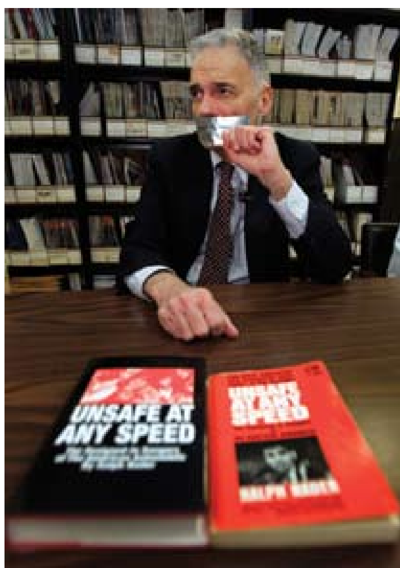
Would you rather be right? Or would you rather get rich? Steven Levitt's book FREAKONOMICS is a national bestseller, but according to this actuary, it could have benefited from some expert opinion.

Go Ahead, Try

BY GERRY SMEDINGHOFF

IN 1965, after several years of steadily increasing auto fatalities, Ralph Nader declared that the automobile was the scourge of the country and must be disciplined. Yet, in the two decades from 1925 to 1945, the auto fatality rate (measured in deaths per mile traveled) had dropped by 50 percent. And in the next 20 years from 1945 to 1965—when his landmark book *Unsafe at Any Speed* was published—the auto fatality rate was reduced by another 50 percent. But instead of praising the auto industry for its unprecedented and phenomenal safety record, in the absence of government regulation, he chose to accuse it of criminal negligence.



Nader may have known numbers, but he was completely ignorant of statistics. What he didn't know was that while auto fatalities were increasing at an alarming rate, Americans were buying cars and driving at an even more alarming rate. In other words, he never adjusted the fatality data for exposures. But while actuaries and statisticians may have ignored or even mocked his buffoonery, Nader became famous and built a legacy, laughing all the way to the bank.

The mass media may now be in the process of anointing a new Ralph Nader, a University of Chicago economics professor named Steven Levitt, co-author of the new book *Freakonomics: A Rogue Economist Explores the Hidden Side of Everything.* A more accurate subtitle would be, "A Rogue Economist Asks the Right Questions but Gets the Wrong Answers."

In spite of the book's problems, Levitt's work and methodology are a huge improvement on Nader's hatchet job of the auto industry. This is why Milton Friedman cites John Maynard Keynes as one of the most important economists of the 20th century: Because brave pioneers must be allowed to get everything wrong, before more knowledgeable successors can get things right. Thus the benefit of this book is not what Levitt says but how he teaches his readers to think.

Levitt's primary fault is that he appears to pose his questions only to himself, where a little peer review and insider expertise would have saved him the trouble of writing much of the book and saved readers from being misled by it. Levitt just can't help but believe that the first possible explanation that comes to his mind to explain two correlating variables must be correct.

His secondary fault is that he fearlessly dives into the most treacherous of academic exercises, employing the discipline of economics to explain everyday phenomena that don't appear to make sense, without realizing just how difficult and frustrating this task can be. Which is another way of saying that most economists find it difficult to do much better. But to Levitt's credit, he does expose several popular media myths with robust statistical data.

Two economists who have written mass market books of this genre, David Friedman with *Hidden Order* (1996) and Steve

