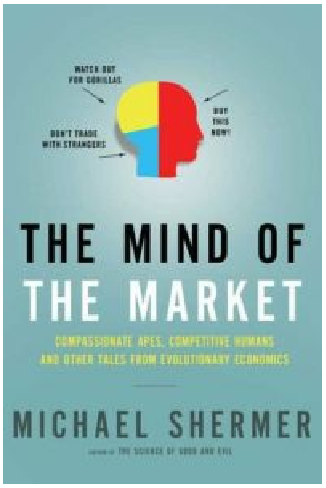

Book The Mind of the Market

Compassionate Apes, Competitive Humans and Other Tales from Evolutionary Economics

Michael Shermer
Times Books, 2007

Recommendation

This is a lively, entertaining, useful and uneven work. Author Michael Shermer ranges over an array of disciplines to synthesize current understanding of the intersection of economics and evolution. He defines and debunks *homo economicus*, or the economic man, a theoretical creation who behaves in a purely rational fashion. Shermer weaves personal experiences with interviews of researchers, summaries of classic texts, and contemporary experiments and observations of such well-known businesses cases as the Enron debacle. Readers with knowledge of behavioral economics or negotiation will find some familiar material in this book. For others, Shermer's connections among biology, psychology, economics and ethics will be enlightening. He overreaches at times, making sweeping claims for the power of the market, but you don't have to agree with every conclusion to enjoy the work. *BooksInShort* recommends this to readers who are interested in behavioral economics, self-knowledge or the machinations of markets.

Take-Aways

- The classic economic model depicting human behavior as purely rational is faulty.
- Better models of economic action and reaction incorporate emotion, values and humankind's evolutionary roots.
- People make bad decisions for reasons that made sense in earlier historic eras.
- Perceptions of the world that were useful to prehistoric humans are now wrong.
- Economic and evolutionary theory both describe complex systems emerging from the bottom up without a single designer in charge.
- Economics and evolution differ on how people and societies change.
- Good rules and good relationships produce good actions.
- Interpersonal and institutional relationships forge the trust that is essential for marketplace interactions.
- Most people misjudge what would make them happy. Happiness stems from love, meaningful work, community participation and spiritual practice.
- To be happy, engage in these things and support a society that allows others to do the same.

Summary

Evolution's Insights into Economic Man

For too long economics worked with the model of *homo economicus*. Economists assumed that this "economic man" was purely rational and "selfish, self-maximizing, and efficient" when making decisions. Put that view to rest. Instead, realize that a range of disciplines, chief among them evolutionary theory, have added profoundly to scientific understanding of seemingly irrational choices. Choices that seem irrational in modern industrial societies were quite rational for humans living in tribes, as did the vast majority of early people. "Reciprocal altruism" is an example of the dichotomy. Playing fair and helping others may seem outdated to people in modern industrial societies, but such practices are critically important to small tribes in hostile environments.

> "Any theory of economics must begin with a sound theory of human nature."

The economic lives of hunter-gatherers and modern humans differ greatly. Tribal peoples earned roughly $100 per year. A village might have only 300 material items. By contrast, contemporary "consumer-traders" in New York City average $40,000 per person per year, and their "village" contains "around ten billion" material items.

What's more, this shift in standard of living did not happen gradually, but instead exploded over the past few centuries. On an evolutionary scale, that's a dizzying pace. Humanity's brains have not caught up with its circumstances.

> "Life, like the economy, is about the efficient allocation of limited resources that have alternative uses."

For example, some decisions make even greater sense when considered in the context of primate biology, for humans are not the only animals who engage in economic reasoning. They share many economic traits with other primates, like reciprocity and a sense of fairness.

Evolution and economics are both "complex adaptive systems," in which individual organisms respond to environmental shifts by changing their behavioral patterns. Theorists say that the two systems also share the characteristic of developing over time from the bottom up, rather than being assembled by some grand designer from the top down. Economics evolve as rivals sell an ever-changing mix of products and services in an ongoing contest for limited resources. The free market encourages such competition and may drive higher standards of living.

> "The environment is the designspace of evolution. The market is the designspace of economics."

