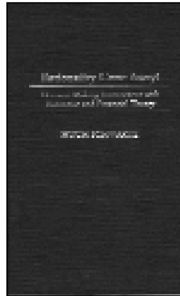
Rationality Gone Awry? Decision Making Inconsistent with Economic and Financial Theory

By Hugh Schwartz, Westport, CT: Praeger Publishers, 1998, 209 pp., hardcover, $65.00.



In the past few years, it has become quite acceptable (some would even say "fashionable") in economics to challenge the heroic portrait of human rationality that is displayed by the theory of maximization of expected utility. One erstwhile devotee (and coinventor) of rational expectations, Thomas Sargent, has even titled a recent book "Bounded Rationality." So perhaps we can say that one important lesson has been learned by the discipline: Any veridical account of economic decisionmaking must take into account the psychological capabilities of decisionmakers, and in particular their limited abilities to envision "all possible" decision alternatives, to deal with the uncertain consequences of taking one decision or another (including especially the reactions of other actors), and even to mediate among their own competing preferences.

But before neoclassical images can be replaced by something that bears a closer resemblance to reality, a theory must come into existence that is based firmly on knowledge about the actual decisionmaking process of real human beings. The lesson that economics is just beginning to learn is that such a theory cannot be constructed in the comfort of an armchair but has to have strong empirical foundations. These foundations must come, on the one hand, from psychology, where a substantial empirically grounded theory of human thinking, learning, problem solving and decisionmaking has been constructed in the past half century. They must come, on the other hand, from economics itself, through direct empirical study of human decisionmaking processes in markets and within business organizations. This process, especially at the microlevel rather than through econometric massaging of rough aggregate data, is just beginning to get under way.

In *Rationality Gone Awry?* Professor Schwartz makes an important contribution to acquainting economists with the existing foundations of a behavioral theory of economics, particularly, but not exclusively, those originating in psychology. In so doing, he surveys a vast number of studies that provide evidence of specific kinds of departures of the decisions of individuals and firms from the neoclassical prescriptions. He devotes a chapter (Chapter 3) to the objectives that individuals and enterprises actually seek, and the frequency and nature of their departures from profit maximization. Chapter 4 focuses on the processing of information: the enormous gap between selecting goals and searching for and analyzing information to arrive at the best choices for implementing these goals. Chapter 5 summarizes the evidence for major anomalies in choice under uncertainty in situations of the sorts that have been explored by Kahneman and Tversky and others who interrogate subjects about decisions involving risk.

Chapter 6 gives a brief account of expectations (including the "rational" kind). Chapter 7 examines the evidence for departures from rationality in individual and corporate investment decisions, including the behavior of financial markets (e.g., their volatility, choices between dividends and capital gains, short-run and long-run profits, corporate takeovers, and portfolio diversification). Although a number of references are made to the work of Roth and Smith, it would have been helpful to have had a more explicit account of the findings from research in experimental economics, which has now become one of the most important sources of new empirical evidence about the working of markets.

In these five chapters we are confronted with an enormous array of specific empirical studies, nearly all of which reveal one or more substantial departures of economic behavior from the behavior that neoclassical theory predicts. In a brief final chapter, Professor Schwartz sums up with some "guidelines for decisionmaking," which consist largely in an enumeration of the dimensions along which "boundedness" may enter into the decision process. But we should not complain if the author does not do what others have not done: lay out systematically the new theory that is to substitute for expected utility

maximization. To fill in the rough framework that is already in place will be a task for the next half century.

Those of us who want to work at this task will find a valuable resource in the final forty pages of *Rationality Gone Awry?* that provides an extensive bibliography, much of it annotated, of the books and papers that the author has examined, which constitutes an enormous mine of facts (and some theories) about how economic decisions are actually made. I found lots of items with which I had not been familiar, and missed only a few that I would have hoped to find there.

If we hold a Popperian view that the function of evidence is to disprove incorrect theories, then against neoclassical economics we can bring in, without delay, a verdict of "failure proven." But then we are faced with shaping the alternative, the new theory that is supposed to replace the old. The evidence amounts to a vast collection of particulars, but these do not painlessly assemble themselves into a new theory. From what we have already learned, what can we say about the shape of that new theory?