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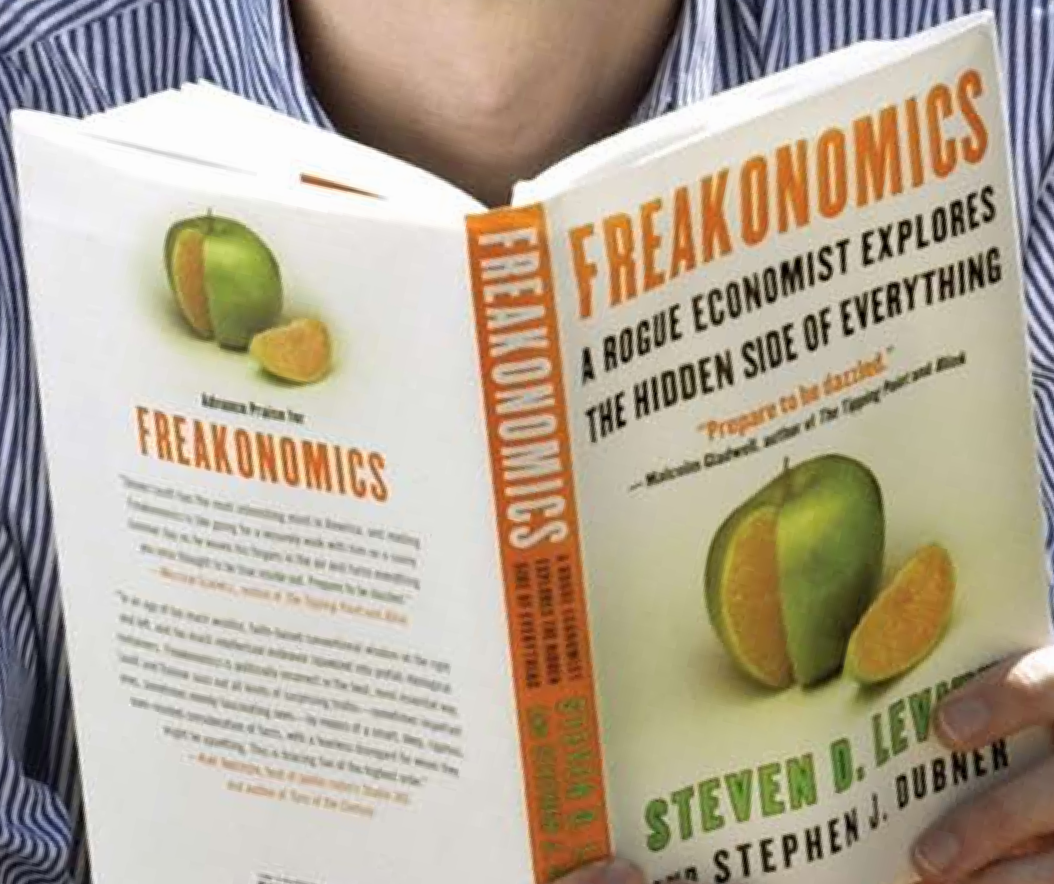

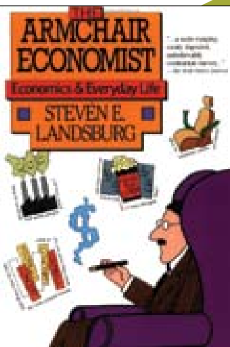

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Landsburg with *The Armchair Economist* (1993) and *Fair Play* (1997), have similarly challenged and frustrated their readers. Anyone reading these books finds that following the authors' logic is repeatedly interrupted by counter-arguments that pop into his head, which negate the premises and the proofs presented.

In the introduction to *The Armchair Economist*, Landsburg stresses, or concedes, that those who want to practice this sort of micro-economic exposition need to rigorously test their hypotheses with long and heated debates of constructive conflict with many colleagues to make sure they haven't missed anything. This is precisely what Steven Levitt fails to do in the research and writing of *Freakonomics*.

Levitt often ignores the simplest and easiest step of research, which is interviewing experts in the field for inside information. For example, Levitt goes into great detail, supported by robust statistical data analysis, to "conclusively" show that residential real estate salespeople are devious and dishonest, because they work harder to sell their own houses at higher prices than they do for their customers and because agents get 100 percent of the sales price when they sell their own house but only 1.5 percent when they sell a customer's house. Anyone with a modest knowledge of economics and statistics would be easily and thoroughly convinced of Levitt's findings…unless he was also an expert in selling residential real estate.

A former real estate agent dismissed this entire chapter of the book in one paragraph: "Levitt totally missed the dynamics here. An agent can time his own sale to get maximum returns. Clients often can't. Usually they have to move when and where their employers dictate, so are willing to take less than the maximum possible price. Plus, a lot of sellers sour deals by being too demanding, being too emotionally tied to a house, and not willing to add the touches that make it more 'show-able.' Agents are motivated by a lot more than the 1.5 percent commission. They want happy clients who give referrals, and they want to build a reputation."

