**FADS AND FASHIONS:**

**IF THEY ARE SO BAD, WHY ARE THEY SO RAPIDLY RICH?**

**Professor Michael Mainelli**

Good evening Ladies and Gentlemen.  I'm pleased to find so many of you gave up an evening's Christmas shopping for this year's Annual Gresham College Buzz Lightyear Lecture.  But we'll come to fads in a moment.

As you know, it wouldn't be a Commerce lecture without a commercial.  So I'm glad to announce that the next Commerce lecture will continue our theme of better choice next month.  That talk is 'Perfectly Unpredictable: Why Forecasting Produces Useful Rubbish', here at Barnard's Inn Hall at 18:00 on Monday, 28 January.

An aside to Securities and Investment Institute, Association of Chartered Certified Accountants and other Continuing Professional Development attendees, please be sure to see Geoff or Dawn at the end of the lecture to record your CPD points or obtain a Certificate of Attendance from Gresham College.

Well, as we say in Commerce - 'To Business'.

We all know that celebrities, sports stars, estate agents, bankers, lawyers and accountants, along with CEO fat cats, are overpaid.  But can we explain why?  One of the great things about fads, fashions and excessive pay is that it gives us an excuse tonight to explore two key points in commerce, namely information asymmetry and positional goods.

**Information Asymmetry**

  [SLIDE: TRUST IN RATIONALITY]

Before we start with information asymmetry, I'd like to share a little puzzle about trust, deterrence and rationality to warm you up.  Imagine that someone promises to leave a bag of oranges by a tree in the woods every day in return for £5 from you.  The first day in the woods, to your delight, you see a fresh bag of oranges next to the tree and leave £5.  This goes on every day until you either worry about losing £5 if he or she doesn't deliver, or you wonder how you could get the last bag of oranges for free.  If you knew the date of the last day, there's no reason for you to leave £5 then; it won't be any good as an incentive because it's the last day and you have all the oranges for free.  But if the other party also knows the last day, there is no reason for them to leave the oranges because they know you have no rational reason to leave the money.  The same argument goes for the next-to-last day.  Since you know the other party won't bring the oranges on the second-to-last day, it makes no sense to leave money on the next-to-last day as incentive.  The other party knows this and so won't bring the oranges on the second-to-last day, or the third-to-last?  In fact, the deal can never get started with rational people.  Trust breaks this jam.  Trust, whatever it is, will get people to leave the money and leave the oranges.  But how can rational people trust?  That's the problem.

  [SLIDE: SOUR COUPÉS]

So let's move from oranges to lemons.  In 1970 George Akerlof wrote a paper on the market for lemons, i.e. bad second-hand cars, for which he shared the 2001 Nobel Prize in economics.  His paper described 'asymmetrical information', where one party, the seller, knows more than the other party, the buyer.  The used-car market is one where quality is variable and guarantees are indefinite.  There are serious incentives for a seller to pass off a low-quality good as a higher-quality one.  However, buyers take this incentive into consideration and refuse to treat any used-car as 'above average'.  Sellers then conclude that they shouldn't sell 'above average' cars on the used-car market which in turn lowers the average car quality.  Ultimately, there are no cars worth trading.  In some ways, the market for lemons exhibits the colloquial form of Gresham's Law, the bad drives out the good when things trade at unknown quality.  The conclusion is that in situations involving great uncertainty over quality competitive markets may fail to emerge or persist.  'When there is uncertainty, information or knowledge becomes a commodity. Like other commodities, it has a cost of production and a cost of transmission, and so it is naturally not spread out over the entire population but concentrated among those who can profit most from it.' [Arrow, 1963, page 946]  When information is too concentrated asymmetrically within the sell-side it kills markets.

Ironically, when asymmetry is in favour of the buyer, when buyers know quality better than the sellers, then markets can exist, so long as the sellers make a profit.  Wikipedia ('The Market For Lemons') gives the example of luxury food, where 'consumers know best what they prefer to eat, and quality is almost always assessed in fine establishments by smell and taste before they pay.  However, a definition of 'highest quality' for food and wine eludes providers.  Thus, a large variety of better quality and higher priced restaurants are supported.'  Writing 'The Economics of Information' in 1963, George Stigler preceded Akerlof with an exploration of how information and ignorance interact with markets.  He posed a suggestion about 'reputation' put to him by Milton Friedman that a department store 'may be viewed as an institution which searches for the superior qualities of goods and guarantees that they are good quality'. Another good example is education.  Much higher education may be strictly unnecessary for employment, but it signals a bright worker and is worthwhile for the worker and the employer to communicate educational qualifications.  Economists have spent a lot of time trying to understand how people 'signal' that they do have higher quality goods or services, for which Joseph Stiglitz also shared the 2001 Nobel Prize.

