



13 September 2009

## The credo of rational stupidity

31 July 2008

But Huw Dixon refuses to economise on brain effort and remains sceptical of the mysteries of price tags

From his preface, Richard B. McKenzie reveals himself as a believer in the "mystery of prices": the Hayekian doctrine on the transubstantiation of private information into public prices by the invisible hand of the market. In this credo, the market is a divine mechanism and human attempts to "subvert the market" - by price regulation for example - can only make things worse owing to the "law" of unintended consequences. For him, prices are never stupid: there is always some hidden purpose (such as making money) giving rise to what may seem an anomaly.

So why is popcorn so expensive? McKenzie does not like the "misguided entrapment" argument that cinemas exploit their monopoly power over the sale of in-house foods and beverages (this goes against the idea of the market's divine benevolence). No, the explanation is that cinemas sell a "bundle" of experiences: the film and the popcorn. The overall price is the combined price of the popcorn-film bundle. Popcorn lovers enjoy the overall movie experience more, and so end up paying more for the bundle than non-popcorn lovers who just buy the ticket. Mmm: well, isn't that just the "entrapment argument": popcorn lovers will get ripped off once they enter the movie premises?

Let us try another example: why prices end in a "9" and other "just below" prices. Well, McKenzie does not like the idea that people are stupid and are fooled systematically in such a pervasive practice. The answer put forward is that there is a cost to thinking, so that consumers choose rationally to ignore the later digits in a price to economise on brain effort. They are not stupid, but rationally stupid: they choose to act dumb because it is too costly to be smart. Geddit? Well, this again seems a sleight of hand, with McKenzie more the Jesuit casuist than simple economist.

Turning to printers, once again McKenzie does not like the entrapment idea in which you are lured into buying a cheap printer and then ripped off on cartridges. No: as in the popcorn, you are buying a package (printer plus cartridges). You know that the cartridges are going to be exorbitant (you will get ripped off), so the printer company has to give you a cheap printer to get you to buy the package. Well, yes, but isn't that similar to the entrapment argument?

In the end, most of the examples considered are similar to those above. McKenzie drives very fine distinctions (as in the case of stupidity versus rational stupidity) to come to the rescue of the rational agent and the market mechanism. I personally prefer to accept that markets are imperfect and people do make systematic mistakes. For example, people routinely make mistakes in simple statistical decisions and the evaluation of risk. This has been well documented in the economic psychology literature and is ruthlessly exploited where possible.

This is an interesting book and a good read. The level is not technical and is similar to some of the recent crop of popular economics writings (including those of Tim Harford and Steven Levitt). Even if you are not entirely convinced by McKenzie's preferred explanation, he takes you through the main arguments and evidence. What differentiates this book is its ideology: markets and people are rational. I prefer to look at the market as a fickle and moody divinity that can result in market imperfections that need the intervention of the state to prevent its worst excesses. As the University of Chicago's Richard Thaler said: "There is no reason to think that markets always drive people to do what is good for themselves." Amen to that.

### **Why Popcorn Costs So Much at the Movies, and Other Pricing Puzzles**

By Richard B. McKenzie

Copernicus Books