. But after the trial failed, she methodically checked every issue and decided the right move was to change the dosage. The next pilot trial was a success, and the key investor who had pulled out after the initial failure came back.

A start-up’s reaction to early failures will help determine whether or not it survives. In the case of Jet.com, we may never know if the company could have continued on its own, because it got lucky. Jet found a buyer in Wal-Mart, anxious to dent Amazon’s sales growth, perhaps at almost any cost. Jet will become part of Wal-Mart’s e-commerce platform, and Jet’s results will roll into the larger company’s successes and failures.

This is a happy ending for the investors in Jet, and we all love happy endings. But before pushing forward with your start-up, think about your pivot point. This will help you develop the correct responses if you don’t hit your numbers the first time around.

Perhaps Clint Eastwood as Dirty Harry said it best: “You feeling lucky today, punk?” Answering this question may well affect the return on your next investment.

James E. Schrager is clinical professor of entrepreneurship and strategic management at Chicago Booth.
SHOULD GOVERNMENT INTERVENE IN THE HOUSING MARKET?

Chicago Booth’s Robert H. Topel and Eric Zwick discuss the effect of the US housing stimulus program and tax breaks for mortgage interest

Did the housing stimulus program work?

Zwick: Together with David Berger at Northwestern and Nick Turner at the US Treasury, I looked into the First-Time Home Buyer Tax Credit, a temporary tax credit of $8,000 for first-time home buyers in the wake of the Great Recession to try and induce them to buy homes and shore up the housing market in 2009-10, when inventories in the housing market were at all-time highs.

We find that it was quite effective in inducing a large amount of demand. We estimated the program increased aggregate home sales by 7-14 percent during the policy period. There’s a lot of evidence that the program facilitated beneficial reallocation of underutilized assets from low-value owners, such as banks or builders, to constrained higher-value buyers previously unable to buy because of disruptions in the credit market or down-payment constraints. This demand didn’t immediately reverse. It was concentrated in the existing-home market, which implies that the direct GDP effects were quite modest and limited to realtor and origination fees, and, perhaps, complementary furniture purchases.

The market stabilized, and house-price growth stopped falling as rapidly, at least temporarily. When evaluated as a stabilizer, the program seems to be more effective than when thought of through the traditional demand-management-fiscal-policy view.

Topel: When the layperson hears you say “stimulus,” they’ll think of activities by the government that increase economic activity and increase total output. Eric finds that the program didn’t really increase economic activity in the housing market in the sense of creating a bigger housing stock. It didn’t have an effect that people would traditionally think of as a stimulus. What it did, on the best interpretation, is reallocate housing from some folks who were holding housing to other people who might have had higher value of the housing. So it’s totally reallocative. The stimulus impact in the traditional sense was really de minimis.
There’s a strong incentive for richer people in more expensive places to buy as much in housing services as they can.”
—ERIC ZWICK

If there is a market failure, can government help in reallocating resources?

Zwck: Foreclosure externalities should be solvable in the private market, but that doesn’t happen, and that’s a market failure that this program was specifically addressing. It’s not necessarily sufficient. You also need to have buyers. If there’s a development and no one actually wants to live there, moving people into those homes isn’t creating any welfare.

Topel: You need to make a case, even for that externality, that intervention to target that externality is a useful way of spending society’s resources. This foreclosure externality is true all the time. You drive through any neighborhood and the guy who doesn’t mow his lawn is creating an externality for the people next door. We have ways for the government to intervene in those cases, rules for how neighborhoods have to be kept up. An intervention in markets with an increase in government spending to internalize that particular externality is a leap of faith. It might be cheaper and more efficient to leave it alone, and recognize that externalities are everywhere: loud noise, unmowed lawns, and things like that. You can’t fix them all.

Do US government subsidies for the housing market—estimated at $70 billion–$150 billion annually—benefit the economy?

Topel: The evidence that the mortgage subsidy improves the operation of the housing market is meager. Would they need such a stimulus in Canada, where there is no mortgage subsidy? I’m not convinced we needed it here.

Zwick: We have very weak evidence of the social benefits. There’s an almost universal agreement among economists that this program should be modified, ranging from capped to replaced.

Topel: . . . to abolished.