  [SLIDE: SELLERS > ASYMETTRIC MARKETS]

So let's look at five conditions of information asymmetry in favour of the seller that lead to market failure:

¨     buyers cannot assess quality before a sale is made;
¨     sellers know the quality prior to sale and gain by passing off lower quality as higher;
¨     sellers have no credible disclosure technology or method;
¨     the market lacks effective public quality assurances (by reputation or regulation);
¨     the market lacks effective guarantees.

Situations where the seller usually has better information than the buyer are numerous -stockbrokers, theatres, language translators and health treatments, all come to mind as examples of highly variable quality markets with difficulties.  In fact, in most 'professional' situations the seller has information supremacy.  Situations where the buyer has better information than the seller are fewer, but include sales of old art pieces without prior professional assessment or consumers buying many forms of insurance, which in turn frequently involves 'adverse selection' or 'moral hazard'.  Looking at the market conditions for company audits, you can see why it's full of sour lemons:

¨     buyers can't tell who is a good auditor.  Most auditors provide unqualified audit reports most of the time.  There is no 'grading' of audit reports and little ability to analyse retrospectively to see if failed companies were close to the line or considered very safe at the time of their last audit;

¨     auditors have some idea how good or bad they are and do gain by passing off more junior or less qualified staff as higher quality;

¨     auditors have been unable over nearly a century and a half to signal effectively their credibility;

¨     the market has weak public quality assurances, and Arthur Andersen showed it's probably a useless all-or-nothing collapse rather than assurance;

¨     auditors provide no guarantees, e.g. your money back as a shareholder or creditor if the firm fails.

You have to ask why such a market doesn't collapse?  Lemon markets don't collapse if the buyers must go to the market regardless.  Company law or articles of incorporation or taxation may require companies to purchase audits.  In other lemon markets, huge potential value may keep the market alive, e.g., you might get a magnificent used car at a very cheap price, effectively a lottery, particularly if you're better informed than average, e.g., a car mechanic yourself.  Or that the market clears at a very base level.   You can get a used car for only £100, and it is probably worth nearly that as scrap metal.

  [SLIDE: INFORMATION ASYMMETRY]

I looked low and high for a joke on information asymmetry and thought I'd share this one with you.  A city slicker sought a donkey for a promotional raffle.  He agreed to buy a donkey for £100 from a farmer.  On the day he was due to deliver the donkey, the farmer drove up in his truck and said, 'Sorry, but I have some bad news. The donkey died on the way here.'  The city slicker said, 'Well, then, just give me my money back.' 'Can't do that.  I went and spent it already.' 'OK, then, just unload the donkey.' 'Whatya gonna do with him?' 'I'm going to raffle him off.' 'You can't raffle off a dead donkey!' 'Sure I can.  Watch me.  I just won't tell anybody he's dead.'  A month later the farmer met up with the city boy and asked, 'What happened with that dead donkey?' 'I raffled him off.  I sold 500 tickets at £2 apiece and made a profit of £898.' 'Didn't anyone complain?' 'Just the guy who won.  So I gave him his two dollars back!'

As markets tend towards collapse due to information deficiencies, brand becomes the crucial component.  In fact, conspicuous investment in a brand functions as a signal to potential customers that you're serious, that you have increasing reputation at risk.  Further, in a market where only brand matters, brands consolidate.  People can only keep a few brands in their head.  It's no surprise that we seem to have only four global auditing firms.  Interestingly, some of the solutions to this problem might be the exact opposite of what is proposed by regulators of the profession - increase the cost of audit failure by requiring indemnities from auditors, publish more details on the quality of their records and change auditing to require much more information on the scale of their gradings.

**Earning Curve - Labour Theory of Value**

  [SLIDE: EARNING CURVE - WATER]

We shall come back to information asymmetry, but in order to explore the iniquity of excessive pay we must appreciate the 'Labour Theory of Value'.  We find huge pay differences hard to swallow.  According to the Wall Street Journal, the star of the Sopranos makes $1 million per episode, co-stars $100,000, and regulars in the supporting cast are in the $35 thousand to $50 thousand range.  In 2005 the average pay of FTSE-350 executive directors was £790,000, 37 times the national average.  Management Today, the monthly magazine, has a regular column entitled 'Brain Food: Earning Curve' which features the emoluments of various people in a sector or industry.  For instance, here is a look at the water industry:

¨     RBS, sale of Southern Water to JP Morgan £4.2bn;
¨     Water Aid, public donations ('06) £16.9m;
¨     Philip Fletcher, part-time chairman, Ofwat, p.a. £100k;
¨     London plumber, weekend rate, per hour £150;
¨     Sewage worker, starting salary (p.a.) £13k;
¨     Kona Nigari seawater mineral concentrate, 2 oz £16.25.

An economist's traditional response to crazy numbers is to assume three things, that the market lacks competition or that there are agency problems or that there are information asymmetries.  Apparently excessive pay or reward without one of these three causes troubles economists for a variety of reasons.  Firstly, a few economists try to deny that excessive pay exists.  The amount must be correct as it is set by the market.   Some ethical economists are bothered because excessive pay seems iniquitous to others.  Rather more economists are bothered because it would be much better to have economists rather higher up on the list.

