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Are People Self-Interested? The Implications of Behavioral Economics on Competition Policy

Maurice Stucke

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1 INTRODUCTION

For 30 years, the neoclassical economic theories associated with the University of Chicago[1] have shaped American competition policies. These

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[1] It is important to recognize that the beliefs of some Chicago School theorists evolved over time. See RA Posner, 'The Chicago School of Antitrust Analysis' (1979) 127 *U Pa L Rev* 925, at 932 (noting that some ideas first advanced by one of the School's founders Aaron Director 'have been questioned, modified, and refined, resulting in the emergence of a new animal: the "diehard Chicagoan" (such as Bork and Bowman) who has not accepted any of the suggested refinements or modifications in Director's original ideas'). At times, its theorists have clashed over competition policy or in their beliefs in market forces. Nobel laureate Ronald H Coase, who is commonly associated with the Chicago School, for example, rejected the self-interest assumption as 'consumers without humanity'. He observed that the 'rational utility maximizer of economic theory bears no resemblance to the man on the Clapham bus or, indeed, to a man (or woman) on any bus'. RH Coase, *The Firm, the Market and the Law* (1988) at 3 et seq. During the recent financial crisis, Richard A Posner, another Chicago School theorist, reconsidered some of his earlier beliefs. M Baram, 'Judge Richard Posner Questions His Free-Market Faith In "A Failure of Capitalism"' (20 April 2009) *Huffington Post* (interview with Posner) (seeing 'the importance of government regulations; the need to strengthen the regulatory structure by directly funding authorities rather than the current fee-based model; the dangers of excessive executive compensation, and even expressed support for the idea of changing bankruptcy law to make it easier for homeowners

theories assume rational individuals and firms pursue their self-interest, which for this chapter's purpose, means seeking to maximize wealth and other material goals, and generally not caring about other social goals, to the extent that they conflict.[2] In effect, greed and self-interest are repackaged as virtues.[3] Self-interested behavior drives markets toward more efficient outcomes. Until the recent financial crisis, markets were assumed to self-correct. When left mostly alone by government regulators, competition would allocate resources efficiently toward users who value them the most. The government generally need not intervene in the economy since rational market participants, in pursuing their self-interest, prevent or quickly cure most market failures.[4] These economic theories assume that the 'natural laws of the market are in essence good . . . and necessarily work for the good, whatever may be true of the morality of individuals.'[5]

This economic orthodoxy is under attack. '[T]he orthodox and unvarnished Chicago School of economic theory is on life support, if it is not dead,' said Commissioner J Thomas Rosch of the US Federal Trade Commission, 'in the real world – as opposed to the worlds of political and economic theory – markets are not perfect; . . . imperfect markets

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who face foreclosure.'), http://www.huffingtonpost.com/2009/04/20/judge-richard-posner-disc_n_188950.html (accessed December 2010); RA Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (2009).

2 GJ Stigler, 'Economics or Ethics?', in S McMurrin (ed.), *Tanner Lectures on Human Values*, vol. II (1981) 176 (when 'self-interest and ethical values with wide verbal allegiance are in conflict, much of the time, most of the time in fact, self-interest theory . . . will win.'); see also RH Bork, *The Antitrust Paradox: A Policy At War With Itself* (1978) at 119 (profit-maximization assumption is 'crucial' to the Chicago School's theories); RA Posner, *Economic Analysis of Law* (3rd edn, 1986) at 3 ('The task of economics . . . is to explore the implications of assuming that man is a rational maximizer of his ends in life, his satisfactions – what we shall call his "self-interest."'); Posner, *supra* n. 1, at 931 (Chicago School's theory offered 'powerful simplifications,' such as 'rationality, profit maximization, the downward sloping demand curve'); RA Prentice, 'Chicago Man, K-T Man, and the Future of Behavioral Law and Economics' (2003) 56 *Vand L Rev* 1665 n. 4 (collecting additional sources).

3 M Jackman, *Crown's Book of Political Quotations: Over 2500 Lively Quotes from Plato to Reagan* (1982) at 31 (quoting John Kenneth Galbraith) ('The modern conservative is engaged in one of man's oldest exercises in moral philosophy; that is, the search for a superior moral justification for selfishness.').

4 H Hovenkamp, 'Post-Chicago Antitrust: A Review and Critique' (2001) *Colum Bus L Rev* 257, at 266 (describing Chicago School policies); Bork, *supra* n. 2, at 405 et seq.

5 J Cardinal Ratzinger, 'Market Economy and Ethics' (1985), http://www.acton.org/publications/occasionalpapers/publicat_occasionalpapers_ratzinger.php?view=print (accessed December 2010).

do not always correct themselves; and . . . business people do not always behave rationally.'[6] Likewise in shelving the Bush administration's highly-criticized Section 2 Report,[7] the new head of the US Department of Justice Antitrust Division rejected the report's underlying assumption that monopoly markets are generally self-correcting: 'The recent developments in the marketplace should make it clear that we can no longer rely upon the marketplace alone to ensure that competition and consumers will be protected.'[8] She noted how these ideologies failed:

> Americans have seen firms given room to run with the idea that markets 'self-police,' and that enforcement authorities should wait for the markets to 'self-correct.' It is clear to anyone who picks up a newspaper or watches the evening news that the country has been waiting for this 'self-correction,' spurred innovation, and enhanced consumer welfare. But these developments have not occurred. Instead, we now see numerous markets distorted. We are also seeing some firms fail and take American consumers with them. It appears that a combination of factors, including ineffective government regulation, ill-considered deregulatory measures, and inadequate antitrust oversight contributed to the current condition.[9]

The Obama administration is re-examining such fundamental issues as the efficiency of markets and the role of legal, social, and ethical norms in a market economy. This re-evaluation raises many fundamental issues, prompting policymakers in the Obama administration to examine behavioral economics literature.[10] I discuss elsewhere how behavioral economics

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[6] JT Rosch, Commissioner, Federal Trade Commission, 'Implications of the Financial Meltdown for the FTC', New York Bar Association Annual Dinner, New York, NY (29 January 2009), http://ftc.gov/speeches/rosch/090129financialcrisisnybarspeech.pdf (accessed December 2010).