One thing we can say with utmost confidence, based on the empirical evidence already available, is that the new theory will resemble the grand laws of physics much less than the numerous painstaking empirically-based generalizations of chemistry or biology. Truly complex systems do not lend themselves to summarization in a few laws of motion. Even within physics, we note the contrast between the sweep of classical mechanics and the painstaking particularities of the theory of solid state devices—electronics. Having made that observation, we can begin to set our research priorities. For real progress, the assemblage of a large and systematic body of fact will need to precede the spinning of webs of theory. And for that to happen, our next generations of graduate students must be trained in a much wider range of research techniques—including experimentation, field study of decisionmaking and historical research—than they now typically encounter.

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Foundations of Organizational Strategy

By Michael C. Jensen, Cambridge, MA: Harvard University Press, 1998, 414 pp., hardcover, $45.00.

Foundations of Organizational Strategy, a collection of papers and articles by Harvard Business School Professor Michael C. Jensen, has only one weakness: its title. Between the covers of this dryly titled and presumably tedious tome is a lively collection of a dozen essays spanning over twenty years of original thinking and outstanding scholarship by one of Harvard's foremost professors. Jensen, with a bit of help from colleagues such as Eugene Fama, Kevin Murphy, and the late William H. Meckling, attacks such diverse issues as the nature of man, the theory of the firm, residual claims and organizational form, agency costs, executive compensation, and organizational performance measurement.

In the author's words, "Economists have historically concentrated on the analysis of markets while treating the organizations in them as black boxes that act as profit-maximizing entities, (and)…behavioral organization theorists have largely focused on the internal aspects of organizations, ignoring the forces of markets in which those organizations exist." In this collection, Jensen bridges these two disparate views, utilizing rigorous economic analysis to forge a superior understanding of both the firm and the individuals who are its employees, partners, and owners.

Organizations, at the most basic level, are networks of individuals drawn together to accomplish a task. The most appropriate place to start is with a robust theory of the individual. Economists are typically accused of viewing individuals only as money-maximizing entities ("economic man"). Jensen demolishes this with an integrative model of the individual as resourceful, evaluative, and maximizing, or REMM. Four postulates exist in the REMM model: Every individual cares, each individual's wants are unlimited, each individual is a maximizer, and the individual is resourceful. The REMM model is contrasted against basic economic, sociological, and psycho-

logical models. The REMM model, a fusion derived from features of each, dominates each of its sources in explanatory power of behavior.

From this base, Jensen proceeds to explore diverse topics, including specific and general knowledge, and the role that knowledge possessed by individuals plays in organizational development and behavior, alienability of decision rights, residual claims and agency theory. Two of the dozen articles review how residual claims influence organizational structure. For example, Jensen observes that, in the financial industry, insurance companies and savings banks have been organized as "mutual" organizations in which the policyholders or depositors are the residual claimants, whereas commercial banking has nearly always been organized as stock companies. Further, professional services organizations have typically been organized as partnerships. There is no market-based reason why an insurance company should choose to be a mutual rather than a stock company, or why a professional services firm could not be organized as a stock company with public ownership (as some have done or are considering). The role of the residual claimant, however, plays a powerful role in the organizational structure.

A welcome surprise was a chapter on executive compensation and CEO compensation. In essence, Jensen identifies the problem of CEO compensation as an agency problem, unchanged from the same agency problems identified by Adam Smith. Building on the framework in the earlier sections, he explores how changes in firm wealth impacts, or fails to impact, the wealth of the CEO. Jensen identified that in many situations, particularly in the largest organizations, increases in firm wealth had little impact on CEO wealth and, presumably, on CEO willingness to increase shareholder value.

CEO compensation packages today, with the emphasis on stock options and the commensurate possibility of immense financial rewards, are dramatically different than when Jensen and his colleagues wrote this and the other articles in the section. While no single individual or article can be credited with the sweeping changes in CEO compensation, there has been a surge in both the attention paid to and the subsequent increase in firm value since the publication of this work in CEO compensation. Jensen diagnosed the problem, and the alignment of CEO compensation and shareholder interests seems to be resolved.

This is not a traditional "popular" book on organizations; rather it is a collection of insightful concepts drawn from years of teaching and research. It is a coherent, orderly, economic explanation of how and why firms organize and the challenges inherent in small and large businesses. In *Foundations of Organizational Strategy*, Jensen opens the "black box" of the organization and provides a coherent and logical framework for understanding how and why organizations develop and operate in the market. His attempt succeeds admirably and will reward the reader with not only concepts and models of theoretical organizational behavior but also keen insight applicable in day-to-day organizational endeavors.

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