The 485th Convocation

Address: “Seeing the World through the Economic Lens”

By Kevin M. Murphy

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It says in the program that I’m supposed to remove my academic cap. So, in keeping with that, I’ll take my academic cap off. Those of you who want to see whether I really have hair under here are just going to have to wait, I guess.

Thank you very much for having me here to speak today. I know that the students play a big role in deciding who gets to talk, and I am very honored to speak to the students of the Graduate School of Business. They are really close to my heart. When I teach them, I can see the desire they have to succeed and to learn and to really develop themselves. I think great things will come from this class. I particularly enjoyed teaching these students last year as first-year students and many of them again this year as second-years.

Let me go on to talk, at least for a little bit. You’re still students, you know, for a few more minutes at least, so you’re going to be subject to one more lecture. I’m going to talk today a little bit about what it is like to see the world through the eyes of an economist. In my classes I discuss the basic principles, and I talk about how far one can go with those few basic principles.

Today I’m going to touch on three principles: one is the principle of equilibrium, the second is the principle that incentives matter, and finally there is the notion of cost-benefit analysis. I’m going to try to relate these concepts to a variety of ways that you see them in business, how you see them in your personal life, and how you see them more generally when you look at the world.

Let me begin with the notion of equilibrium. In the classroom, we talk about equilibrium in terms of supply and demand—the trade-off between risk and reward in financial markets. This is sort of a formal treatment of equilibrium. When economists think about equilibrium more casually, perhaps the best notion goes back to the old line that there is no free lunch. Why do economists say there is no free lunch? The basic idea is simple. If lunches were free in some places and people had to pay in other places, everybody would gravitate toward the place where they were free, bidding up the price until there was no longer a free lunch available.

Now that story is simple, but it does take us a long way. One of the best applications of no free lunch is the use of the efficient markets hypothesis to study financial markets. Taken literally, the efficient markets hypothesis says that you're going to get equal-risk adjusted returns in all investments.

However, that's not quite right from the point of view of thinking about equilibrium the way economists do. If in fact all investments are equalized in return, what got them there? Why did we get there? If there are no differences, there would be no one searching out differences. So in equilibrium, that won't be quite right. There will be some people who are able to beat the market, but of course they won't be easy to find either. If they were easy to find, then they would become the market and one would no longer be able to beat the market.

So how does it work? The basic idea is simple when applied to financial markets. There will be some people who can beat the market, and there will be a lot of people who claim they can beat the market. So if you go out and just choose randomly among financial advisers or fund managers, guess what? You'll probably actually under-perform the market a little bit. Only by doing some research, or by having some advantage and identifying those who are truly better, would we be able to see a true market equilibrium. So that's the idea that you want to think about in life: that there is a market that tends towards equilibrium. This is not to say that it's perfect. The market can be improved. There are ways to beat the market, but they're not going to be easy to find. You know there's no assurance that you'll be able to just go out and find a superior fund manager. And that's the person who's going to lead the way. Because in a world in which only good mangers existed, there would be no incentive to separate the good from the bad.

The charlatans would run wild. So there's no way in a financial market that you can have a free lunch.

I'd like to now apply that to something that is probably more mundane but equally important. Many of you are going to go out and get a new job. And when you go out and get a new job, you're going to see things—institutions and practices—that you might think seem silly. You might say, "I can improve upon that idea. I have a better idea. I've been here five minutes. These guys have been here five years. But hey, maybe I'm the smartest person in the world!" With five billion people, there's some chance of that—roughly one in five billion. So keep in mind the notion of equilibrium. Those institutions and practices evolved because they had advantages. They're probably better than what you could come up with off the cuff.

But just like the financial markets, the idea markets aren't perfect either. There is room for improvement. There is room to develop new ideas that surpass those that are there. But they're not going to be any easier to find than it is to find a scheme that beats the financial markets. Only by hard work, superior intelligence, and superior application of what you've learned here at the University of Chicago will you be able to actually bring that idea to market.

People often talk about thinking outside the box. And indeed, there are many good ideas outside the box. Unfortunately, there are more bad ideas outside the box than there are good ideas. Does that mean you should not pursue them? No! That's the same as not trying to beat the financial markets. Just remember that most of the ideas you come up with are going to be put aside. They're not going to be good ones. But the reward for finding a good idea is still there. And in fact the product of the reward of getting a good idea and the probability of finding it are going to be roughly equal to the cost of finding and developing an idea . . . let alone the market for ideas being in equilibrium as well. So that's one notion I want you to take with you. The notion that the status quo has value doesn't mean it's perfect. The notion that the market equilibrium model for finance has value doesn't mean it's perfect either. It carries over in an exact way.