Zwick: The question is, what would be the effect of such an abolition on house prices? It would be different in Houston than in New York. That would be an interesting area of research.
there some transition cost for getting such a program implemented? The second question is, are there more-efficient ways—if we want to stimulate homeownership at all—to promote it? If downpayment constraints are the primary market failure, maybe we should think about a more cost-efficient program, potentially replacing [the mortgage subsidy] with a payment subsidy.

Topel: Economists are really good at saying that if there’s some subsidy that’s creating a large distortion—such as the mortgage subsidy, which pushes people toward consuming more housing services and less of other things—it would be a more efficient world if we didn’t have such distortions. Getting from A to B is another story, because getting rid of the mortgage tax deduction would affect housing prices and redistribute wealth from people who now own houses. The political support is unlikely to be there. It’s the same as the tax-preferred status of employer-provided health care. Americans overconsume health care because of that distortion, but getting rid of it is costly, because it’s so redistributive.

Who benefits and who is harmed by those subsidies?

Zwick: They seem to benefit owners relative to renters. They benefit high-priced areas relative to low-priced areas because of their structure. They benefit second-home buyers, because you’re allowed to deduct mortgage interest on two homes, up to about $1 million, in the amount of mortgage balance outstanding. Relative to other social programs, it’s actually quite regressive. Its value increases in your marginal tax rate, so the more income you make, the bigger the subsidy is. There’s a strong incentive for richer people in more expensive places to buy as much in housing services as they can, or to increase [spending] relative to what they would buy without a program.

Topel: Think of buying versus renting. It increases homeownership, and some politicians would say that a function of government is to do just that. Why we should have a larger proportion of people buying houses rather than renting homes escapes me.

Zwick: Or it changes the number of bedrooms you buy. Does a third bedroom really benefit society more than a second bedroom?

Fannie Mae and Freddie Mac—the government-sponsored agencies that buy mortgages and turn them into risk-free bonds—are supposed to help promote homeownership to low-income families. Does it work?

Zwick: There is an argument that support for the mortgage market reduces interest rates or stabilizes them across places in a way that makes some [rates] unnatural relative to the underlying risks. I think of that as less of a concern than the originate-to-distribute model. Freddie and Fannie buy mortgages for which they are not the lending officer. They’re not talking to the borrowers. It probably helps make sure that there’s some sort of financing available during bad times when credit markets are weaker, although those are exactly the times when affordability or the likelihood of repaying is low. We are trying to reevaluate as a society how we should intervene in the housing market. As house prices increase—by a lot in places where younger generations want to buy—we need to think about what role we want the government to have in the housing market, because there’s going to be increasing calls from relatively uninformed people for support and help in the housing market.

Topel: The premise of the question was that a larger fraction of the population should own houses rather than rent them. Is that a good public-policy goal? Is there some market failure that’s causing more people to be renting and fewer people to be owning houses than would occur in an efficient world? That’s got to be the rationale for some government intervention, but I don’t know that there is such a distortion. Some people should be renting, some people should be owning, depending on their preferences and their financial constraints.

For more on the United States’ mortgage-interest subsidy, see “Advice for the Next President” on page 24.
Lending market’s future: Which model will lead the way?

Chicago Booth’s Future of Financial Services Initiative convened a forum of 40 financial and academic leaders at Booth’s London campus to explore the state of the alternative lending industry and whether it will be able to boost the funding of small and medium-sized companies around the world. The group debated how the rapidly growing marketplace model, focused on data, automation, and bypassing intermediaries, is disrupting the business of traditional lenders—and who will come out on top.

Scenarios voted on by the forum
- **Strong support**: Traditional lenders and alternative lenders will coexist in parallel.
- **Some support**: Alternative lenders will lead the way, supplanting the traditional lenders.
- **No support**: Traditional lenders will lead the way, absorbing the alternative lenders.

Emerging themes in the alternative lending market

The forum explored how well alternative lenders are managing risk—from platform programming to avoidance of customers with poor credit. The group also considered to what extent regulators should require alternative lenders to keep loans on their own books.

