

Misbehaving – The Making of Behavioral Economics*

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*Richard H. Thaler:
Misbehaving: The Making of Behavioral Economics
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Richard H. Thaler, a professor of the Chicago Booth School of Business since 1995, focuses his research activities on behavioural economics, an interdisciplinary field between economics and psychology. His studies are based on the assumption that the participants in economic life are humans, in contrast to the premise in classical economics that every actor in the economy is rational. Thaler claims that his role models and mentors were Amos Tversky and Daniel Kahneman, psychologists, the creators of prospect theory. He was awarded the Nobel Memorial Prize in Economic Sciences in 2017.

In the author's own words, the book is not the sort one might expect an economics professor to write. The book wishes to give a comprehensive overview about the findings in behavioural economics of Thaler and his colleagues over the years. These findings are illustrated with stories from everyday life, practical examples and experiments.

Behavioural economics originated from the idea that classical economics cannot accurately predict economic events, as it replaces homo sapiens with a fictional character, homo economicus. One of the basic doctrines of economics is that people optimise, make rational decisions, and thus choose the best among goods and services they can afford. Decisions are distorted by nothing, they are only influenced by rational expectations. In economics, this is combined with a theory of equilibrium, according to which on competitive markets, supply equals demand. Behavioural economics examines the elements of these doctrines with a critical, empirical approach. It states that the assumptions in classical economics are flawed, as the optimisation problems faced by average humans are often difficult, or even

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impossible, to solve. Moreover, the assumptions on which decisions are based are biased, and therefore the optimisation model disregards several other factors (supposedly irrelevant factors – SIFs).

Thaler devoted himself to behavioural economics in the 1970s. On the so-called “List”, he collected instances of human behaviour that he believed to be incompatible with the economic model of rationalisation. To take one example: the author and his friend, Jeffrey, got free tickets to a basketball game a 1.5-hour drive away. As a blizzard struck on the day of the game, they decided to stay home. Jeffrey contended that if the tickets had cost money, they would have set out anyway. Jeffrey ignored the basic economic principle that sunk costs have to be disregarded. The author first came across the works of Kahneman and Tversky around this time, and used the two kinds of theories and the value function described in their paper, “Prospect Theory,” to further analyse the behaviours on the List. The two kinds of theories mean the existence of normative theory and descriptive theory. Normative theory stipulates the right way of thinking about a given problem. Economists usually use one theory to achieve both normative and descriptive goals. One good example for this is the economic theory of the firm, according to which companies seek to maximise profits or increase their value, setting prices so that marginal cost equals marginal revenue. Prospect theory breaks with the widespread idea that any theory on human behaviour can be normative and descriptive at the same time. It maintains that one should concentrate on the changes in wealth rather than the levels of wealth, since people experience life through changes. This is because if they get accustomed to their environment, they are prone to disregarding it. Changes can occur with respect to the status quo or the expected situation, and changes can make people happy or sad. As the value function shows, both gains and losses exhibit diminishing sensitivity. People are risk-averse for gains and risk-seeking for avoiding losses. It can be seen from the function that losses hurt twice as much as gains give pleasure. The greatest weapon of behavioural economics is derived from this finding.

Thaler started working at Cornell University in August 1978, and examined how people think about money, a process Kahneman and Tversky called mental accounting. The research into this defined the subsequent career of the author. According to economics, consumers take into account opportunity costs, i.e. the given time and the alternative uses of money. By contrast, behavioural economics contends that it is unrealistic to assume the above decision-making process in consumers, since this thinking is too complex for them. In connection with this, the author has developed a formula with two types of utility. Acquisition utility describes the surplus gained when the opportunity cost of the choice forfeited is deducted from the utility of the acquired object. It is large if the consumer values the given good more than the market. Transaction utility is the difference between

the actual price and the reference price. If the actual price is above the reference price, transaction utility is negative and the transaction is considered a rip-off. If the actual price is below the reference price, transaction utility is positive and the transaction is a bargain. Transaction utility may prevent transactions that enhance welfare and support those that are rip-offs. Therefore, sellers can make certain transactions seem like bargains by manipulating the expected reference price, i.e. displaying a high recommended retail price and offering their goods in constant sales.