The next thing I want to talk about is incentives. One of the ways that economists see things differently than others is the notion that incentives matter. In the classroom we talk about incentives in terms of optimal executive compensation schemes, such as backdating your options and things like that. We don't teach that one here, actually. Someone came up with that one on their own . . . another one of those bad ideas, I think. But we also talk about the economics of crime and punishment, as well as many other things that embody the notion that people respond to incentives.

So let's apply that in different contexts to think about incentives. Let's think about your parents. Now parents do a lot of great things. They raise children. They encourage them to do well. Of course parents have incentives, too. Parents prefer that their kids be happy and successful, as opposed to just happy. Why? Well, then they don't freeload off of them. So incentives apply in many departments. And to say that incentives matter doesn't mean that people are inherently bad or people are inherently lazy. We only mean that, on the margin, incentives make a difference. So parents are more likely to encourage their kids to be successful than they are to encourage them simply to be happy by enjoying themselves being lazy on the couch.

Secondly, we can observe that incentives matter in many other contexts. For example, when we look at the world over the last twenty years, one thing we see in the United States is a tremendous increase in the degree of income inequality. We've seen growth in the differentials in the wages between college and high school graduates, with the difference roughly doubling over twenty years. The returns for having a graduate degree—good for you guys! — have increased just as much or more. So the rewards for education have risen.

But it's not just about education. The rewards for being successful in the economy today are far greater than they were in the past. Now when people talk about inequality, they commonly think about it in terms of the consequences . . . we have a wider range of incomes, and isn't this terrible? That may be, but at the same time the rise in returns has been associated with an increase in incentives. The incentive to do well is greater today than it has been in the past. This fact has spurred investments in education, spurred investments in other forms of training, and spurred greater growth in the economy as a whole. And the returns for individual endeavor are greater now than they have been in the past.

So that's what an economist sees. When you look at the world from a newspaper's point of view, maybe you see widening inequality as being all about distribution of income. The economist brings in the part about incentives . . . that part of the growth in income equality is a change in the incentive structure as well. So that's kind of the difference between the way economists approach the world and how somebody in the everyday world might look at things.

The final thing I want to talk about is something that economists talk about relentlessly: cost-benefit analysis. If taken literally, cost-benefit analysis comes down to saying: Let's enumerate all the costs, let's enumerate all the benefits, and let's decide whether the costs exceed the benefits. But that's not where the greatest value lies. The value of cost-benefit analysis is really two-fold: (1) It forces you to define an objective, that is, decide what I am trying to accomplish. After all, if I'm going to calculate the benefits and costs, I have to decide what those benefits consist of. (2) It also forces you to find where the costs are. Sometimes the costs are hidden. So, for example, you might start a public policy where you want to fight poverty, or fight something else, where the cost is being hidden somewhere else. So it forces you to look at the full range of costs and benefits, not just theory.

More importantly, it forces you to focus on the alternatives. And this is absolutely critical. You can't talk about benefits of a policy without addressing what the alternatives are. So, for example, let's take a topic like global warming. The question is not just whether or not we should do something about global warming. The questions are: What is the alternative? Should we do something now versus later? Maybe later is a better alternative than nothing at all or a big effort today. So maybe you might decide it's better to do less today and more in the future, or vice versa. The point is that you have to enumerate the alternatives to think about the costs and benefits.

One common criticism of cost-benefit analysis is that it is kind of cold. It only focuses upon the tangible economic measurable dollars. But that's not correct at all. The same principles apply when thinking about goals, identifying alternatives, and enumerating the costs and benefits. It doesn't matter whether those costs and benefits are psychic, monetary, reputation, or the like. So when economists are presented with a problem, their economic approach is to think about cost-benefit analysis not as a technique but as a method. That is a way of approaching problems and hopefully solving those problems in the process.

So when you leave here, on top of the things you have learned in class, hopefully you can make the jump from thinking about things on the blackboard to thinking about how you use those same principles in practice.

So don't forget the concepts of equilibrium, such as there's no free lunch. And if it looks too good to be true, it probably is. But that doesn't mean you shouldn't push forward. Just be cautious and be humble, because most likely you are going to turn out to be wrong.

On the incentives side, remember that incentives matter. You give people incentives to do good things, and they will do good things. You give people incentives to do bad things, and they will do bad things. And remember incentives apply in all contexts. So, for example, a common response to a public policy problem is to say that the solution is to get the government to do it. But does the government have the incentive to do it right? What incentive do they have? Their incentives often are not to do it right. Their incentive is to do it with a lot of people at a lot of expense, because that's how they define success in their business. So it's not that the people in government are bad or evil but rather that they are subject to the same incentives as you and me. You just have to recognize what those incentives are. And when faced with a problem, use the principles of cost-benefit analysis. Think about the true goals, identify the goals, and, most importantly, identify the options and make comparisons between benefits and costs of one option versus another.

Thank you very much. I enjoyed speaking to you today.

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