Mitchell's Musings 5-18-15: Two (Unrelated) Lessons That Seem Hard to Learn

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Two recent events suggest to me that there are certain lessons which – despite repeated experience – seem hard to learn. One such lesson or non-lesson involves a micro issue: employer-based incentive systems. The other involves a macro issue: international trade policy.

Incentives

During the past couple of weeks, there have been headlines about litigation against Wells Fargo Bank because employees engaged in marketing the bank's services apparently opened accounts for customers which they hadn't ordered.[1] But Wells Fargo is not unique in such activities. Readers may be familiar with the practice of "cramming," the putting of charges on phone bills that weren't ordered.[2]

If you reward employees for undertaking certain actions – or penalize them if they don't reach certain goals – such practices are inevitable. Recently, for example, school teachers in Atlanta were put on trial for faking student test scores (the results of which affected their careers).[3] From time to time, there are complaints involving traffic ticket quotas within police departments.[4] I recently attended a presentation on the use of forbidden drugs by athletes at the Olympics and other contests.[5] The list is endless.

Usually, explicit incentive systems are promoted in human resources circles as "pay for performance." The abstract concept seems so enticing. Employers have an "agency" problem, which in non-economics jargon terms comes down to saying they need to find ways to get the help to do what they want. So why not just pay the help on the basis of what they accomplish for the employer rather than just for time spent on the job? Align the interests of the help with those of the employer, etc., etc., etc., blah, blah, blah.

You don't have to be a true believer in rational economics to be attracted to the idea of pay for performance. Research in behavioral economics – the intersection of economics and psychology – in no way contradicts that idea that you can influence behavior through systems of reward and penalty. The key word, however, is "behavior." Behavior can definitely be altered. But it is unlikely that any reward system can fully align interests of the agent and – to continue the jargon – the "principal," i.e., the employer. You will induce a behavioral change by altering the surrounding set of rewards and penalties. Whether you get the *desired* behavior is entirely another issue.

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[1] http://www.latimes.com/business/la-fi-wells-fargo-class-action-20150515-story.html. Full disclosure: The author is a Wells Fargo customer and has not had the problem described in the article.

[2] https://www.consumer.ftc.gov/articles/0183-mystery-phone-charges; http://www.cleveland.com/consumeraffairs/index.ssf/2015/05/does_sprint_or_verizon_owe_you.html

[3] http://www.usatoday.com/story/news/nation/2015/04/30/atlanta-educators-resentenced/26643997/

[4] http://www.latimes.com/local/lanow/la-me-ln-whittier-ticket-quotas-20150304-story.html

[5] https://ia800309.us.archive.org/33/items/EmeritiReceptionAwards51315/Emeriti%20meeting%20Catlin%20presentation%205-13-15.mp3

So when you read…

"*Wells Fargo officials said they make ethical conduct a priority and punish or fire employees who don't serve customers properly. They acknowledged the bank's strong focus on selling, but said it is intended to benefit customers by identifying their needs*."[6]

…just take it as a symptom of a lesson that seems hard to learn. Pay for performance is a great slogan, but tough in practice to implement effectively. The fact is that you can never do it right, if by "right" you mean perfect. At best there are some arrangements that may work better than others and all systems will produce some degree of perverse behavior. But "may work better than others" is not a catchy slogan, particularly if you are in the business of trying to pitch a particular system.

Trade Policy

President Obama is trying to obtain "fast track" authority from Congress on an international trade agreement known as the Trans-Pacific Partnership (TPP) and is running into resistance, especially within his own party.[7] Under fast track, the Congress can't amend the proposed deal but essentially can only accept or reject it as a whole. One of the sticking points in Congress is a demand that the deal include a mechanism for dealing with foreign currency manipulations. Such manipulations occur when exchange rates relative to the dollar are kept at levels that make foreign production costs artificially cheap. The result has been a chronic negative trade imbalance – about which past Mitchell's Musings have repeatedly dealt - that ends up particularly hurting manufacturing in the U.S.

It's a Good Thing that the currency manipulation problem is being raised in the context of TPP although, as we have long noted, the problem much pre-dates TPP and has been an issue since at least the 1980s. However, as those folks now emphasizing the issue concede, in theory currency manipulation is already against the formal international rules that are supposed to govern trade. Their approach, however, is to improve the enforcement mechanisms.[8]

The fact is, however, that negotiated bureaucratic enforcement mechanisms are ill-suited to deal with the issue. They are slow moving and a form of political litigation. A complaint – to be successful – must prove manipulation and inherently must single out countries doing it. But singling out villains is a problem since the same countries that would be singled out are those from which the U.S. wants cooperation in other matters. To be blunt, China would be named in any such complaint mechanism. But the U.S. wants cooperation from China in dealing with Iran and North Korea, to take two current examples. Japan would surely be named in a complaint. But the U.S. seeks Japanese cooperation in dealing with China.

What would be the likely result were complaints made against offending nations? A probable outcome would be that the offender would make a relatively minor currency adjustment for some period and the result would be heralded as a sign that the problem would be addressed over time. Villains reluctantly

[6] http://www.latimes.com/business/la-fi-wells-fargo-sale-pressure-20131222-story.html

[7] http://www.huffingtonpost.com/2015/04/24/obama-tears-into-elizabet_n_7137854.html

[8] http://s2.epi.org/files/2015/stop-currency-manipulation-in-the-trans-pacific-partnership.pdf

named, complaints, and assurances of corrections over time has in fact been the history of the currency manipulation issue. It hasn't fixed the problem in the past. New bureaucratic procedures are not likely to make much difference in the future.

We have noted in past musings – in fact a musing as recent as April 27 - that there is a remedy that was proposed in the 1980s and that involves no tribunals and no villains. It relies instead on a market mechanism.[9] It was proposed by financier Warren Buffett in an op ed in the *Washington Post*, received its 15 minutes of fame, and then was promptly forgotten.[10] In essence, Buffett's proposal was a variation on what we now call the cap-and-trade approach that is used for air pollution control purposes in order to substitute a market mechanism for bureaucratic regulations and procedures.

Under the Buffett plan, U.S. exporters would receive vouchers allowing imports of the same value as their exports. They could exercise them directly (for imports) or sell them in the market to other importers. Imports could only occur with the requisite vouchers. The result would be balanced trade, i.e., value of U.S. exports = value of U.S. imports with beneficial effects on U.S. manufacturing in particular, both on the export side and for those sectors facing import competition. The *de facto* exchange rate – the combination of the actual exchange rate and the cost of the voucher – would be the exchange rate consistent with a zero trade balance. And, yes, there would be some administrative costs and complications. But there would be no villains, no tribunals, and no token adjustments to smooth international relationships.

What is the actual prospect of our learning lessons from the history of the currency manipulation issue and adopting some variant of the Buffett plan? The odds, unfortunately, are about the same as the prospect that there won't be periodic waves of excitement in the future over the concept of pay for performance. The only thing we learn from history is… well, you know the rest.

[9] http://employmentpolicy.org/page-1775968/3318550#sthash.WuKmYVo9.dpbs

[10] https://drive.google.com/file/d/0BzVLYPK7QI_4NmYyOGQzYzQtMWU1MC00MDEwLWI0ZGUtMzYxYmM2OTY5NjMz/view?usp=sharing. Warren E. Buffett, "How to Solve Our Trade Mess Without Ruining Our Economy," May 3, 1987, *Washington Post*, page B1.