[7] US Dep't of Justice, 'Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act' (2008), http://www.usdoj.gov/atr/public/reports/236681.pdf (accessed December 2010).

[8] Press Release, US Dep't of Justice, 'Justice Department Withdraws Report on Antitrust Monopoly Law: Antitrust Division to Apply More Rigorous Standard With Focus on the Impact of Exclusionary Conduct on Consumers' (11 May 2009), http://www.usdoj.gov/atr/public/press_releases/2009/245710.htm (accessed November 2009).

[9] CA Varney, Assistant Attorney General, Antitrust Division, US Dep't of Justice, 'Vigorous Antitrust Enforcement in This Challenging Era, Remarks as prepared for the Center for American Progress' (11 May 2009), http://www.usdoj.gov/atr/public/speeches/245777.htm (accessed December 2010) 4 *et seq*.

[10] FTC Commissioner Rosch, for example, has been interested in behavioral economics' implications on competition policy. JD Rosch, 'Antitrust Law Enforcement: What To Do About The Current Economics Cacophony? Before the Bates White Antitrust Conference, Washington, DC (1 June 2009), http://

can inform merger analysis[11] and cartel[12] and monopolization cases,[13] so this chapter addresses a key assumption of the Chicago School's neoclassical economic theories – namely, that people pursue their self-interest.[14] First, do people actually behave like the Chicago School's self-interested rational agents? Second, if the answer is no, should self-interested behavior be the desired norm? Third, what are the risks if governmental policies promote self-interested behavior?

2 DO PEOPLE ACTUALLY BEHAVE LIKE SELF-INTERESTED RATIONAL AGENTS?

The Chicago School's theories are derived from the assumption of humans as rational, self-interested, and with perfect willpower.[15] Behavioral economics, in contrast, uses facts and methods from other social sciences such as psychology and sociology to understand the limits of this assumption.[16]

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www.ftc.gov/speeches/rosch/090601bateswhite.pdf (accessed November 2009); Rosch, *supra* n. 6; A Spiegel, 'Using Psychology To Save You From Yourself' (June 8, 2009) *NPR* (June 8, 2009), http://www.npr.org/templates/story/story.php?storyId=104803094 (accessed December 2010).

[11] ME Stucke, 'Behavioral Economists at the Gate: Antitrust in the Twenty-First Century' (2007) 38 *Loy U Chi LJ* 513; ME Stucke, 'New Antitrust Realism' (January 2009) *GCP (Global Competition Policy) Mag*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1323815 (accessed December 2010).

[12] ME Stucke, 'Am I a Price-Fixer? A Behavioral Economics Analysis of Cartels', in C Beaton-Wells and A Ezrachi (eds), *Criminalising Cartels: A Critical Interdisciplinary Study of an International Regulatory Movement* (2011); ME Stucke, 'Morality and Antitrust' (2006) *Colum Bus L Rev* 443.

[13] ME Stucke, 'Should the Government Prosecute Monopolies?' (2009) *U Ill L Rev* 497.

[14] It is beyond this chapter's scope to examine whether firms (which are a collection of individuals) pursue (or should pursue) their self-interest. Just as individual behavior may differ depending upon the norms and expectations in that social setting, so, too, firm behavior may vary. Moreover, profit-maximization, as a normative corporate theory, has many packed issues.

[15] Posner, *supra* n. 1, 928; see also RA Posner, *Antitrust Law* (2nd edn, 2001) at ix (noting how everyone involved in antitrust agrees that firms 'should be assumed to be rational profit maximizers'). But as Posner admitted, 'It is a curiosity, and a source of regret, that to this day [1979] very few of [one of the Chicago School's founders Aaron] Director's ideas have been subjected to systematic empirical examination.' Posner, *supra* n. 1, at 931 n. 13.

[16] For interesting surveys of the behavioral economics research, see GA Akerlof and RJ Shiller, *Animal Spirits* (2009); D Ariely, *Predictably Irrational: The Hidden Forces that Shape our Decisions* (2008); RH Thaler and CR Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness* (2008); H Gintis et al.

Pioneered by Nobel laureate Daniel Kahneman and Amos Tversky, behavioral economics is fundamentally empirical. In testing the Chicago School's assumptions in lab and field experiments, and by using data from actual market transactions,[17] the behavioral economics literature shows that many individuals do not always pursue their self-interest. Human behavior is more nuanced, diverse, and complex. People generally care about treating others, and being treated, fairly. Even when not in their financial interest, many aspire toward benevolence in accordance with religious, ethical or social norms of fairness.[18] We see this everyday. Many donate blood,[19] take time to help strangers, or tip waiters in cities they are unlikely to revisit.[20] Also contrary to the Chicago School's assumption, people in these behavioral experiments sacrifice wealth to punish unfair behavior. Neoclassical economic theory predicts that the punishment mechanism, if it imposes a cost on the punisher, should not affect the outcome.[21] But in the behavioral public goods and trust experiments,

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(eds), *Moral Sentiments and Material Interests: The Foundations of Cooperation in Economic Life* (2005); CF Camerer et al. (eds), *Advances in Behavioral Economics* (2004); C Jolls et al., 'A Behavioral Approach to Law and Economics' (1998) 50 *Stan L Rev* 1471, at 1487. For a broader survey of literature attacking the conventional economic theories, see ED Beinhocker, *The Origin of Wealth: The Radical Remaking of Economics and What it Means for Business and Society* (2007).

