Economics Focus

An adventurous economist
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Franco Modigliani, who died aged 85 on September 25th, left a rich intellectual bequest

SERENA MODIGLIANI warned her husband not to turn around if someone shouted his name on the streets of Rome. “Otherwise they’ll shoot you,” she said. It was the winter of 1978, and Italy was gripped by political violence and economic chaos. Franco Modigliani, an economist at the Massachusetts Institute of Technology, had returned to the country of his birth to take part in a televised debate, urging unpopular reforms.

When Mr Modigliani left his hotel the next morning, he heard a man behind him call his name. He tried to walk faster, but his pursuer drew nearer, and finally caught him, grabbing his jacket. An assassin? No: a cobbler, in fact, desperate to tell him that, of all the bigwigs on the television the previous night, Mr Modigliani had been the only one to say “anything comprehensible”.

With Mr Modigliani and Charles Kindleberger (see article), the economics profession has recently lost not only two of its best minds but also two of its finest communicators. Few economists leave a single mark, yet Mr Modigliani left several, for which he won a Nobel prize in 1985. He crafted a theory of people’s saving decisions, which is how most undergraduates first hear of him. His insights into corporate finance launched a revolution in the valuation of companies.

Before Mr Modigliani came along, economists regarded saving as largely the preserve of the rich. For poorer people, how much they spent and saved depended on their current income. Thus Keynes wrote in his “General Theory” that it was a “psychological law” that saving rose with income. Moreover, to Keynes and his followers saving was as much vice as virtue: in the Depression, it seemed that people were holding back, and were not spending enough to keep the economy going.

Mr Modigliani was sceptical of this thinking. He noted that the whole story of economic growth and development was one of accumulating capital through thrift. That led him to create—with Richard Brumberg, a graduate student—a more detailed model of how and why people save.

The upshot was the “life-cycle hypothesis”. In essence, this says that people save during their working lives in order to spend when their income wanes in old age. In a similar way to Milton Friedman’s “permanent income hypothesis”, which was developed at about the same time, Mr Modigliani’s theory supposes that people base their saving on their expected incomes over their whole lives. Thus they save more when their income is above its expected lifetime average because of transitory shocks, such as an unexpected bonus or a few high-earning years. This may sound obvious now, but the mere idea that people at all income levels forecast their expected lifetime income and save accordingly gave economists a way to model saving—and its counterpart, consumption—mathematically. In the policy arena, any debate about, say, today’s pension crisis in rich countries owes much to Mr Modigliani.

Mr Modigliani later put his talent to work on another problem. In the early post-war years, the study of
corporate finance was in its infancy. Questions of how much debt was optimal for a company, or what the effects of a change in dividends would be, were typically left to grey-flannelled businessmen to chat about over three-martini lunches. However, with Merton Miller, a fellow Nobel laureate, Mr Modigliani worked out that, assuming perfect capital markets and tax neutrality, the amount of debt a company has is immaterial.

That is because investors base their valuation of a firm on its profits, not the details of its financing. If a company takes on too much debt, making it more risky, investors can take this into account when choosing their personal portfolios. They see through a company's mix of debt and equity (unless, of course, it is obscured by Enronesque devices) and value it appropriately. Nowadays this theory, known as the first Modigliani-Miller proposition, is taught to business students everywhere.

By a similar logic, the pair devised a second proposition: that dividend policy is also irrelevant. It makes no difference to investors whether a company pays out all its profits to shareholders or keeps and reinvests the lot. In practice, tax systems skew companies' decisions. America's tax system has led companies to pile up debt and until this year favoured capital gains over dividends.

An independent mind

Despite his technical gifts, Mr Modigliani showed little appetite for mathematics at school. As he recalled in his autobiography, “Adventures of an Economist”, he received help in the subject. This allowed him to pass his exams early. He left Mussolini's Italy in 1938. Once in America, he took to maths only after seeing its value to the study of economics. Many economics students since have reluctantly learned the same lesson.

In an age of politically partisan economists, Mr Modigliani maintained his independence. He opposed America's war in Vietnam, but praised Ronald Reagan's cold-war victory for freeing millions from “slavery”. He was an implacable foe of the Gipper's economic policy, criticising what he saw as insane deficits and tax cuts for the rich. Yet he was contemptuous of Italy's high tax rates, which forced ordinary people to become tax-evaders merely in order to live decently. George W. Bush's deficits also drew Mr Modigliani's scorn, as did Mr Bush's recent plans to privatise America's social-security scheme. He argued that private accounts would create more risks and inequalities, but no new incentives for hard work or thrift.

One assumption of his life-cycle hypothesis was that people saved mostly to take care of themselves, rather than their heirs. That seems to have explained the real behaviour of people quite well. Yet the theory fits Mr Modigliani's own life extremely poorly. Generations of students have learned from his work, and the entire economics profession is the richer for it.