Levitt's neophyte enthusiasm results in another comic slip on a banana peel when he attempts to expose the life insurance industry's history of "gouging" its policyholders by charging excessive rates, because it could exploit customers' lack of access to information with which to compare prices. Again, Levitt's flaw is that he based his research solely on the statistical data available to him (term life rates quoted on the Internet) instead of interviewing experts in the field—in this case, actuaries.

The three life insurance actuaries I polled all dismissed Levitt's hypothesis, citing improved and updated mortality tables approved by regulators, changes in reserve requirements, new "creative" reserving techniques, and evolution in marketing toward low-balling rate quotes. One noted that Levitt's research only compared rates quoted on websites, which are largely preferred, super-preferred, and ultra-preferred rates for very large policy volumes. Most of these rates are merely teaser come-ons to unsuspecting customers, for which very few actually qualify. Had the research measured rates for term life insurance actually sold, the results would have told a different story—most likely showing a steady downward trend going back to the 1970s.

By far the best chapter in the book, and it may be worth the cover price by itself, is the summary of Sudhir Venkatesh's intimate research into the socio-economics of a Chicago crack-cocaine-dealing street gang. The chapter is titled, "Why Do Drug Dealers Still Live With Their Moms?" Levitt shows how big-city drug dealing operates on the same economic, logic, and social principles as normal businesses such as fast-food franchises, with the exception that murder is an accepted tactic among competing rivals. Not only did Venkatesh base his research on interviews with industry insiders—from drug kingpins at the top to lowly foot soldiers at the bottom—he lived with and observed them for six years during the 1990s, gaining unprecedented insights unavailable anywhere else.

Levitt's conclusions here are contradictory but tough to improve on. He describes in detail the life of the average drug-dealing foot soldier, who earns less than the minimum wage and who must accept an on-the-job mortality rate of 25 percent, which is five times greater than the mortality rates of convicted killers on death row in the state of Texas. There is either an error or some confusion on this point, however, as the mortality rate is noted in a later chapter to be only 7 percent.

Levitt explains why they're immune to these unimaginable and outrageous risks, yet he also concedes later on that once a turf war breaks out and the shooting starts, many foot soldiers abandon their posts, despite the additional combat pay they're offered. In support of Levitt's conflicting conclusions here, there's no doubting that militaries in any country, at any period in history, have formed two well-developed motivational profiles of new recruits: those who enlist in peacetime versus those who enlist once war has been declared.

Usually Levitt doesn't appear to consider the opposite of his hypothesis or alternative ways that people might think. He tells the story of a baker who daily delivers and sells bagels to office complexes for $1 each, where patrons pay on the honor system. The baker notes that shrinkage (cheating by non-payment) increases on rainy days and decreases on sunny days.

Levitt accepts at face value that bad weather increases people's propensity to steal bagels. Yet he fails to consider even one of numerous possible alternate explanations. Perhaps people don't cheat more on rainy days, but people simply shortchange the baker because it's too inconvenient to get soaked in the rain going to the ATM. But they make up for it by overpaying the following day after they've replenished their cash supply, thus lowering the observed

level of cheating on sunny days, simply because people were repaying the unilateral "loans" they took from the baker the day before.

In his story of a day-care center, Levitt explains the counterintuitive fact that the number of parents who arrived late to pick up their children at the end of the workday actually increased once the day-care center imposed a $3 fine for late pickups, by saying that the relatively small fine relieved parents of their social guilt when it was priced so low.

Instead of guilt, however, equally valid explanations are fear and uncertainty. Perhaps, before the fines were imposed, parents could never be sure what would happen to their children when they showed up late. Would the day-care staff go home and leave their children with little or no supervision? Would their small children be at the mercy of the larger, tougher bullies who wouldn't be inhibited with a low ratio of adult monitoring? Perhaps by imposing this small fine, the day-care center sent a very reassuring message to parents that their children would receive the same standard of care, even if they broke their promise to pick up their children on time.