[17] For recent surveys of the literature, see S DellaVigna, 'Psychology and Economics: Evidence from the Field' (2009) 47 *J Econ Lit* 315; A Tor, 'The Methodology of the Behavioral Analysis of Law' (2008) 4 *Haifa L Rev* 237. For an earlier informative examination of the criticisms of behavioral economics and responses thereto, see RA Prentice, 'Chicago Man, K-T Man, and the Future of Behavioral Law and Economics' (2003) 56 *Vand L Rev* 1665.

[18] See D Kahneman, JR Knetsch and RH Thaler, 'Fairness as a Constraint on Profit Seeking: Entitlements in the Market' (1986) 76 *Am Econ Rev* 728, at 729 ('A central concept in analyzing the fairness of actions in which a firm sets the terms of future exchanges is the *reference transaction*, a relevant precedent that is characterized by a reference price or wage, and by a positive reference profit to the firm.').

[19] Voluntary blood donations in Britain declined sharply when a policy of paying donors was instituted alongside the voluntary sector. H Gintis et al., 'Moral Sentiments and Material Interests: Origins, Evidence, and Consequences' in H Gintis et al. (eds), *Moral Sentiments and Material Interests: The Foundations of Cooperation in Economic Life* (2005) 20.

[20] In one study, the mean response by those surveyed of the tip they would leave in a restaurant they frequent regularly or in another city which they do not expect to revisit was nearly identical ($1.28 versus $1.27 for a $10 meal). Kahneman, Knetsch and Thaler, *supra* n. 18, at 737; D Kahneman et al., 'Fairness as a Constraint on Profit Seeking: Entitlements in the Market' in CF Camerer et al. (eds), *Advances in Behavioral Economics* (2004) 252, at 264.

[21] Because punishment is costly for the punisher (which the punisher does not recoup through cooperation), self-interested players would not punish.

participants incur costs to punish free-riding.[22] In fact the punishment mechanism has a positive effect in deterring free-riding; in repeat games, contributions steadily increase until nearly all participants contribute 100 percent of their endowment.[23] The behavioral experiments in bargaining settings, as Samuel Bowles summarizes, systematically show 'that substantial fractions of most populations adhere to moral rules, willingly give to others, and punish those who offend standards of appropriate behavior, even at a cost to themselves and with no expectation of material reward.'[24] This 'strong reciprocity' in human behavior entails 'a predisposition to cooperate with others and to punish those who violate the norms of cooperation, at personal cost, even when it is implausible to expect that these costs will be repaid either by others or at a later date.'[25]

One common behavioral experiment is the Ultimatum Game. In this experiment, you are given money (say $100) with two conditions. First you must offer another person some portion of the $100. The second condition is that the other person can accept or reject your offer. If the other person accepts, both of you keep your portions of the $100. If the other person rejects your offered amount, neither of you keep the money. So how much should you offer?

A Chicago School theorist predicts that you would offer the nominal amount. If everyone pursues their self-interest, then you want to keep as much money as possible, and the other person recognizes that one penny/cent/yen is better than nothing. But actual experiments of this Ultimatum Game in over 20 countries show the contrary. Most people offer significantly more than the nominal amount (ordinarily 40 to 50 percent of the total amount available) and recipients typically (about half

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Recognizing this, self-interested players will not contribute to public goods games. Thus, with or without costly punishment mechanisms, the predicted response under neoclassical economic theory is zero contributions.

[22] E Fehr and U Fischbacher, 'The Economics of Strong Reciprocity' in H Gintis et al. (eds), *Moral Sentiments and Material Interests: The Foundations of Cooperation in Economic Life* (2005) 169.

[23] Id. at 169 et seq. In the last few periods of the multi-period games, the actual rate of punishment is low. Id. at 170.

[24] S Bowles, 'Policies Designed for Self-interested Citizens May Undermine "The Moral Sentiments": Evidence from Economic Experiments' (20 June 2008) *Science*, at 1606.

[25] H Gintis et al., 'Explaining Altruistic Behavior in Humans' (2003) 24 *Evolution & Hum Behav* 153, at 154. These authors argue that 'the evolutionary success of our species and the moral sentiments that have led people to value freedom, equality, and representative government are predicated upon strong reciprocity and related motivations that go beyond inclusive fitness and reciprocal altruism.' Id.

the time) reject nominal amounts (less than 20 percent of the total amount available).[26] Consequently, most receivers in this game forgo wealth to punish unfair offers, and offerors generally offer more than the nominal amount.[27]

These results cannot be explained as maximizing one's reputation. Similar results occur in anonymous one-shot games.[28] Even when the game is repeated ten times to allow for learning, similar results follow.[29] In the Dictator Game, a variation of the Ultimatum Game where the receivers must accept any offer, people still share, although the amount shared may vary depending on certain conditions, such as social isolation and whether the recipients stand up and give a few facts about themselves or are identified as a charity.[30]

Not everyone, of course, is cooperative and charitable – some act selfishly. So the outcome in the behavioral experiments can depend on several factors, including whether the participants are primed with non-conscious reminders of the concept of money.[31] Recent behavioral experiments show that even nonconscious reminders of money can cause people to be more independent in their work, but also less likely to seek help from others, less willing to spend time helping others, and stingier when asked to donate to a worthy cause.[32] Those primed with money in get-acquainted conversations put more physical distance between themselves than in the control group.[33] Unlike the people primed with a control condition (their desk faced a poster showing a seascape or flower garden), participants reminded of money (their desk faced a poster showing various currency

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[26] RH Thaler, *The Winner's Curse: Paradoxes And Anomalies Of Economic Life* (1992) at 21–35; C Jolls et al., 'A Behavioral Approach to Law and Economics' (1998) 50 *Stan L Rev* 1471, at 1489–93; W Guth, R Schmittberger and B Schwarze, 'An Experimental Analysis of Ultimatum Bargaining' (1982) 3 *J Econ Behav & Org* 367, at 371–4, 375 tbls 4 and 5; D Kahneman, JL Knetsch and RH Thaler, 'Fairness and the Assumptions of Economics' (1986) 59 *J Bus* S285, S291 tbl 2.