Where UK borrowers sought money before turning to alternative platforms

<table>
<thead>
<tr>
<th>Source</th>
<th>% Sought Funding</th>
<th>% Received Funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>79%</td>
<td>22%</td>
</tr>
<tr>
<td>Friends and family</td>
<td>30%</td>
<td>26%</td>
</tr>
<tr>
<td>Government or public sources</td>
<td>19%</td>
<td>2%</td>
</tr>
<tr>
<td>Building societies or credit unions</td>
<td>13%</td>
<td>3%</td>
</tr>
<tr>
<td>Angel investors</td>
<td>13%</td>
<td>4%</td>
</tr>
<tr>
<td>Venture capital firms</td>
<td>12%</td>
<td>5%</td>
</tr>
<tr>
<td>Philanthropic organizations</td>
<td>7%</td>
<td>2%</td>
</tr>
</tbody>
</table>

How alternative lenders fare at securing business from UK borrowers with good credit

- **A**: lowest risk, **E**: highest risk

All small and medium borrowers in the UK

- **A**: 6.4%
- **B**: 20.3%
- **C**: 35.3%
- **D**: 25.7%
- **E**: 12.3%

Borrowers that use alternative lenders

- **A**: 6.4%
- **B**: 21.5%
- **C**: 39.9%
- **D**: 26%
- **E**: 6.6%

How frequently automatic processes are used to connect borrowers and lenders

- **UK**: Consumer lending: 96%
- **Business lending**: 36%
- **Real-estate lending**: 16%

- **Asia/Pacific**: 85.7%
- **US**: 80.2%
- **China**: 45.4%
- **Latin America/Caribbean**: 28.7%

While alternative lenders get less business from “A” and “B” firms, they do well with satisfactory “C” firms.

Charts do not total 100% because of rounding.

Three big markets account for almost all alternative-finance borrowing.

- **US**: $36.17 billion
- **China**: $101.69 billion
- **UK**: $4.72 billion

Growth, 2014–15

- **UK**: +84%
- **US**: +213%
- **China**: +319%
The two faces of the common market

We must consider darker aspects of political union

BY ARTHUR A. SHENFIELD

By any measure, the European Common Market is one of the most momentous developments of our time. But its purposes and devices are not uniform in character or free from inner conflicts and contradictions. From almost every angle it presents two faces; but the faces change from angle to angle, so that in the final analysis the Common Market has many faces and many contrasts.

The Common Market is at once both retrograde and progressive; both inward looking and outward looking; both a menacing threat to the unity of Europe and its most encouraging hope. It contains the seeds both of a scowling new European nationalism and of a smiling new Western internationalism.

The Common Market has so much in it that is uplifting and encouraging that its darker aspects have been given relatively little attention, at least until the slamming of the door in Britain’s face forcibly drew the world’s attention to them. This has especially been the case in the United States, where the Common Market appeared to show that Europe, whose disastrous divisions had twice shattered the world, had at last learned the meaning of “E Pluribus Unum” and had thus begun to follow in the footsteps of her most successful daughter, now the stay and sheet anchor of the Western world.

For a citizen of Britain to draw attention to these darker aspects will not, it is to be hoped, be construed as a case of sour grapes or an expression of resentment at Britain’s probably temporary exclusion. In fact, in her postwar relations with Europe, Britain has herself presented a forbidding as well as a smiling face.

She refused leadership to Europe when she could have given it and when it would have been received with acclaim; she underestimated the
The creation of trade means the creation of wealth or the reduction of poverty.

capacity and determination of the Six (the six signatories of the Treaty of Rome: Belgium, France, Italy, Luxembourg, Netherlands, and West Germany) to follow their plans through; and she failed to present a reasonable alternative to the Common Market, free from some of its defects, until it was too late.

In addition, when she did decide to join, she found herself powerless to avoid the acceptance of most of the Common Market’s objectionable features. When the negotiations came to an end, Britain rightly protested that her hands were clean, that she had promised to accept the Treaty of Rome under which the Common Market was set up and would do so, and that the adjustments that she proposed were within the provisions of the treaty. But this meant that she accepted much that in her heart she knew was bad and that she could rely only on the possibility of changes within the community to make the good decisively outweigh the bad.

The Common Market was conceived both as a political and as an economic union; its contrasting faces display themselves both in its political and its economic aspects. Let us consider the political aspect first, for, though its political aims are at present more nebulous than its economic aims, they are likely in the end to be the more fundamental.

Political aspect
The political unification of western Europe is a splendid aim of statesmanship. The Common Market is without doubt unifying for the Six, but it is divisive, as it stands, for western Europe as a whole. The Treaty of Rome envisages the accession of other European countries, but its application has made accession difficult.

