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ECONOMIC SCENE

A Career in Hedge Funds and the Price of Overcrowding

By ROBERT H. FRANK

What are the career aspirations of the nation's most accomplished and ambitious students these days? I haven't seen a formal survey, but a rapidly growing percentage of the best students I teach say they want to manage hedge funds or private equity firms.

Little wonder. According to Institutional Investor's Alpha magazine, the hedge fund manager James Simons earned \$1.7 billion last year, and two other managers earned more than \$1 billion. The combined income of the top 25 hedge fund managers exceeded \$14 billion in 2006.

These managers also enjoy remarkably favorable tax treatment. For example, even though "carried interest" — mainly their 20 percent commission on portfolio gains — has the look and feel of ordinary income, it is taxed at the 15 percent capital gains rate rather than the 35 percent top rate for ordinary income. That provision alone saved Mr. Simons several hundred million dollars in taxes last year.

Congress is now considering a proposal to tax carried

interest as ordinary income. To no one's surprise, private equity lobbyists were quick to insist that doing so would cause grave economic damage. The deals brokered by their clients often create enormous value, to be sure. Yet the proposed legislation would not block a single transaction worth doing. What is more, economic analysis suggests that it would actually increase production in other sectors of the economy by reducing wasteful overcrowding in the market for aspiring portfolio managers.

This market is what economists call a winner-take-all market — essentially a tournament in which a handful of winners are selected from a much larger field of initial contestants. Such markets tend to attract too many contestants for two reasons.

The first is an information bias. An intelligent decision about whether to enter any tournament requires an accurate estimate of the odds of winning. Yet people's assessments of their relative skill levels are notoriously optimistic. Surveys show, for example, that more than 90 percent of workers consider themselves more productive than their average colleague.

This overconfidence bias is especially likely to distort career choice because, in addition to the motivational forces that support it, the biggest winners in many tournaments are so conspicuous. For example, N.B.A. stars who earn eight-figure

salaries appear on television several nights a week, whereas the thousands who failed to make the league attract little notice.

Similarly, hedge fund managers with 10-figure incomes are far more visible than the legions of contestants who never made the final cut. When people overestimate their chances of winning, too many forsake productive occupations in traditional markets to compete in winner-take-all markets.

A second reason for persistent overcrowding in winner-take-all markets is a structural problem called “the tragedy of the commons.” This problem helps explain, for instance, why we see too many gold prospectors, an occupation that has much in common with prospecting for corporate deals. In the initial stages of exploiting a newly discovered gold field, adding another prospector may significantly increase the total amount of gold found. Beyond some point, however, additional prospectors contribute little. The gold found by a newcomer to a crowded field is largely gold that would have been found by existing searchers.

A simple numerical example helps illustrate why private incentives often lead to wasteful overcrowding under these circumstances. Consider a man who must choose whether to work as an engineer for \$100,000 or become a prospector for gold. Suppose he considers the nonfinancial aspects of the two careers equally attractive and expects to find

\$110,000 in gold if he becomes a prospector, \$90,000 of which would have been found in his absence by existing prospectors. Self-interest would then dictate a career in prospecting, since \$110,000 exceeds the \$100,000 engineering salary. But because his efforts would increase the total value of gold found by only \$20,000, society's total income would have been \$80,000 higher had he instead become an engineer.

Similar incentives confront aspiring portfolio managers. Beyond some point, adding another highly paid manager produces little increase in industry commissions on managed investments. As in a crowded real estate market, the additional manager's commissions come largely at the expense of commissions that would have been generated by existing managers. So here, too, private incentives result in wasteful overcrowding.

Matthew Rhodes-Kropf, a finance professor at Columbia Business School, has argued that higher taxes on hedge fund and private equity firm managers are bad economic policy. "Private equity is a very important part our economy," he said, adding that higher taxes will discourage it. Others have characterized the proposed legislation as envy-driven class warfare.

Both observations miss the essential point. No one denies that the talented people who guide capital to its most highly

valued uses perform a vital service for society. But at any given moment, there are only so many deals to be struck. Sending ever larger numbers of our most talented graduates out to prospect for them has a high opportunity cost, yet adds little economic value.

By making the after-tax rewards in the investment industry a little less spectacular, the proposed legislation would raise the attractiveness of other career paths, ones in which extra talent would yield substantial gains. And the additional tax revenue could pay for things that clearly need doing. For example, we could reduce the number of children who currently lack health insurance, or reduce the number of cargo containers that enter our ports without inspection.

Opponents of higher taxes often invoke the celebrated trade-off between equity and efficiency. But that objection makes no sense here. Ending preferential tax treatment of portfolio managers' earnings would serve both goals at once.

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