[27] ME Stucke, 'Behavioral Economists at the Gate: Antitrust in the Twenty-First Century' (2007) 38 *Loy U Chi LJ* 513, at 530.

[28] C Jolls et al., 'A Behavioral Approach to Law and Economics' (1998) 50 *Stan L Rev* 1471, at 1492.

[29] Id. at 1490.

[30] N Ashraf et al., 'Adam Smith, Behavioral Economist' (2005) 19 *J of Econ Persp* 131, at 135–6; E Hoffman et al., 'Social Distance and Other-Regarding Behavior in Dictator Games' (1996) 86 *Am Econ Rev* 653–60.

[31] KD Vohs et al., 'The Psychological Consequences of Money' (17 November 2006) *Science*, at 1154–6.

[32] Id. at 1154–6; see also B Carey, 'Just Thinking About Money Can Turn the Mind Stingy' (21 November 2006) *NY Times*, at F6.

[33] Vohs et al., *supra* n. 31, at 1156.

denominations) chose more individually-focused leisure experiences and preferred to work alone rather than with a peer on a task.[34]

3 SHOULD SELF-INTERESTED BEHAVIOR BE THE DESIRED NORM?

People do not predictably and uniformly pursue their self-interest. Because social perceptions and other factors can influence behavior, the second issue is whether humans should aspire toward self-interested behavior. Is greed good? Will it improve overall well-being? The answer is not necessarily.

Few economists defend self-interest on normative grounds.[35] Milton Friedman defended the rationality assumptions not on normative grounds, but on his theories yielding sufficiently accurate predictions.[36] Judge Posner characterized earlier economists' attempts to defend wealth

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[34] Id. at 1156. In another experiment, the participants played the board game Monopoly. After seven minutes, the game was cleared leaving the participants with one of three different amounts of Monopoly play money: $4,000 (high-money condition); $200 (low-money condition) and no money (control condition). For the high- and low-money condition participants, their play money remained in view for the rest of the experiment. Each participant in the high-money group was asked to imagine a future with abundant finances. Those in the low-money group were asked to imagine a future with strained finances. Those in the control group (which received no money at the end) were asked about their plans for tomorrow. An accident was staged: one confederate to the experiment (who did not know the participant's priming condition) spilled 27 pencils before the participant. Participants in the high-money condition on average gathered fewer pencils than the low-money participants, which gathered fewer pencils than the control group. Id. at 1155.

[35] R Skidelsky, 'How to Rebuild a Shamed Subject' (6 August 2009) *Fin Times*, at 11 ('Ever since modern economics started in the 18th century it has presented itself as a predictive discipline, akin to a natural science.'); L von Mises, *Human Action: A Treatise on Economics* (1998) 243 ('Economics is not intent upon pronouncing value judgments.'); D Lewinsohn-Zamir, 'The Objectivity of Well-Being and the Objectives of Property Law' (2003) 78 *NYU L Rev* 1669, at 1688 (criticizing law and economics scholars as typically and conveniently assuming that although ideal preferences are superior to actual preferences as a criterion of well-being, there usually will be no significant empirical differences in applying the two measures); E Zamir, 'The Efficiency of Paternalism' (1998) 84 *Va L Rev* 229, at 251 (noting that economic analysis ordinarily assumes rationality as descriptive, rather than normative or logical).

[36] M Friedman, 'The Methodology of Positive Economics' in (1953) *Essays in Positive Economics* 15; see also Bork, *supra* n. 2, at 120 et seq.

maximization as a societal goal and to make economics a source of moral guidance as 'doomed efforts.'[37] Instead, the economist's role is prescriptive.[38]

Another branch of economic research on happiness confirms the age-old wisdom that once one's basic needs are met, money has a weak influence on happiness.[39] In the US, higher-income individuals (those in the highest decile) reported on average the highest level of happiness.[40] But the happiness economic literature does not identify a correlation between self-interest and greater happiness. After one's basic needs are met, there is no strong correlation between *increases* in wealth and subjective happiness. For example, the mean income (adjusted for inflation) of the top income decile in the US increased 33 percent between 1972 and 1996, but the mean happiness rating for the wealthiest decile remained the same.[41] Personal control – the ability to control one's life or achieve a spiritual indifference[42] – according to a British life satisfaction study, is a better predictor of happiness than income.[43] This is not especially controversial as economists generally recognize the diminishing marginal utility of money.[44] Likewise, once a country's gross domestic product per capita

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[37] RA Posner, 'The Problematics of Moral and Legal Theory' (1998) 111 *Harv L Rev* 1637, 1670.

[38] Id. ('What the economist can say, which is a lot but not everything, is that if a society values prosperity (or freedom or equality), these are the various policies that will conduce to that goal, and these are the costs associated with each. The economist cannot take the final step and say that a society's ultimate goal should be growth, equality, happiness, survival, conquest, stasis, social justice, or what have you.').