  [SLIDE: EARNING CURVE - THE SUN]

Yet most economists are troubled because the difficulties in modelling excessive pay call into question the value of economics itself.  Even Adam Smith and David Ricardo struggled with earning differentials.  They both placed great store in the idea that value was created principally by labour.

'The real price of every thing, what every thing really costs to the man who wants to acquire it, is the toil and trouble of acquiring it.  What every thing is really worth to the man who has acquired it, and who wants to dispose of it or exchange it for something else, is the toil and trouble which it can save to himself, and which it can impose upon other people.' [Smith, 1776, page 43]

This argument leads to two notions of value - value 'in use' or value 'in exchange'. Smith used the example of water having great value-in-use but little value-in-exchange, while diamonds had little value-in-use but great value-in-exchange.  The things which have the greatest value-in-use often have little or no value-in-exchange; and vice versa.  For instance, paper money has little value-in-use but great value-in-exchange.  Food, at least in the past few decades, retains great value-in-use but has been of little value-in-exchange.

I will have to glide over some complex points on value-in-use and value-in-exchange, but it is important to recognise that early economists cherished a third idea, 'intrinsic value'.  Early concepts of 'intrinsic value' are wrapped up in the Labour Theory of Value, i.e. something ought to be worth how much effort it took to produce it.  Sir William Petty, John Locke, Benjamin Franklin and others all felt that property derives from labour through the act of 'mixing' one's labour with items in the common store of goods, which in turn led inexorably to the importance of property rights.  Classical economists sought an invariable measure of value and spoke of 'real costs' and 'absolute values'.  Classical economists began with the assumption that value-in-exchange was equal to or proportional to labour. Adam Smith observed, 'Labour, therefore, is the real measure of the exchangeable value of all commodities' [Smith, 1776, page 43].

  [SLIDE: EARNING CURVE - COFFEE]

While this approach is appealing, the problems are many.  Is an hour's work just an hour's work or do we need to distinguish between hard workers and slackers?  Clearly too we need to distinguish skilled workers from unskilled workers.  We should also highlight the fact that some workers work only with their minds, while other workers, even if they wished to work with their minds, would be considered mentally worthless.  And similarly some workers work only with their hands, while others would be considered manually worthless.  Of course, some workers use copious quantities of raw materials, or specialist tools or power - the means of production, so they need to be distinguished from purely manual or mental labourers.  And the means of production, as well as control of natural resources, leads us to consider the role of capital in producing intrinsic value.  Finally time becomes a problem.  Some goods and products are perishable, say this autumn's bumper harvest.  Some labour can be stored indefinitely, say stonemasonry.  Other goods, such as wine, increase in value over time.

Henry George (1839-1897), a US political economist, inspired a philosophical and economic ideology that everyone should own what they create, but everything supplied by nature, most importantly land, belongs to all humanity.  Georgists argue that all economic rent (unearned income), i.e., revenues collected from land, emission rights, broadcast spectra, fishing quotas, airway corridors and natural monopolies should go to the community rather than the owner and that no other taxes or burdensome economic regulations should be levied.  In practice, Georgists support high land taxes, but few other taxes.

  [SLIDE: EARNING CURVE - INTERIOR DESIGN]

According to Smith, in primitive societies the amount of labour that produced a good determined its exchange value, but in more advanced societies the exchange value included compensation for the owner of the means of production.  In our relativistic, post-modern world we like to think we are comfortable with the idea that 'something is only worth what some one is prepared to pay for it', though if that were true we couldn't be outraged by 'unfair' pay.  Early classical economists slid on 'value' banana skins too.  Smith, Ricardo and Marx all tried to relate value to labour.  Smith understood that profit came when the 'labour commanded' for a product, that is the amount of labour that is purchased by selling the product, exceeded the 'labour embodied' in the manufacture of the product.  Ricardo more clearly distinguished, as did Marx, 'labour commanded' from 'wages'.  Marx, of course, then examines whether the excess of 'labour commanded' less 'wages' is profit or exploitation.

The Austrian economist Eugen von Böhm-Bawerk introduced the concept of 'roundaboutness' or 'round about methods of production' to point out that capital goods must be made before consumer goods can be produced, yet the capital goods production is responding to consumer demand.  In more modern terms, profit is compensation for the risk that when goods go for sale the proceeds may not cover the production costs.  As well, von Böhm-Bawerk developed Menger's ideas of marginal utility in decisions, helping us to realise that value is related to marginal utility as well as risk.

Smith and the early classical economists understood many of these complexities.  For them, price and value were related to labour, but not identical.  The Labour Theory of Value does not deny the role of supply and demand in influencing price, because classical economists saw the value of a commodity as something other than its price.  In Value, Price and Profit (1865), Karl Marx acknowledges that he believes prices are based on labour, but only when supply and demand are in equilibrium: 'It suffices to say that if supply and demand equilibrate each other, the market prices of commodities will correspond with their natural prices, that is to say, with their values as determined by the respective quantities of labour required for their production.'