Now it is true that the Six are not responsible for Swiss and Swedish neutrality and could not be expected to hold up their plans until Switzerland and Sweden could be weaned away from neutrality. But, if they had really wanted western European political union, they would have applied economic measures calculated to facilitate the weaning. Their ring-fence tariff would have been planned to fall to a low level, approaching free trade, and tendencies to the centralization of economic power would have been avoided.

To be strong and cohesive, a political federation does not need the centralization of economic power. The growth of federal economic power in the US in the last 30 years has not necessarily been justified even in the circumstances of the US. In the circumstances of Europe, the prospect of strong federal economic power is in any case uninviting to the smaller countries and repellent to those with traditions of neutrality.

But the die has not yet been cast, and it is still possible for the Six to pursue methods of political unification that will be attractive to the rest of western Europe.

Britain’s special extra-European relationships are more important than Swiss or Swedish neutrality. In the end, she accepted the prospect of European political union even at the possible cost of a weakening of her extra-European relationships.

But when negotiations start again, as they surely will sooner or later, it is doubtful whether Britain will, or should, stomach political union unless it is clear that the new Europe will be firmly committed to the most cordial cooperation possible with the US, the British Commonwealth, and the rest of the free world.

Political unity conceived in rivalry with the US would be a repugnant prospect for Britain and a dangerous prospect for the world.

Economic aspect
Let us now turn to the economic aspect. The two faces of the Common Market display themselves in four principal features of the Treaty of Rome and its application by the Commission in Brussels.

First, there is the customs union itself, with the removal of obstacles to intermember trade and the establishment of a common ring-fence tariff against nonmembers. Second, there is the drive toward harmonization of taxation and of labor legislation, and possibly also toward the centralization of economic initiative. Third, there is the grant of special preferential status to the dependent, or recently dependent, territories of the members. Fourth, there is the scheme for a managed agriculture.
Two faces of trade
The removal of obstacles to intermember trade is per se clearly an immense stride toward freedom of trade and hence the creation of trade. The creation of trade means the creation of wealth or the reduction of poverty. The Six deserve congratulation on their resolution in achieving this great change at an accelerated rate.

But, in combination with the ring-fence tariff, freedom of intermember trade is a system of discrimination; and too little attention has been given to this aspect of it. The higher the common external tariff, the greater will be the discrimination, and the worse will it be for nonmembers.

The Common Market has paid little respect to the principle of Article 24 of the General Agreement on Tariffs and Trade (GATT), to which most countries of the free world are signatories. The article, which lays down the conditions under which customs unions are permissible, ought to be an essential part of the code of behavior of the countries of the free world. Unfortunately, though the spirit of Article 24 is clear—namely, that customs unions should be so fashioned as to minimize the harm to nonmembers of the discrimination against them—its wording is vague.

Hence it has been possible for the Common Market to obtain the right to impose severe discrimination if it wishes, without breaking the letter of the article and without attracting the censure of the other contracting parties.

In this respect the Free Trade Area, proposed by Britain, though discriminatory, would have been better, for its discrimination would have been less. The maintenance of the individual tariffs would almost certainly have done less harm than their averaging on the Common Market lines. On the other hand, it must be admitted that the Free Trade Area would probably have had less inherent durability than the Common Market.

Two trajectories for the Common Market
In the end the question of whether the Common Market as a customs union will be beneficent for the world depends, first, on what happens to the level of the common tariff and, second, on whether the existence of the union produces an expansion of the economies of the members.

If the outward-looking influences predominate, the tariff will fall, and the Common Market will be a source of increased wealth and welfare for the world. If the inward-looking influences predominate, the world may suffer more trade destruction than trade creation.

As to the effect of the union as such upon the economies of the members, it is by no means certain that it has as yet been a significant cause of their splendid growth of recent years. But it can be a cause of growth, if the extended market produces economies of scale and if the resources of the members are propelled into more-economic uses by the removal of protection for less-economic uses.

In fact, in their generally benevolent attitude to the Six, most nonmembers are counting on this expansion. For, even if discrimination harms them, the nonmembers may gain on balance from the trade effects of the growth of the economies of the Six. It is, of course, not any expansion that nonmembers should have in mind here but only such expansion as arises simply from the existence of the union. This expansion has yet to prove its existence decisively.

Harmonization, centralization
The tendency to harmonization is in part an aberration. Some harmonization—for example, that of the members’ turnover taxes—is undoubtedly desirable. But it is a dangerous error to think that free trade demands a complete harmonization of taxation or more than a minimal harmonization of labor laws, practices, and conditions.