[39] In multivariate regressions, income as it correlates to subjective happiness evaluations has a low coefficient. BS Frey and A Stutzer, 'What Can Economists Learn from Happiness Research?' (2002) 40 *J Econ Lit* 402, 410; see also E Dunn et al., 'Spending Money on Others Promotes Happiness' (21 March 2008) *Science*, at 1687.

[40] Frey and Stutzer, *supra* n. 39, at 410 (on a three-point scale ranging from not too happy (1), pretty happy (2), and very happy (3), the tenth decile between 1994 and 1996 had a mean happiness rating of 2.36, which was slightly higher than the ninth decile's mean of 2.3).

[41] Id.

[42] Saint Ignatius of Loyola described this spiritual indifference, 'we must above all endeavour to establish in ourselves a complete indifference towards all created things, though the use of them may not be otherwise forbidden; not giving, as far as depends on us, any preference to health over sickness, riches over poverty, honour over humiliation, a long life over a short. But we must desire and choose definitively in every thing what will lead us to the end of our creation.' Saint Ignatius of Loyola, *Manresa or the Spiritual Exercises of St. Ignatius* (1881) at 22.

[43] D Nettle, *Happiness* (2005) at 73.

[44] M Rabin, 'Diminishing Marginal Utility of Wealth Cannot Explain Risk Aversion', in D Kahneman and A Tversky (eds), *Choices, Values, and Frames* (2000).

exceeds a moderate level of income, societies do not get happier as they get richer.[45] For example, per capita income (adjusted for inflation) in the US more than doubled between 1945 and 1991, but Americans are not necessarily happier.[46] The percentage of 'very happy' Americans has not increased; nor has the percentage of 'not very happy' Americans substantially decreased.[47]

One interesting behavioral experiment recently reaffirmed that there is more happiness in giving than in receiving.[48] The study's authors found that personal spending was unrelated to happiness, but spending more of one's income on charities or on other people predicted greater happiness. In one before-and-after field study, employees who spent more of their profit-sharing bonus on others experienced greater happiness, and how they spent their bonus (on themselves or others) was a more important predictor of their happiness than the bonus's amount. In another experiment, after rating their happiness in the morning, the study's participants were divided into two groups: the first was told to spend by 5 pm the money in the envelope (either $5 or $20) on themselves. The second group was told to give the money to someone else or a charity. After 5 pm, the participants were asked about their happiness. Although the amount of money received ($5 or $20) did not significantly affect the participants' happiness, the prosocial spending group reported greater post-windfall happiness than did the personal spending group.

So if giving leads to greater happiness, the study's authors ask, why don't we spend a little less on ourselves and donate a little more? People predict poorly. The authors found that 63 percent of the university students predicted personal spending would make them happier than prosocial spending, and that $20 would make them happier than $5.[49]

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45 D Kahneman et al., 'Would You Be Happier If You Were Richer? A Focusing Illusion' (30 June 2006) *Science*, at 1909; see also Nettle, *supra* n. 43, at 72 et seq.; R Di Tella and R MacCulloch, 'Some Uses of Happiness Data in Economics' (2006) 20 *J Econ Persp* 25, at 26; D Kahneman and AB Krueger, 'Developments in the Measurement of Subjective Well-Being' (2006) 20 *J Econ Persp* 3, at 15 et seq. (despite China's real income per capita increasing by a factor of 2.5 between 1994 and 2005, no increase in reported life satisfaction, and an increase in percentage who are dissatisfied); Frey and Stutzer, *supra* n. 39, at 413 (Japan's income per capita increased six-fold between 1958 and 1991, while average life satisfaction remained unchanged).

46 Frey and Stutzer, *supra* n. 39, at 403; R Layard, *Happiness: Lessons from a New Science* (2005) at 29 et seq.; Di Tella and MacCulloch, *supra* n. 45, at 26.

47 Layard, *supra* n. 46, at 29 et seq.

48 Dunn et al., *supra* n. 39.

49 Dunn et al., *supra* n. 39, at 1688.

Behavioral economists describe this 'focusing illusion' in pursuing happiness as '[n]othing in life matters quite as much as you think it does while you are thinking about it.'[50] The happiness economic studies show how people inaccurately predict first, the impact of future life events on their happiness (such as junior professors' prediction if denied tenure),[51] second their adapting to their new condition (whether a physical disability or winning the lottery),[52] and third the strong effects of relative rather than absolute wealth on satisfaction.[53] People often predict greater happiness if they were only wealthier. But 'increases in income have mostly a transitory effect on individuals' reported life satisfaction.'[54] Winners of large amounts of money in lotteries, for example, have a temporary boost in happiness.[55] Individuals may desire more goods and services, but after obtaining them, they become preoccupied with obtaining other goods and services.[56]

Many people do not care solely about absolute levels of wealth or personal consumption, but changes in their wealth and consumption relative to others.[57] One's total income is less important than relative income, namely earning slightly more than one's peers, neighbors, friends, or as

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[50] D Kahneman and RH Thaler, 'Anomalies: Utility Maximization & Experienced Utility' (2006) 20 *J Econ Persp* 221; DA Schkade and D Kahneman, 'Does Living in California Make People Happy?' (September 1998) *Psychological Science*, at 340 et seq.

[51] Nettle, *supra* n. 43, at 72 et seq.

[52] Di Tella and MacCulloch, *supra* n. 45, at 36 n. 7 (collecting sources).