  [SLIDE: EARNING CURVE - BOATS]

There is some empirical evidence to support Smith, Ricardo & Marx that value based on labour commanded or avoided approximates value-in-exchange over the longer term.  Shaikh [Shaikh, 1998] showed that value-in-labour correlates strongly with value-in-exchange, though neo-classical economists would say that where prices approximate value-in-labour these are just accidental cases where prices also correlates with costs, rents and profit levels.  The Labour Theory of Value with its intrinsic values contrasts with subjective theories of value, where the value of a good derives from its usefulness in satisfying a want and its scarcity.  Neoclassical economics favours the subjective, non-normative side of the debate.  Neoclassical economics is underpinned by general equilibrium theory in which prices form through supply and demand, taking account of the interaction of preferences, technology and endowments.

Rather handily, the distinction between value-in-use and value-in-exchange points us to the observation that increases in the value-in-exchange of something with a previously low value-in-use correlate with times of scarcity.  The British economist Lionel Robbins famously defined economics as 'the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses.'  Scarcity can be natural or artificial.  Somewhat perversely, scarcity can be created.  If you want to be rich, make a lot scarcity.  A monopoly is an example of control of scarcity.  Wilful destruction can create scarcity.  Scarcity can be created through many manner of exclusionary or exclusivity tactics such as seals of approval, royal warrants, branding or death.  Nothing guarantees the value of artists' extant work more than the certainty that they won't produce any more.  If you want to be rich, make yourself scarce.

Agency problems (as described in the 4 October 2007 lecture, 'What I Like About This Country Is That It Has A Nice Level Of Corruption!') can also create scarcity.  If you have to act through an agent, for example the old stockmarket distinction between broking and jobbing, or the legal distinction between barristers and solicitors, then opportunities exist to use scarcity to push up prices.  This year's Nobel Prize was awarded to three people for their work in Mechanism-design theory, in many cases usefully applied to simplifying calculations for the revelation of private information in order to reduce agency problems.  But tonight we're going to examine the particular problem of weirdly skewed information, and where better to start looking than at fads.

**Fads or Fashions?**

  [SLIDE: FAD?]

Fads are crazes adopted for brief periods of time.  Fashions are modes of expression where people expect the mode to change more rapidly than the culture, yet they endure longer than fads.  Fads are typically ephemeral, frivolous and of little significance.  You know something is a fad when hating it is almost as faddish in a short space of time.  'I just simply hate that new gadget/song/style/celebrity.'  Fashion too, by definition, must change, but it's more enduring and often becomes synonymous with a period or culture.  You know something is a fashion when people find the need to conform quietly despite their dislike, and often don't speak their true thoughts for many years.  'You know, I never could stand blue jeans'.

  [SLIDE: FAD OR FASHION?]

In lecture 6, 'How Can You Have Too Much Choice?' I quoted Carlo Emilio Gadda:

*'Se un'idea è più moderna di un'altra, è segno che non sono immortali né l'una né l'altra.'*
    '*If one idea is more modern than another, it is a sign that neither one nor the other is timeless.'*

Neither fads nor fashions are timeless.  Fads are things like hula hoops, mobile phone ringtones or chav gear.  Fashions involve larger commercial decisions such as a real Gucci bag, Armani suits or a house in the neighboring country.  Commitment matters.  Peel-off tattoos are a fad, while painful, ubiquitous tattoos are a fashion.  And yes, there is often quite a bit of evolution and competition between the two, for example the subtle undermining of Burberry's fashion by chav faddists.

  [SLIDE: FASHION?]

Oscar Wilde remarked that, 'Fashion is a form of ugliness so intolerable that we have to alter it every six months.'  Interestingly, for those to whom fashion is 'business', Wilde touched on a sore point.  In fashion brand names and logos are well-protected, yet designs are not.  Smaller innovative designers often lose their designs to bigger businesses with more resources.  Yet the relative freedom that fashion designers have to 'take inspiration' from others' designs helps to start new fads and fashions, keeping the industry successful.  Stronger intellectual property rights could kill the business.  But then Oscar Wilde is sooo last century.

Economists are very interested in how fads and fashions start.  Bikhchandani, Hirshleifer and Welch [1992] observed that 'One of the most striking regularities of human behavior is *localized conformity*'.  They point out that economics dictates you should believe something or follow someone when the benefits of believing or following outweigh the costs, otherwise don't.  'An informational cascade occurs when it is optimal for an individual, having observed the actions of those ahead of him, to follow the behavior of the preceding individual without regard to his own information.'  Localized conformity of behaviour and the fragility of mass behaviors can be explained by informational cascades.  The implication is that 'informational cascades' can develop where no one questions behaviours.  These behaviours may be correct or incorrect.  Cox [2003], notes, 'Believing a falsehood is not necessarily a dumb or crazy thing to do. It may well be the smart choice. After all, the truth is costly to unearth, so having more of it [truth] means having less widgetry and everything else; if we spent all our time checking facts there'd be no time left to earn a living, go to the beach, sleep.'