Most people fail to understand this though, because they make moral and political judgments based on what might be called "folk science." They take principles that applied in the evolutionary past, and apply them to contemporary economic situations without proper adaptation or understanding. The mismatched results often are bad or even dangerous economic policies. For example, in a tribe of hunter-gatherers, a member who accumulated wealth did so at the expense of others. This is not only morally wrong but is also potentially harmful. Others might starve. However, wealth in a capitalist society comes from very different sources than wealth in tribal societies and arrives often in such abundance that no one has to suffer because someone else is rich. Instead, the opposite is often true.

> "The standards set for us by modern society distort our perceptions about what will actually bring us satisfaction because we evolved in an environment radically different from the one in which we now live."

People also misunderstand evolutionary theory. Misconceptions about Darwinian thought lead many people to believe that evolutionary theory assumes that "humans are inherently selfish" and compete with one another for survival. They do compete, but they also cooperate, which is sometimes the superior survival strategy for both the self and the species. People prefer a social system that permits as much personal freedom as possible while minimizing the destructive consequences of selfishness. Thus far, the best social organization is "a liberal democracy and free market capitalism."

The Development of Markets

Once a product is established in the marketplace, so-called "path dependency" can take hold. No matter why consumers initially choose an established product or service, they tend to avoid alternative paths to satisfaction, even when other companies produce imitations of established products. An established product also can inspire loyalty among social circles or "social networks" of satisfied users. However, market dominance can be fleeting. Established products may not stay that way. Rival products and standards constantly emerge.

> "The first principle of what I call virtue economics is this genetically embedded reflex of reciprocity: When someone gives us something, we feel that we should give something back."

Pivotal differences "between biological and cultural evolution" relate to their potential for variation. Biological organisms may mutate but they avoid hybridizing with radically different species. By contrast, a change introduced in one industry may suddenly cross-pollinate with a completely different type of industry.

Dissonance, Decisions and Desires

If you strongly believe one thing and have invested accordingly, but evidence clearly demonstrates the opposite and you lose money, you have a dilemma. Rather than resolve this "cognitive dissonance" by objectively identifying the best option, many people rationalize their decisions to avoid admitting that they were wrong.

> "In other words, the evolution of moral (or immoral) behaviors came first, the attribution of moral value came later. We really are moral primates."

People often "filter" their consumption of news to obtain information that confirms their existing opinions. This can be dangerous in the market. This tendency has evolutionary roots. Since humans began their evolution living in small packs of hunter-gatherers, tribe members learned to read one another's every cue, tracking body language and facial expression with great accuracy based on extended intimacy. This made them highly attuned at telling when someone was lying, which then led to social punishment (such as shunning the liar). Thus, people need to feel they "are doing the right thing" when they speak and to believe fully in their statements, even if it means discarding some contrary evidence.

> "Happiness is a subjective state of well-being that depends on relative frames of reference, grounded in an evolved psychology that finds meaning in the simple social pleasures and purposes of life."

This often leads to poor decision making, and to bias and other distortions in perception. People tend to notice others falling prey to bias and to believe that they can avoid it. Study subjects asked to rank their personal character against others' usually ranked their own higher. People tend toward a "self-serving bias" to support their belief that they are morally superior to others and better at self-monitoring. They believe that they catch their own biases through introspection while others often fool themselves. Also, people are more likely to give themselves credit for good intentions and to see their own failings as honest errors, while casting the missteps of others as malicious and intentional.

> "Cognitive dissonance drives people to rationalize irrational judgments and justify costly mistakes, whether they are end-of-the-world cultists or political leaders."

A more general flaw in decision making comes from a human tendency to find patterns in things – even when they aren't there. Related human failings include the “representative fallacy,” a tendency to imbue events with excess importance, and the “availability fallacy,” when people see frequently dispersed or recent information as more credible than other data. In negotiations, this leads to the “anchoring fallacy,” when an initial offer may anchor the rest of a discussion, even illogically. How you frame a question shapes the response as well: People will go out of their way to save $50 on a $100 item, but not on a $1,000 item.

> “Humans also have an amazingly low tolerance for economic ambiguity.”

Many failed models of modern economic reasoning made good sense in the evolutionary past. Consider the “endowment effect,” or over-appraising the value of things you own. This refers, for example, to a tendency among some stock owners to value their shares more highly than nonowners do, and to resist selling them. This sort of attachment makes sense for a hunter, who needed to hoard food to survive. In the modern world, though, it leads to the “sunk-cost fallacy,” which keeps people invested in a stock even after their initial reasons for investing in it have evaporated. In general, people seek data that supports their “existing beliefs” and they “ignore or reinterpret” contrary evidence, a tendency called the “confirmation bias.”