[53] Nettle, *supra* n. 43, at 73; Layard, *supra* n. 46, at 41 et seq. Similarly, humans rarely choose things in absolute terms, but their relative advantage to other things. Ariely, *supra* n. 16, at 2. As Professor Ariely discusses, by adding a 3rd more expensive choice, for example, the marketer can steer consumers to a more expensive 2nd choice. In one behavioral economic study, 100 MIT students were offered three choices for *The Economist* magazine: (i) Internet-only subscription for $59 (16 students); (ii) print-only subscriptions for $125 (0 students); and (iii) print-and-Internet subscriptions for $125 (84 students). When the 'decoy' second choice (print-only subscriptions) was removed and only the first and third options were presented, the students did not react similarly. Instead, 68 students opted for Internet-only subscription for $59 (up from 16 students) and only 32 students chose print-and-Internet subscriptions for $125 (down from 84 students). Id. at 5–6.

[54] Kahneman et al., *supra* n. 45.

[55] Nettle, *supra* n. 43, at 75. Even people with acquired disabilities or health problems show considerable, but always not complete, adaptation to happiness. Id. at 83.

[56] Id. at 15; Kahneman et al., *supra* n. 45, at 1909–10.

[57] M Rabin, 'A Perspective on Psychology and Economics' (2002) 46 *Eur Econ Rev* 657, at 661.

HL Mencken observed, one's wife's sister's husband.[58] We compete by comparing ourselves to the wealth and consumption of our peers and the socio-economic class immediately above us. After adapting to the higher rung, we strive for more.[59]

So if self-interested behavior does not necessarily promote happiness, what according to the happiness economic literature does? Although measuring happiness can be fickle,[60] drawing from large diverse samples, the literature yields consistent conclusions. In examining happiness in 50 countries in up to four years, one study identified six factors that can explain 80 percent of the variation in happiness: divorce rate, unemployment rate, level of trust, membership in non-religious organizations, quality of government, and fraction believing in God.[61] On an individual level, the primary sources of happiness are family relationships, employment, community and friends, health, self-control or autonomy, personal ethical and moral values, and the quality of the environment.[62] Individuals who look beyond their self-interest and practice religion, belong to community organizations, do voluntary work, and have rich social connections generally are healthier and happier than those who do not.[63] Likewise, the most satisfying jobs were, as one recent survey found,

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58 Kahneman et al., *supra* n. 45; see also D Neumark and A Postlewaite, 'Relative Income Concerns and the Rise in Married Women's Employment' (1998) 70 *J Pub Econ* 157 (finding that women's employment decisions are positively related to sisters' employment decision; women, whose sisters live nearby and worked the past year, are all else being equal about 10 to 15 percent more likely to work than women whose sisters did not work).

59 Ariely, *supra* n. 16, at 17 et seq.

60 Individual responses can depend on the order or wording of questions, the scales applied, a fortunate event (like the individual discovering a dime before the questioning), or the current weather. Frey and Stutzer, *supra* n. 39, at 406; Kahneman and Krueger, *supra* n. 45, at 6 et seq. One study for example examined the correlation between the responses of two questions: 'How happy are you?' and 'How many dates did you have last month?' When the happiness question was asked first, no correlation was found between the responses. But when the dating question was asked first, there was a significant correlation between the two questions' responses. Likewise, in another study, individuals were first asked to report either three positive or negative recent life events. Respondents who were first asked to recall the recent positive events reported higher current life satisfaction than those who were first asked to report three recent negative events. N Schwartz and F Strack, 'Reports of Subjective Well-Being: Judgmental Processes & Their Methodological Implications' in D Kahneman et al. (eds), *Well-Being: The Foundations of Hedonic Psychology* (1999) at 63–5.

61 Layard, *supra* n. 46, at 71.

62 Id. at 62–73; Nettle, *supra* n. 43, at 85, 87.

63 Nettle, *supra* n. 43, at 156 et seq.

'especially those involving caring for, teaching, and protecting others and creative pursuits,'[64] not those jobs with the highest salaries or that reward self-interest.[65]

4 WHAT ARE THE RISKS IF THE GOVERNMENT PROMOTES SELF-INTERESTED BEHAVIOR?

The Chicago School's assumption of self-interest does not depict how people actually act or ought to act. This leads to the third and final issue: what are the risks of a government policy that promotes such self-interested behavior?

A Chicago School theorist might agree that humans do not (nor should they) invariably pursue their self-interest. Instead, the assumption of self-interested behavior is useful in the context of commercial transactions. No one quibbles when consumers seek to save money by going to the cheaper gasoline station. Manufacturers compete by offering the optimal mix of quality, price, and choices to consumers. Within these happy confines, promoting self-interested behavior is undisputed. No one contends that consumers should opt for higher-priced, inferior-quality goods and services or that a market economy benefits from cartels.

But policymakers can become restless within these confines and press further. If society benefits whenever consumers pursue their self-interest in opting for lower-priced, better-quality goods, shouldn't society likewise benefit whenever people seek to maximize their wealth? 'Greed is the foundation of much economic activity.'[66] So if self-interest is good within the happy confines of price competition, why isn't self-interest good generally?

Even without governmental prodding, profit-maximizing firms will continue to encourage consumers to pursue their self-interest. But to what extent should the government either through soft paternalism or hard policies promote self-interest for its own sake? A helpful exercise is to consider the risks from governmental policies that promote self-interested behavior

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64 TW Smith, 'Job Satisfaction in the United States' (17 April 2007), http://www-news.uchicago.edu/releases/07/pdf/070417.jobs.pdf (accessed December 2010).

65 Heading the list were members of the clergy (87.3% very satisfied), followed by physical therapists (with the second highest mean score and 78.1% very satisfied) and firefighters (80.1% very satisfied). Occupations with the happiest reported people were the clergy (67.2% very happy) and firefighters (57.2% very happy). Id.