As for the tendency to centralization, the elaboration of a plan for the whole of the Common Market on the lines of the French plan would be a nightmare.

Fortunately, it is likely to be a nonstarter. The men who understand how a free economy is coordinated without a plan, and better than by a plan, are influential in Europe and perhaps numerous. What is problematical is what may happen if the larger members fall into balance-of-payments difficulties. Then there may be strong tendencies to increase power at the center.
As yet the two faces of the Common Market have only half-developed features here, and it is too early to decide how they will set.

**Generosity and discrimination**
The arrangements for those underdeveloped countries that have been given the status of Associated Overseas Territories (AOT) are splendidly generous. Their goods will have complete freedom of entry into the Common Market. However, these arrangements are potentially exceedingly damaging to the rest of the underdeveloped world and, hence, to most of the poor people of the world.

What logic is there to bring this damaging discrimination against Brazil, Liberia, Indonesia, Siam, and the rest? Is it that France provides generous aid to her former colonies and holds valuable investments in them? This is not enough. The generosity deserves praise, and her interests deserve respect, but AOT status is too high a prize to be limited to some countries simply by the accident of their association with members—in most cases, France.

Aid to underdeveloped countries ought to be based on a principle different from this, and in any case it ought to be concerted among the developed countries. The Common Market would gain, not lose, if it were thrown open to the products of the whole underdeveloped world, and even the AOTs would gain in the not very long run.

The Six did, indeed, agree to the extension of AOT status to most of Britain’s tropical colonies and former colonies. It is to be hoped that this bespeaks a larger vision and a bolder spirit than the existing provisions display.

**Agricultural provisions**
The critical test of the Common Market is agriculture. The agricultural provisions are extremely important, but they can be dealt with in a few words. They are bad. They will impoverish Europe and the world. They will retard the economic progress of France and Germany, especially Germany. They will aggravate the evils that have already been produced by farm supports in Europe and North America.

Overproduction and maladjustment will become even greater and more intractable. The overseas food-producing countries will be propelled further into the morass of uneconomic secondary industrialization. And sooner or later, the Common Market itself, together with Britain and the US, will be asked to bail the overseas primary producing world out of the troubles into which it will have been locked.

This is what Britain perforce had to accept. It was an expression of her bargaining weakness, not of her moral strength. The face of the Common Market in this aspect is not a handsome one. Yet it is interesting to see that, unless he knew not what he was doing, General de Gaulle cannot have regarded these agricultural provisions as vital when the showdown came on Britain’s negotiations for entry. For at the moment when he slammed the door on Britain, he offered to open it to Denmark, and this would have reduced the privileges of French farmers in the new, managed Common Market agriculture without giving them the opportunities of the great British market.

The faces of the Common Market are still in the process of taking shape. The mold that they will take depends almost as much upon the US as upon the Six themselves.

There is good reason to believe that the forces for international cooperation in the Common Market are stronger than those against it. But they need encouragement and leadership from the US. American timidity, half measures in trade expansion, and the tying of strings to trade liberation may induce the Six to turn inward upon themselves.

The Marshall Plan, which rehabilitated Europe, cost the US a great deal. Vigorous trade liberation will cost the US nothing and give her much. But it will require equal vision and it will take even greater understanding.

Arthur A. Shenfield was 1963 Ford Foundation Visiting Professor of Business Economics at Chicago Booth and economic director of the Federation of British Industries. He passed away in 1990.

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There is good reason to believe that the forces for international cooperation in the Common Market are stronger than those against it.
WHAT ECONOMISTS THINK ABOUT ADMITTING HIGHLY SKILLED IMMIGRANTS

In the 2016 US presidential election, immigration reaffirmed its status as one of the most prominent wedge issues in American politics. More often than not, the campaign-trail conversation focused on illegal immigration—but the candidates disagreed on policies for legal immigration too. On the Democratic side, Hillary Clinton proposed increasing the number of immigrants with advanced degrees in STEM fields by “stapling” green cards to their PhD diplomas. Her plan may sound familiar to political observers, as both former Republican nominee Mitt Romney and President Barack Obama have suggested similar policies. By contrast, Republican nominee Donald Trump wanted to modify the H-1B visa program to increase the prevailing wage for foreign workers, while also requiring companies to hire American workers first.