But localized conformity can be dangerous.  While you might waste a lot of time seeing useless films that are 'hits', you'll find it more disturbing to realize that medical doctors follow fads too.  Tonsillectomies were a baby-boomer fad.  After a few colds, my tonsils were removed.  The procedure was frightening and useless, and sometimes fatal.  Cox [2003] relates informational cascades to another medical fad, the useless treatment of ulcers, until Warren and Marshall developed their bacterial treatment.  Informational cascades only reverse when the benefits of discovering true information start to outweigh the costs, but the cascade itself increases the costs and thereby reduces the likelihood that benefits will exceed them.  When asked why he no longer went to a popular Minneapolis restaurant, Yogi Berra tried to reverse an informational cascade by exclaiming: 'Nobody goes there no more, it's too crowded!'  Human behaviour develops inertia, and thus herd behaviour is not as random or 'Brownian' as many economic models would like.

  [SLIDE: TYPICAL RISK/REWARD]

Many fashions start as seeming fads, but then endure.  If fads become embedded in the culture then they start to become fashion.  Let's look at the risk/reward tradeoffs.  Most of the time, when we make a decision that involves greater degrees of risk or reward, that decision correlates with greater uncertainty.  On this slide you can see that the big black decision with the greater degree of pay-off, or loss, is on the far left and more uncertain.  You can also see that the red decision with the greater degree of certainty simultaneously contains less risk and less reward.

However, market decisions are not that straightforward.  I would ask some of you to recall lecture 3, 'Perceptions Rather Than Rules: The (Mis)Behaviour Of Markets', where we explored how people's perceptions of other people's perceptions lead to positive feedback or feed-forward and, in turn, bubbles and busts.  A fad is only fun if others recognize what you are doing and, in turn, decide to participate, or at least appreciate.

  [SLIDE: FADS AND FASHIONS - RISK/REWARD]

Now fads are typically frivolous, i.e. they involve little risk and little reward, but are of uncertain value.  You may decide to go to a friend's party wearing something strange and faddish you wouldn't have been seen in a month ago, but laugh it off if everyone starts to make fun of you.  However, wearing the wrong fashion to work, even today, can set your career back.  This, in a funny way, actually reverses the typical risk/reward tradeoffs.  A fad is very uncertain, but involves little risk or reward, while a fashion is rather more certain but involves some genuine risk and reward.

When a herd of investors enter a market together, you have a fad.  In the finance literature both a fad and a bubble describe asset prices above what is considered to be the asset class's fundamental market value.  But how do we know what is the fundamental market value?  Well we don't.  We just believe that strong shifts are transitory and that we will see 'reversion to the mean' in the longer term.  There is a strong resonance here with Smith, Ricardo and Marx seeking 'intrinsic' value.  In the long-term they expected to see prices reflect the amount of labour in a good.

Brands are an intrinsic part of fads and fashions.  In the case of information asymmetry, brands convey information from sellers to buyers.  'You don't know how good or bad my product or service is, but at least you know the brand'.  In the case of fads and fashions, brands communicate two different things.  First, the brand exacerbates the localized conformity.  We have a 'passive consumption culture', i.e., we just buy it if everyone else has.   'Every one else has a Gucci bag, they must be good and I can't be bothered to find out if they are or not, so unless they're grossly overpriced I'll just buy one.'  Second, the brand is meant to convey something about the user or wearer.  'I'm a member of the Gucci tribe'.  Information is being conveyed to the community.  And this leads us to positional goods.

**Positional Goods**

  [SLIDE: POSITIONAL GOODS]

To Aristotle, actuality was the fulfillment of the end of the potentiality.  To Adam Smith, freedom of trade led to freedom from want.  To John Stuart Mill, the social, generous, moral, intellectual and aesthetic pleasures constitute the higher pleasures.  So clearly, it took a crass 20th century economist to face up to real people and their need to keep up with the Joneses.  Fred Hirsch, in his 1976 book, The Social Limits to Growth, distinguished between material and positional goods.  Material goods are traditional, private goods whose production and supply interact with demand under a law of diminishing marginal utility.  Consumers derive less utility from each successive unit until they cease to purchase.  Food is a good example.  You can only eat so much.  You can only use so many washing machines.

Positional goods possess a relative or social value rather than an absolute one.  Examples of positional goods include exclusive real estate, branded education, or trendy restaurant reservations. Satisfaction from a positional good depends on how much you have in relation to everyone else.  Material goods can be created with time and effort, while positional goods are more easily redistributed than created.  Positional goods are inherently scarce, at least in the short term.  In economic terms their supply is inelastic.  Supply cannot rise enough to satisfy the demand of everyone wanting a positional good.  The supply of beautiful lonely beaches at best fixed, or at worst dwindling.  Not everyone can have a high-status job.  If some people have better educations, then others must have worse.