Yet these two stories, and their overly simplistic and unsatisfactory explanations, represent the best argument for reading this book. Because actuaries, like anyone else in the business world, spend their working lives identifying and trying to make sense of seemingly unrelated variables. For example: Do free wellness programs reduce health insurance costs by luring people with unhealthy lifestyles into changing their ways? Or do they simply increase costs by subsidizing the fitness programs from those who are already healthy? Are new customers attracted by low term rates or brand prestige? Do your underwriting restrictions accept too many bad risks, reject too many good risks, or drive too much business to your less demanding competition?

Regardless of what business you're in, or how much and what type of research you do, you may never know whether you're right or wrong. And neither does Steven Levitt. But that's no excuse for standing still and ignoring the tools and disciplines of micro-economics, as well as the dynamics of the market forces you live and work with.

The chapter that has captured the most media attention is Levitt's conclusion that the 1973 *Roe v. Wade* Supreme Court ruling legalizing abortion was the primary driver behind the national drop in crime rates beginning in the early 1990s. His line of reasoning roughly is as follows:

- Norma McCorvey (a.k.a. Jane Roe), the single mother who became famous for her Supreme Court case, is the prototypical progenitor of the model juvenile delinquent.
- Babies born out of wedlock are disproportionately destined to live in low-income, one-parent households.
- Violent criminals are disproportionately likely to come from low-income, one-parent households.
- The *Roe v. Wade* decision allowing (especially unmarried) women to abort unwanted children is the primary cause of the dramatic and unexpected drop in violent crime two decades later, when these aborted children, who were primary candidates to become violent criminals, were aborted instead of allowed to be born.

This thesis might be worth considering, except that illegitimate births, both in number and as a percentage of all births, continued to increase unabated—nearly tripling both in number and as a percentage of all births—since the *Roe v. Wade* decision. Indeed, by correlating these two variables, one should naturally conclude that most abortions are performed on married women. And if *Roe v. Wade* were repealed, the illegitimacy rate would revert to levels of the early 1970s.

One chapter, which tells an almost-too-good-to-be-true history of the Ku Klux Klan and the Superman radio series of the late 1940s, doesn't even belong in the book and gives the appearance that it was placed there at the insistence of the publisher for the purpose of marketing the book to a broader audience. Nevertheless, it makes for a fascinating tale readers will enjoy.

The next yet-to-be-written chapter of *Freakonomics* will be the unfolding story of Steven Levitt's career as an economist. If he chooses to be right, by remaining an academic, seeking the truth and prestige among his peers, the market forces of worldwide publicity and rigorous interaction and debate among professional economists will soon expose the errors, omissions, and methodological flaws of his work.

Several years ago, when a noteworthy University of Chicago economics professor graciously granted my unsolicited request to send a reprint of one of his articles from the *Journal of Political Economy*—which both time and academic rigor had unkindly exposed as amateurish—he appended a brief apologetic note that read, "Bear in mind, it's 25 years old."

But should Levitt choose to get rich, chasing the intoxicating high of mass-media publicity by distorting the facts to please various special interests, usually by supporting conspiratorial theories of devious real estate agents, life insurance companies, inside traders, and the like, he may never be confronted by the errors of his ways. Perhaps, like Ralph Nader, he will become so wealthy that he can pass the time in his retirement years in that most expensive hobby of the upper-class elite: running for president of the United States, just for the fun of it.

And should Steven Levitt's career ultimately take him to Stockholm to accept the Nobel Prize in Economics, he will likely have to face at least one reporter who will press him on some details in his long-since-out-of-print book, *Freakonomics*, which he will sheepishly and apologetically dismiss with the brief comment, "Yes, I see your point. But you have to remember, I was much younger then." ●

GERRY SMEDINGHOFF is the director of actuarial services for TriWest Healthcare Alliance in Phoenix. He is a frequent speaker on actuarial and economic issues, and his writings have appeared in the *Washington Post*, *Las Vegas Review-Journal*, *Skydiving*, *Vital Speeches of the Day*, *Contingencies*, and Society of Actuaries publications.