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

About the IGM Economic Experts Panel
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 a diverse panel of expert economists, all senior faculty at the most-elite research universities in the United States. The panel includes Nobel laureates and John Bates Clark medalists, among others. Questions 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.
Question A: Allowing US-based employers to hire many more immigrants with advanced degrees in science or engineering would lower (at least temporarily) the premium earned by current American workers with similar degrees.

Larry Samuelson, Yale
“One would expect a temporary decrease in the premium, but it is not obvious that the effect would be significant or long-lasting.”
Response: Agree

Darrell Duffie, Stanford
“The short-term story is supply versus demand. In the long run, high-skill immigration could perhaps increase demand for high-skill workers.”
Response: Agree

Markus Brunnermeier, Princeton
“Highly skilled researchers create positive spillovers and make the overall environment more productive, which can boost other skilled workers.”
Response: Uncertain

Kenneth Judd, Stanford
“Any effect would be tiny at any politically feasible level of such immigration.”
Response: Disagree

Question B: Allowing US-based employers to hire many more immigrants with advanced degrees in science or engineering would raise per capita income in the US over time.

Steve Kaplan, Chicago Booth
“More highly skilled immigrants here, more jobs here, more income here all generate more jobs in services and more innovation.”
Response: Strongly agree

Caroline Hoxby, Stanford
“Statement requires certain complementarities on which evidence is so far from strong and precise that certainty would be silly.”
Response: Uncertain

Austan D. Goolsbee, Chicago Booth
“See under ‘History, American.’”
Response: Strongly agree

David Autor, MIT
“Much US wealth comes from innovation, and foreign-born STEM workers are a huge contributor to that effort.”
Response: Agree

Oliver Hart, Harvard
“A simply free-trade argument suggests the US would gain overall. The problem is that there may be losers as well as winners.”
Response: Agree

Responses

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<th>Strongly agree</th>
<th>Agree</th>
<th>Uncertain</th>
<th>Disagree</th>
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<td>7% (10%)</td>
<td>64% (70%)</td>
<td>17% (16%)</td>
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Strongly agree

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<td><strong>Weighted by experts’ confidence</strong></td>
<td>36% (44%)</td>
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<td>5% (6%)</td>
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How strong is your evidence?

Accounting standards can be based on rules, principles, or both. Standards with the optimal balance of rules and principles can discourage a company's managers from tampering with evidence and bribing auditors, according to research by Chicago Booth's Pingyang Gao and Haresh Sapra and New York University's Hao Xue. The research suggests that when a company’s evidence seems genuine and straightforward and exceeds a defined threshold—enough to convince an auditor that a certain transaction occurred, for example—the standard can be principles based. But if the evidence doesn’t meet the threshold, rules-based standards apply. Learn more about the model at Review.ChicagoBooth.edu and on page 9 of this issue.
UPCOMING EVENTS
January to May 2017

Economic Outlook: New York

JANUARY 12
Economic Outlook, New York. Hear Chicago Booth’s Marianne Bertrand, Randall S. Kroszner, and Amir Sufi explore inequality, high student debt, and other issues facing the president. Visit ChicagoBooth.edu/EO for more information.

JANUARY 18
Economic Outlook, Chicago. Chicago Booth’s Marianne Bertrand, Austan D. Goolsbee, Randall S. Kroszner, and Amir Sufi discuss the top economic challenges facing the new president. Visit ChicagoBooth.edu/EO for more information.

FEBRUARY 13–17
Executive Program in Corporate Strategy, Chicago. Examine multiple perspectives of strategic analysis and execution in today’s complex, competitive global environment. Visit ChicagoBooth.edu/EPCS for more information.

FEBRUARY 15
Chicago Conversations Series, Hong Kong. With the rise of the Chinese consumer, how are companies worldwide leveraging big data? Visit ChicagoBooth.edu/conversations for more information.

FEBRUARY 16–17
Leading High Performance Organizations, Hong Kong. Learn behaviors that accelerate or stifle high performance. Visit ChicagoBooth.edu/LHPO for more information.

MARCH 2

MARCH 20–22

MAY 5

Visit ChicagoBooth.edu/programs for more information about our Full-Time MBA, Evening MBA, Weekend MBA, and Executive MBA programs, our PhD degree, and our Executive Education courses. Chicago Booth has campuses in Chicago, London, and Hong Kong, as well as a center in Singapore.
HOW HISTORY SHAPES THE OUTCOMES OF MARKET REFORM Page 18