The ideas behind positional goods are not new.  Anthropologists have explained potlatch cultures & Kula rings, while biologists have explained peacock's tails, all in terms of signalling position and fitness.  People have made fun of the *nouveau riche*, for centuries; Thorstein Veblen coined the term 'conspicuous consumption' in his 1899 book The Theory of the Leisure Class; and we update our expressions; today it's 'keeping up with the Gateses'.  An increase in ownership of positional goods benefits some participants at the expense of others.  We can't all be the trendiest, most famous or live in the best neighbourhood.  We even have the pseudo-disease 'affluenza', negative symptoms arising from being, or desiring to be, relatively wealthy.  Some positional goods can't be expanded, for example there may be only one President of your country.  Most goods have a positional and a material component.  You may want a ticket to a concert, but might also pay vastly more to have a private box so people envy you.  Your car has a material function, it gets you from A to B, but your car also has a positional function, it conveys social cachet - at least that's what my friends say about our family's Italian sports car, the Fiat Multipla.

Intriguingly, we use resources from the material economy in order to buy the capacity to compete in the positional economy, so one affects the other, sometimes wastefully.  Luxury brands are the positional goods a lot of people like to mock.  Perversely, adding to the price of a luxury product increases its positional value.  Christian Dior supposedly advised Pierre Cardin not to sell at low prices. 'Make it expensive. Talent should be paid for.'  We may also need to consume more material goods simply to preserve our relative position.  Betts says, 'A 'decent' house in a middle class suburb, like our parents may have had, now costs more, in relative terms, than it did for them.  A 'decent' job like they had now requires more education than theirs did. So we have to use more material resources in order to hold on to the same, relative, place. And as more young people continue their education, parents feel that they must do everything they can to maximise their children's chances, so they invest in private schools, private tuition and so forth. The house, the future for the children and the children's education?  All these require more household resources.  Wives look for paid jobs, everyone works overtime, and stress rises. - Being satisfied with a given income is too dangerous; others might get in front.'

Hirsch explores the allocation of positional goods and points out that traditional supply and demand via price is insufficient.  He looks at three common methods of allocating positional goods, viz. screening, crowding and auctioning, and their weaknesses.  Screening, such as for university entry, encourages elitism.  Crowding, such as on a popular exotic island, destroys the positional good.  While auctioning of scarce goods leads to absurd valuations.  Hirsch explored well the limits of market economies in improving people's conditions, but failed to provide ways of breaking beyond those limits.  Hirsch himself favoured vague cooperative actions, reducing high status jobs' pay and moving positional goods out of the private sector into the public sector.

So does any of this, information asymmetry - fads - fashions - localized conformity - informational cascades - positional goods, help us understand excessive pay?  First, we need to understand one more distinction, price competition versus tournament competition.

**Tournaments**

  [SLIDE: TOURNAMENT COMPETITION]

A tournament is a competition in which contestants play a series of games to decide the winner.  A tournament differs from price competition in that there is one winner, not two or more players with more or less profit.  The American football coach Vince Lombardi used to say, 'Winning isn't everything; it's the only thing'.  Winning outright changes the nature of competitions.  The economics are no longer about matching supply and demand at a price, rather you need to pay the price to win.  Normal commercial operations provide plenty of examples of tournaments from competitive tendering with its 'best and final offer' stage, to bidding for television franchises, spectrum bandwidth or mineral concessions.  There are two major observations on commercial tournaments.  The first is that winners of commercial competitions frequently gain Pyrrhic victories or reap a 'Winner's Curse', i.e. winning bidders in auctions overpay on average.  The second is that cost/benefit analysis becomes binary; it's all or nothing.  This binary nature of tournaments explains, to a large degree, the large amounts paid to sports stars in team sports.  Being second-best in a tournament makes little sense when you could have paid a little bit more to be champion.  But then everybody else pays a little bit more, and so on.  Better to just buy the best players regardless of cost.

We can turn to drawing these four threads together - information asymmetry, localized conformity, positional goods and tournaments - to help us understand excessive pay.

**To Infinity And Beyond - Fat Cats**

  [SLIDE: TO INFINITY AND BEYOND - PROFESSIONS]

I want to look briefly at excessive pay in three areas, the professions, corporate executives and the UK health service.  If we start with the professions you can see how each of the four threads adds to pressure for excessive pay:

¨     information asymmetry: no one knows how good any professional is until after, sometimes well after, they have been commissioned.  This leads people to focus on the wrong element of price, i.e. not the outcome but some input such as hours worked;

¨     localized conformity: people tend to follow others in the way they commission and reward professionals.  A good example is everyone giving estate agents a commission based on the value of the home sold when frequently a larger home is easier to sell.  Other approaches (used in other countries) include the buyer paying the commission, splitting the commission, have staged commissions, or even having sliding commissions downward based on size.  Poor incumbent service also undermines the impetus to move to anything better by making improvement seem unlikely;

¨     positional goods: the brand of a professional can matter to others.  Your private banker on your cheque book or the tour holiday operator you use may be no better than others, but if the brand, and its consequent cost, say something to others, you may find social cachet worth the additional expense;

¨     tournaments: Sometimes you need to win.  If you are about to embark on a major law suit, the name of a major law firm behind you can often bring things to a speedy, even non-litigious solution.  You can't afford to lose.  It may be unfair to the many excellent lawyers working in unbranded practices, but if it works?