66 *Kumpf v Steinhaus*, 779 F.2d 1323, 1326 (7th Cir. 1985) (Easterbrook, J).

as a norm. As I elaborate elsewhere several risks of such policies,[67] this chapter will briefly discuss one risk.

Although humans engage in commerce to promote their satisfaction and at times self-interest, this collective pursuit of self-interest will not always lead to optimal outcomes. Appealing to self-interested behavior, rather than support, at times can undermine a market economy. In examining the recent financial crisis, for example, Richard Posner described how self-interested behavior of 'law-abiding financiers and consumers can precipitate an economic disaster.'[68] Judge Posner draws a distinction of self-interest as a private virtue and public vice. Self-interest is a private virtue in that competition drives businesses to profit maximization, which drives economic progress.[69] But such self-interested behavior can be, at times, a public vice. An overleveraged financial institution may ignore the small probability that its risky conduct in conjunction with its competitors' risky conduct may bring down the entire economy. Each firm in pursuing its self-interest will incur greater leverage to maximize profits. Here, Posner argues, the government must serve as a countervailing force to such self-interested private behavior by better regulating financial institutions.[70]

But Posner's conception of self-interested behavior as a private virtue/public vice is problematic. The more government policies promote self-interested behavior as a private virtue, the more difficult it will be to characterize it over time as a public vice. For example, Posner criticizes government officials for not protecting the public against the risks of self-interested behavior: government officials 'heavily invested' in the ideology of self-correcting free markets deregulated the banking industry, which increased competition and the leverage banks undertook.[71] But these government policies in a sense reflect the will of the public (or those interest groups with the greater political clout). If market participants

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67 See ME Stucke, 'Money, Is That What I Want? Competition Policy & the Role of Behavioral Economics' (2010) 50 *Santa Clara L Rev* 893.

68 Posner, *supra* n. 1, at 107; see also id. at 111 et seq. Fielding congressional questioning during the financial crisis, the former Fed Chairman Alan Greenspan also expressed his 'distress' in discovering a 'flaw' in his free-market beliefs: 'Those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief.' K Scannell and S Reddy, 'Greenspan Admits Errors to Hostile House Panel' (24 October 2008) *Wall St J*, http://online.wsj.com/article/SB122476545437862295.html (accessed December 2010).

69 Posner, *supra* n. 1, at 107.

70 Id. at 107.

71 Id. at 130, 134–5.

personally will profit from deregulation of their industry, they will be more sympathetic to political candidates who broadly construe their self-interested behavior as virtuous, and narrowly consider the likelihood of market failure. With each election cycle, and as the earlier financial crisis loses its salience, the market participants will promote political candidates who praise the virtues of self-interest and more narrowly consider the likelihood of market failure. With each election cycle, voters who survived the last depression will be fewer in number (as they die off), replaced by more confident voters who lived what John Mills described the 'Middle or Revival Period' and the later 'Speculative Period.'[72] As greed seemingly becomes more virtuous in correcting market failures, elected officials will find it increasingly difficult to characterize self-interested behavior as both a private virtue and a public vice.

Rather than maintain this dichotomy, government policies instead can recognize that an economy 'needs other values and commitments such as mutual trust and confidence to work efficiently.'[73] There is nothing inherently virtuous about self-interested behavior. Self-interested market participants – free of legal, social and ethical institutions – are not a prerequisite for a market economy or for promoting overall happiness. Unbridled capitalism, as Professors Akerlof and Shiller write, 'does not automatically produce what people really need; it produces what they *think* they need, and are willing to pay for.'[74] It can maximize output of snake oil or products that eventually wipe out the economy.[75]

At times appealing to self-interest is less effective than appealing to social, moral, or ethical norms. In many behavioral experiments, financial rewards or penalties when displacing social, moral, or ethical norms actually decrease motivation. Behavioral economist Dan Ariely describes several experiments where he divided the participants into three groups – all performing the same mundane task.[76] But one group (the social-norm group) was not compensated, and was asked to undertake the task as a favor. In the first experiment, the social-norm group outperformed the group members who received $5 as compensation for the task, who

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72 J Fox, *The Myth of the Rational Market* (2009), at 309 et seq.

73 A Sen, 'Adam Smith's Market Never Stood Alone' (11 March 2009) *Fin Times*, at 9; *see also* Ashraf et al., *supra* n. 30, at 136 (collecting some of the literature on importance of trust in market economies).

74 Akerlof and Shiller, *supra* n. 16, at 26.

75 See A Faiola et al., 'What Went Wrong?' (15 October 2008) *Wash Post*, at A1 (noting several Clinton and Bush administrations officials' opposition to regulation of derivatives).

76 Ariely, *supra* n. 16, at 69 et seq.

outperformed the group members who received 50 cents. In the second experiment, the two groups did not receive cash but a gift of comparable value (a Snickers bar for the 50-cents group and a box of Godiva chocolate for the $5 group). These two groups performed as hard as the social-norm group. In the third experiment, the gifts were monetized to the two groups – a '50-cent Snickers bar' or a '$5-box of Godiva chocolates' – who again devoted less effort than the social-norm group.[77]

Another implication is that a social policy that promotes the perception that its citizens are self-interested may be self-defeating. People are not inherently selfish. But if they perceive that many others are behaving selfishly (such as cheating on their taxes), then they may be more inclined to behave selfishly as well.[78] For example, one study of more than 5,000 business (mostly MBA) and non-business graduate students at US and Canadian universities found that graduate business students cheat more than their non-business student peers. The largest influence in the business students' behavior, found the study's authors, was the students' perception that their peers were also cheating.[79]

There must be a good reason why many societies internalize in their children the norms of altruism, compassion, and empathy. Before advocating self-interest, one must inquire why societies promote these other norms. Empathy, even for adults, can debias moral judgments. People at times lack the capacity to reach moral judgments through pure reason. Thus a principal pathway to moral judgments is empathy.[80] Studies find that psychopaths understand the rules of social behavior and their action's harmful consequences, but they simply do not care.[81] By putting oneself in the other person's position, one may experience multiple competing intuitions,[82] which helps mitigate self-serving bias,[83] and has been identified as the 'single most effective skill in negotiation.'[84]

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77 Id.

