observations

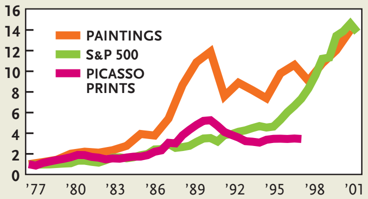
Smart Art

There's more to the art world than pretty pictures. Many prospective buyers consider art an investment. When art prices escalated in the late 1980s, the odds of a favorable return seemed good. "Yo Picasso," priced at $5.8 million in 1981, sold for $47.8 million in 1989; the 1990 $82.5 million sale of Van Gogh's "Portrait of Dr. Gachet" made history as the highest price ever paid at auction. Though this was a high-water mark, savvy collectors Victor and Sally Ganz netted $183.8 million in revenue in one 1997 auction, which was $50 million more than the couple would have earned if they'd invested in small company stocks, and $137 million more than in large company stocks, estimated University of Chicago professor William Landes.

What are the chances for the rest of us? Because artworks are usually one-of-a-kind pieces and change hands so infrequently, average returns are difficult to estimate and vary greatly, depending on the body of works and the time periods considered. On the one hand, using an index of repeat sale prices of paintings on auction at Christie's and Sotheby's, Stern School of Business professors Jiangping Mei and Michael Moses at New York University found promising results. Art generated an average annual return of 8.2 percent over the last 50 years, comparable to the 8.9 percent return on S&P 500 stocks, and was only somewhat more volatile. But in a similar study of Picasso prints, where comparable duplicates enabled a large sample size, University of Toronto professor James Pesando found only a 1.5 percent annual return over the last 20 years, with as much volatility. Furthermore, these estimates may be high because of large transaction costs—auction houses take up to 20 percent of the sale price—and because of a survivor bias—already successful works, like those included in these indexes, may poorly represent the broader pool of not-yet-famous art.

Painting the returns

Index 1977=1



SOURCES: Paintings Index from Mei and Moses, "Art as an Investment and the Underperformance of Masterpieces," *American Economic Review*, forthcoming; Picasso Prints Index from Pesando and Shun, "The Returns to Picasso's Prints and to Traditional Financial Assets, 1977 to 1996," *Journal of Cultural Economics*, 1999; and S&P 500 from the *Wall Street Journal*.

Whether or not art investments can measure up on their own, evidence that they are not very correlated with traditional financial assets suggests they might be useful for portfolio diversification. With this in mind, the British Rail Pension Fund included a relatively successful portfolio of art and antiques between 1977 and 1996. But in Pesando's study, even when diversification is taken into account, the return on art is not attractive enough to significantly improve portfolio performance. A better strategy may be for buyers to take advantage of their own expertise in lesser-known art markets. For example, Pesando himself favors 18th-century American furniture; he might find a deal on a valuable chair at a flea market in Vermont, but there's little chance of finding a Picasso.

Of course, art also provides consumption value. Many buyers are willing to spend more on art than monetary returns alone justify because of the pleasure of viewing the object. Indeed, the vast majority of the Ganzes' 1,000-plus-piece collection remains on their estate. Perhaps the safest bet is to select art investments that buyers actually enjoy—art for art's sake after all. —*Kristin Lovejoy*

Test driving the Internet

Buying a car ranks as one of the biggest purchases consumers make. They invest great amounts of time in researching models and options, not to mention going from dealer to dealer to test-drive and haggle for a reasonable price.

Can the Internet make this process any easier? Numerous websites offer free information on the dealer cost of new cars, trade-in value of used ones, and even dealership inventory. Others, such as Autobytel.com, are third-party "infomediaries." Aside from providing vital statistics on vehicles, Autobytel connects consumers with car dealers. Potential buyers submit a request for a price quote on a specific car—along with their name, zip code, and contact

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illustrations by marc rosenthal

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information—which is forwarded to the dealer assigned to the area.

And customers may be reaping the benefits. Economists Florian Zettelmeyer, Fiona Scott Morton, and Jorge Silva-Risso found that buyers who used Autobytel saved an average of 1.2 percent compared to those who purchased a car through conventional means. The researchers estimate that the savings are even greater—slightly above 2 percent—if the customers who opted for the Internet are those that pay higher prices at conventional dealers (such as those who are poor bargainers).

The researchers found several reasons for the lower prices. First, dealers have a contract with Autobytel that provides incentives to offer lower prices. Dealers are required to have a salesperson who only handles Internet requests and is paid based on sales volume, rather than on the profit extracted from negotiating with each customer.

In addition, some customers used Autobytel but made their purchase at a dealer other than the one they were referred to—and they also received lower prices. This suggests that Internet research makes online consumers more educated about their purchase and, thus, better negotiators. The low cost of searching on the Internet could also expand buyers' options and make it easier to explore distant dealerships and more types of cars in search of a better deal. Or, perhaps a specific price quote from an Autobytel-associated dealer gives them leverage to obtain a better price elsewhere.

Alas, the emergence of the Internet has not made haggling a thing of the past. A recent online buyer found that instead of being given a direct quote on a new car, dealerships invited him to come in and discuss the issue with them. According to JD Power and Associates, 14 percent of dealers associated with Autobytel will quote a discounted price by email or phone only if the customer insists, and 2 percent won't give quotes at all until the customer comes to the dealership.

—Jennifer Duval

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perspective

Tobacco manufacturers are now compensating states for smoking-related costs. How will this affect the economy?

By David M. Cutler, Jonathan Gruber, Raymond S. Hartman, Joseph P. Newhouse, and Meredith B. Rosenthal

SMOKING COSTS THE Massachusetts Medicaid program money. The more people smoke, argues the Attorney General's office, the more the state spends on Medicaid to pay for smoking-related illnesses. To recoup these costs, the Attorneys General of Massachusetts and 45 other states took the tobacco manufacturers to court. In November 1998, cigarette companies agreed to pay out $104.7 billion in damages through the year 2025—the largest sum of money paid in any civil litigation in American history. The master settlement agreement (MSA) requires tobacco manufacturers to pay reparations for states' Medicaid expenses, totaling up to $9 billion per year. They must also sponsor several billion dollars' worth of anti-smoking advertising and education over the next ten years and must restrict their advertising in public places such as outdoor arenas and public transit. The cost will be covered by a 45 cent per pack price increase on cigarettes, which was put into effect immediately following the settlement.

What are the economic impacts of the settlement for Massachusetts? The most obvious is an increase in state revenues; the MSA will net the Commonwealth an estimated $4.2 billion in revenues over the next quarter-century, roughly 2 percent of total tax receipts. But, while this will be an important source of funds to cover the state's smoking-related expenses, it doesn't lead to a net gain for society since it simply represents a transfer of resources from one group (future smokers) to another (all the citizens of the state). The benefits to society depend on how much smoking rates decline due to the agreement, and on assumptions about why people start smoking in the first place.

THE SOCIAL PAYOFF OF IMPROVED HEALTH

How big a social benefit we reap is determined, in part, by how the settlement influences smoking behavior. First, the 45 cent per pack price increase raised the cost of cigarettes by about 15 percent per pack. This is likely to reduce tobacco consumption since as the price of cigarettes increases, smokers cut back and nonsmokers are less likely to start smoking. In fact, recent research shows that the 15 percent price increase should lead to about a 5 percent decline in smoking participation among adults. Estimates of the impact of the price increase on youth smoking are somewhat more difficult to quantify and range from zero to about 6 percent. The anti-smoking advertising campaign should also cut smoking rates; other experiments with this type of advertising have yielded a 5 percent or greater reduction in smoking. The