Rules, Community and Virtue

Broadly speaking, a society’s organizing rules can develop in two ways. People can establish rules organically and informally, keeping things flexible and basing conflict resolution on social norms. Or they can develop formal, written rules, leading them to resolve conflicts through more formal interactions, such as a legal system.

> "The web of trust is cast upon everything we do, and without it, we would be like strangers in a strange land.”

While groups of people can move from one system of organization to another, they can’t do so without consequences. One societal model may be more appropriate than the other, depending on the context. Informal rules work better in smaller communities where members have ongoing social relationships, and share interests and a knowledge base. People interact with each other in a specialized environment on an ongoing basis in enterprises ranging from start-up companies to cattle ranches.

> “The point of having moral codes – whether you are a hunter-gatherer or a consumer-trader – is to construct an environment of trust that encourages the expression of moral behavior.”

Formal institutional rules, on the other hand, spread from the top down, and can cross communal and ethnic boundaries. These rules need to be standardized, in part, because they operate separately from human contact. These formal and informal sets of rules can interact. For instance, knowing that the law stands behind them may enable people to make informal agreements with greater trust.

> “There is nothing natural about a free economy, and there is nothing inevitable about human groups evolving towards a free market.”

A society that tries to design “markets to be moral” must minimize abuses. The society must nurture trusting relationships among market members, interactions that can flourish under the shelter of the rule of law as “reinforced by social institutions.” The choice is between the ruthless, self-aggrandizing behavior of Enron and the culture of Google, as epitomized by the Internet search company’s explicitly stated code, “Don’t Be Evil.” Success at Google is defined as doing good things for society, not just doing well for shareholders. This is harder than you might think. Tribal ancestry nudges people to align closely with their immediate group and to ridicule notions that outsiders are somehow equal.

Money and Happiness

Various proverbs have long warned that money can’t make you happy, but science has finally confirmed that idea. Economic growth has exploded in recent decades. By every economic measure, people in the U.S. have a higher standard of living now than they did 50 years ago. They also live longer. But their personal experience of happiness is less pervasive for two broad reasons. First, human beings are genetically predisposed to varying levels of happiness. The environment exerts only a limited influence on their happiness. Second, people tend to evaluate their wealth and satisfaction in relative, not absolute, terms. The value of an individual’s improved status is diluted if everyone in his or her “social group” has experienced similar improvement.

Most people misjudge the sources of their happiness as well as the duration of any changes in their happiness. Most people think that more money would make them happier, even if it doesn’t, and that a big change, like winning the lottery or losing a job, would affect their level of happiness for a long time. In reality, most people have a standard level of happiness – a habitual mood – to which they regularly gravitate regardless of outside circumstances. The majority of people also presume that novelty produces more happiness than it really does.

But why feel happy at all? Why feel any emotion? For emotions to have survived as part of the human inheritance, “they must have some adaptive function.” Emotions work with conscious reasoning to guide human action. Emotions associated with depression, for example, can signal a need to make a major change. Indeed, emotions actually are an even better guide to human action than rational thoughts are in many situations. Studies from various disciplines indicate that some factors contributing to happiness transcend rational thought.

The first of these factors is “deep love and family commitment”; the second is a career that means something to you and gives you a “sense of purpose”; third, because humans are “a social species,” community involvement leads to happiness. Finally, people generally need some spiritual practice in their lives, anything – from meditation to religion to art appreciation – that transcends the mundane.

Taken in combination, these tendencies call for some guiding moral principles based on human nature that serve as the foundation of any successful society. Pursuing happiness is good when the result makes someone else happy and bad when it hurts others. Freedom is a worthy pursuit, as well, especially if it leads to greater freedom for others, but unworthy if it encumbers others. Similarly, the decision to “pursue purposeful goals” is especially good if it also lends purpose to others, but bad if conducted at the expense of other people’s dignity and self-worth.

About the Author

Michael Shermer is a columnist for *Scientific American* and the author of several books including *Why People Believe Weird Things*.