78 Fehr and Fischbacher, *supra* n. 22, at 167.

79 DL McCabe et al., 'Academic Dishonesty in Graduate Business Programs: Prevalence, Causes, and Proposed Action' (2006) 5 *Academy of Management Learning & Education* 294, http://faculty.mwsu.edu/psychology/dave.carlston/Writing%20in%20Psychology/Academic%20Dishonesty/Grop%204/business2.pdf (accessed December 2010).

80 J Haidt, 'The Emotional Dog and Its Rational Tail: A Social Intuitionist Approach to Moral Judgment' (2001) 108 *Psych Rev* 814, 819.

81 Id. at 824.

82 Id. at 819.

83 C Jolls et al., 'A Behavioral Approach to Law and Economics' (1998) 50 *Stan L Rev* 1471, 1503–4.

84 W Ury, *Getting Past No* (1993), at 19.

Ultimately our survival depends upon cooperation and our ability to look beyond our self-interest. Thus the behavioral economics experiments' larger implication is in preventing society's perception of civic duties as unraveling. Once the conditional cooperators perceive others as acting selfishly, they too will act selfishly. Any social policy should discourage, rather than encourage, the assumption that most people act selfishly, and instead emphasize that others are cooperating in their civic duties.[85]

This is especially important as the Internet and global commerce over the past 20 years have broadened social relationships and increased the interdependence of citizens throughout the world. To evolve, economies must rely on complex, large-scale cooperation. When conducting their Ultimatum Game experiment in 15 small-scale economies from 12 countries on 4 continents, the researchers found that the range of offers varied more than the range of offers by university students.[86] The differences among societies in 'market integration' and 'cooperation in production' explained a substantial portion of the behavioral variation between the different economies: 'The higher the degree of market integration and the higher the payoffs to cooperation, the greater the level of cooperation and sharing in experimental games.'[87] Moreover, 'the nature and degree of cooperation and punishment in the experiments,' they found, were 'generally consistent with economic patterns of everyday life in these societies. In a number of cases, the parallels between experimental game play and the structure of daily life were quite striking.'[88] Likewise, in reviewing traits that appear with regularity in studies of cultures of high-performing and adaptive companies, a senior advisor to McKinsey & Co. identified ten

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[85] Fehr and Fischbacher, *supra* n. 22, at 167.

[86] Gintis et al., *supra* n. 25, at 154.

[87] The societies were rank-ordered in five categories – 'market integration' (how often do people buy and sell, or work for a wage), 'cooperation in production' (is production collective or individual), plus 'anonymity' (how prevalent are anonymous roles and transactions), 'privacy' (how easily can people keep their activities secret), and 'complexity' (how much centralized decision-making occurs above the level of the household). Using statistical regression analysis, only the first two characteristics, market integration and cooperation in production, were significant. Id. at 158.

[88] Id. BM Friedman, *The Moral Consequences of Economic Growth* (2005), at 79–102 (describing whenever America was mired in economic stagnation its democratic values stagnated as well. Hostility toward immigrants, the poor, and other competing groups, whether by nationality, religion, race, or gender, increased as these groups were seemingly threatened by others stealing their fixed, or dwindling, share of the pie. In contrast, during periods of economic growth, our society slowly progressed from this zero-sum mentality toward openness, mobility, and democracy).

illustrative performing, cooperating, and innovating norms.[89] These coincide with religious and ethical norms involving respect and reciprocity (for example, do unto others as you would have them do unto you), honesty, and trust.

The recent financial crisis has provided the needed impetus for government policymakers to re-examine many assumptions underlying our current economic policies. A competition policy that assumes self-interested behavior may be misguided. It ignores how ethical, moral, and social norms may hinder undesirable conduct and promote desirable behavior more effectively than financial incentives and penalties. In understanding the drivers of behavior (beyond the assumption of wealth-maximization), competition policy can better understand how such informal norms can promote the desired objectives. Money may be an inefficient mechanism to motivate, noted behavioral economist Dan Ariely. 'Social norms are not only cheaper, but often more effective as well.'[90]

Competition policy's greatest failing, over the past 30 years, has been empirical. Policymakers do not have an effective feedback mechanism to quickly learn of and correct their mistakes when predicting a merger's or restraint's likely competitive effects. Thus they incompletely comprehend how competition works in particular markets, in particular communities, at particular time periods, and the interplay among private institutions, government institutions, and informal social, ethical, and moral norms. Rather than rely on financial incentives and disincentives, policymakers can use the behavioral economics literature to consider how ethical, moral, and social norms can assist in attaining the desired outcome. By undertaking more empirical research, competition authorities will better understand the dynamics of human motivation under different settings and how legal, social, and ethical norms interact to influence individual behavior and competition generally.

The lessons do not end there. The financial crisis has fueled outrage against greedy Wall Street bankers. But did one really expect these bankers to exercise restraint and forgo bonuses? Instead, the financial crisis's larger implication is how many of us were taken in with the notion that self-interest was somehow virtuous. Although greed may now appear repulsive, did we not ourselves once revel in it?

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89 ED Beinhocker, *The Origin of Wealth: The Radical Remaking of Economics and What it Means for Business and Society* (2007), at 370–71.

90 Ariely, *supra* n. 16, at 86.