  [SLIDE: TO INFINITY AND BEYOND - FAT CATS]

Corporate Fat Cats are very similar to professionals:

¨     information asymmetry: neither the incoming chief executive, nor the board hiring him or her, even knows if the job at a large corporation is manageable;

¨     localised conformity: as pay negotiations involve more the 'black arts' of valuing old masterpiece paintings than accounting calculations, it is hardly surprising that people look to see what other firms pay, ensuring an upwards spiral.  In fact, for some companies, the pay of the chief executive is seen as some perverse sign of virility of the corporation;

¨     positional goods: having a branded, famous chief executive means that some other firm doesn't.  It's hardly surprising that large, listed corporations' chief executives spend much time burnishing their personality cults, their lecture circuits, their autobiographies, rather than their firms.  It will do them more good in the long run;

¨     tournaments: You don't know whether a 100,000 person firm depends on a charismatic chief executive or not.  But do you want to be the board member who tried to find out and failed?  Just pay top dollar and sit back comfortable that you've bought the best you could afford.  And at even 1,000 times the average salary in the firm, it's less than a 1%-of-the-wage-bill gamble.

But how can these four elements apply to UK health?  Back in 1963, a contemporary of Stigler, Kenneth Arrow, looked at the role of information in health care economics:

¨     information asymmetry: Arrow pointed out the implications of moral hazard, the notion that the widespread availability of health insurance would increase demand for health care.  He also stressed that the uncertainty inherent in health care, from diagnosis to treatment efficacy, would augment the role of non-market social institutions (such as norms, ethics, and professionalism) or nonprofit institutions, as a response to overcoming uncertainty and market failure and, in more modern parlance, signalling trust.  Extreme information asymmetry between insurers and physician, between insurer and patient, and between doctor and patient, only heightened trust issues;

¨     localised conformity: we've already seen the 'follow the herd' mentality on treatments.  In fact it can be difficult to get the bulk of practitioners, as opposed to specialists, to challenge traditional treatments of little efficacy;

¨     positional goods: private health in the UK is rather perplexing.  If the NHS did what 'it said on the tin', private health would have a small market.  Instead, private health providers are paid to provide queue-jumping services in a peculiar symbiosis with NHS staff and services.  And they thrive.  Companies provide private health care to employees as a positional differentiator.  Amongst other things, people need to be able to show that they provided good health to family members;

¨     tournaments: in the ultimate tournament of life, if you do know the best treatment, the best physician or the best facility, you will take it.  Health is definitely a positional and tournament good, leading to intense upward pressure on costs.

**To Infinity And Beyond - Globalisation**

  [SLIDE: TO INFINITY AND BEYOND - GLOBALISATION]

Looking ahead to a more integrated world, where we put more and more bags of oranges under more and more trees, on the one hand global interactions may be less likely to reward cooperation and punish defection because the odds of iterative interactions are lessened.  On the other hand, globalisation may increasingly reward cooperation and punish defection because the odds of being held to account over geography and time for previous deeds is increasing.  Are we developing new communities and new methods of handling iterative cooperative games of prisoner's dilemma, or are we [Betts] 'living on moral capital built up in earlier days when religious values and other ethical principles had wider currency?'

Globalisation may also be increasing the tournament nature of work, and the intensity of competition.  Musgrave [2006] says, 'It is not just the Olympics where being fourth is not one-fourth as good as getting the gold - think of being fourth behind Microsoft or Google - It is not just generals or lawyers who get paid a lot for participating in fierce competition.  No one wants to come in second in a competitive battle that may mean life or financial death.'

  [SLIDE: UNI-DIMENSIONAL]

Finally, a global culture weakens the importance of local positional goods.  Do I care that you live on the locally-ritzy avenue in two-bit-town?  Perhaps only the highest skyscraper in Singapore might impress me.  Do I care that you're a member of some exclusive golf club in Paraguay?  That you're professor at some large, but modern university?  Or some ancient, but small college?  Mega-yachts may comparable as we can sail around the world to pull up alongside each other and see who has the largest... yacht; but increasingly the international lingua franca for positional goods is their value.  How much did it cost you - to send your daughter to that school, get your son that holiday, earn that award, buy that house?

The cost of the positional good helps us understand its value, and paradoxically now unites the positional good with the material good.  Sadly, this approach of uniting everything under a single measure, some single currency, makes us more uni-dimensional.  Instead of celebrating the richness of life and its measures - health, happiness, family, fame, location, intellect, success, influence, beauty - we have one single measure.  These days it's really money that talks.  Globalisation forces us to make our positional goods more liquid, more comparable around the globe.  If we succumb to wealth as the measure, we have truly created a world where only a few can feel relatively superior.  Max Ehrmann warned in 1927:

  'If you compare yourself with others,
  you may become vain and bitter;
  for always there will be greater and lesser persons than yourself.'

Perhaps we have realised the ultimate paradox - wealth itself is a positional good and, like most positional goods, it may not be that satisfying.

  [SLIDE: DISCUSSION]

Thank you, and have a positional-goods-free Christmas.

**Discussion**

1.        Does the internet move us to infinity and beyond lemon markets?
2.        Does globalisation lead to tournaments of higher inequality?

**Further Reading**

1.        AKERLOF, George A, 'The Market For 'Lemons': Quality Uncertainty And The Market Mechanism'. The Quarterly Journal of Economics, Volume 84, Number 3 (August 1970), pages 488-500.

2.        ARROW, Kenneth J, 'Uncertainty and the Welfare Economics of Health Care', The American Economic Review, Volume 53, Number 5 (December 1963), pages 941-973 - [http://www.uofaweb.ualberta.ca/economics/pdfs/Econ699A2-F07-RuseskiJ-Uncertainty-&-Welfare-Econ-of-Med-Care.pdf](http://www.uofaweb.ualberta.ca/economics/pdfs/Econ699A2-F07-RuseskiJ-Uncertainty-%26-Welfare-Econ-of-Med-Care.pdf)

3.        BIKHCHANDANI, Sushil, HIRSHLEIFER, David, and WELCH, Ivo, 'A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades', The Journal of Political Economy, Volume 100, Number 5 (October 1992), pages 992-1026.

4.        COX, Donald, 'The Economics of 'Believe It Or Not'', 4 August 2003 - <http://www.econlib.org/library/Columns/y2003/Coxbelieve.html>

5.        SHAIKH, Anwar M, 'The Empirical Strength of the Labour Theory of Value', in: BELLOFIORE, R (Ed.), Marxian Economics: A Reappraisal, Volume 2, Basingstoke, Macmillan/St Martin's Press, 1998 - <http://homepage.newschool.edu/~AShaikh/labthvalue.pdf>

6.        SMITH, Adam, The Wealth of Nations, 1776 [Bantam Classic Edition, March 2003].

7.        STIGLER, George J, 'The Economics of Information' The Journal of Political Economy, Volume 69, Number 3 (June 1961), pages 213-225 - <http://www.iset.ge/upload/stigler.pdf>

**Further Surfing**

1.        BETTS, Katharine, 'Positional Goods And Economics - Hirsch: The Positional Economy - Social Limits To Economic Growth - Sociological Explanations For High Levels Of Per Capita Consumption In Affluent Societies' - <http://home.vicnet.net.au/~aespop/positionalgoods.htm>

2.        The Economist, 'Brands: Who's Wearing the Trousers', 6 September 2001 - <http://www.economist.com/world/displaystory.cfm?story_id=E1_SSDJJN>

3.        HUNTER, Anita, 'Conspicuous Consumption', New Millennium, 1997 - <http://www.garfnet.org.uk/new_mill/autumn97/ah_cons.htm>

4.        Management Today, 'Brain Food: Earning Curve' - <http://www.managementtoday.co.uk/search/index.cfm?&sSearchPhrase=%22earning%20curve%22&lstJournalCodes=MT,WBR,HR&sSortBy=relevance&bAdvancedSearch=true&fuseaction=mt.search.searchresults&sArticleDate=2007>

5.        MUSGRAVE, Gerald R, 'John Bogle's Views On Executive Compensation', Business Economics, April 2006 - <http://findarticles.com/p/articles/mi_m1094/is_2_41/ai_n16675914>

6.        Royal Swedish Academy of Sciences, 'Mechanism Design Theory', Scientific background on the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2007 Compiled by the Prize Committee of the Royal Swedish Academy of Sciences, 15 October 2007 - <http://nobelprize.org/nobel_prizes/economics/laureates/2007/ecoadv07.pdf>

7.        Temple University essay on 'market for lemons' - <http://courses.temple.edu/economics/Econ_92/Game_Lectures/11th-Lemons/market_for_lemons.htm>

8.        Wikipedia - 'Information Asymmetry' - <http://en.wikipedia.org/wiki/Information_asymmetry>

9.        Wikipedia - 'Labour Theory of Value' - <http://en.wikipedia.org/wiki/Labor_theory_of_value>

10.     Wikipedia - 'Positional Goods' -<http://en.wikipedia.org/wiki/Positional_goods>

11.     Wikipedia - 'The Market for Lemons' - <http://en.wikipedia.org/wiki/The_Market_for_Lemons>

**Thanks**

My thanks to Tony Dillof, Stephen Haggard and Ian Harris for prompting some ideas in this talk.

©Professor Michael Mainelli, Gresham College, 17 December 2007