Thaler added further examples to the List in 1975–1988. One common problem in these examples was the lack of self-control, which, according to economics, is non-existent, as there is no need to differentiate between what we want and what we choose, since our choices are our stated preferences. The author has developed a tentative model based on the premise that self-control is about conflicts, requiring two parties, therefore the self can be divided into two: a forward-looking planner who is concerned about the future and a negligent doer who lives for the present alone. The author based this on the principal–agent model from the theory of organisations, where the principal is the boss and the agent is someone to whom authority is delegated. In the intrapersonal framework, agents are doers living for 24 hours, who would like to enjoy life and are not concerned about future doers. By contrast, planners regard doers as being paramount, and wish they would be collectively as happy as possible. Planners have two tools to influence doers: rewards and penalties, and the imposition of rules limiting options. If planners do not have the latter tool, they arouse the bad conscience of doers for not being concerned about the welfare of those coming after them. However, guilt makes life less pleasant, and therefore the use of rules provides more pleasure.

In 1983–2003, Thaler turned towards analysing finance, as he was convinced that behavioural economics could get a boost from the confirmation that behavioural biases also counted on financial markets. In the 1980s, financial markets were dominated by Eugene Fama’s efficient market hypothesis (EMH). One component of the EMH is illustrated by the author with the phrase “*the price is right*,” according to which assets will always sell at their true intrinsic value. Thaler describes the other element of the EMH with the expression “*no free lunch*,” i.e. that one cannot beat the market, as all publicly available information is reflected in stock prices, therefore it is impossible to predict the future and thus gain an advantage. The author searched for proof of breaches of the EMH during his research, and found, among others, the following. The real forerunner to behavioural finance was John Maynard Keynes, who pointed out in the mid-1930s that stock prices of ice companies were higher in the summer months, when their sales were stronger. However, in the EMH, on an efficient market, stock prices show a firm’s long-run value, i.e. one that does not reflect the summer heat and the winter cold, therefore

such predictable fluctuations in stock prices are strictly forbidden. The analysis of closed-end funds' share prices show that market prices are often different from net asset value, typically indicating a discount of 10–20 per cent as compared to the latter. This runs counter to the EMH theory that states that the market price of closed-end fund shares equals net asset value. The author argues that despite the anomalies, the EMH is still the best place to start, and 90 per cent of all markets are efficient, however, the price is often wrong, and in the case of a major difference from the real value, resources may be misallocated to a considerable degree.

In the mid-1990s, one of the objectives of behavioural economists was to use behavioural economics to make the world a better place. Classical economics is not concerned with the planning of retirement savings plans, as it claims that people save exactly as much as they need to. Economists have only one policy tool: the after-tax rate of return on savings. By contrast, behavioural economics takes into account more factors. The author collected the obstacles why people fail to save enough, which are the following: 1) inertia, i.e. that most retirement savings plan participants believe they should save more but procrastinate and do not take actual action; 2) loss aversion, i.e. that people do not like to lose, especially in the form of deductions from their wage; 3) people have more self-control with respect to the future than the present, therefore they are present-biased. Thaler's basic idea is that people have to be convinced to increase their savings rate when they get their next pay rise. To this end, people have to be kept in savings programmes until they opt out or their savings rate reaches a specific level. If increases in the savings rate are tied to pay rises, the problem of loss aversion can be avoided. If a decision has to be made that will take effect in the future, the present bias poses no issue either, and if the programme works until people opt out, inertia also supports savings.

Behavioural economics exerted the greatest influence in finance, because the latter had mature theoretical doctrines, and a rich dataset was available to test the theories. The author also expects behavioural approaches to become widely used in macroeconomics, as better understanding people and firms and the examination of their behaviour are crucial for selecting the appropriate economic policy and public policy measures. One impediment to this is that macroeconomics does not make easily rebuttable predictions and does not have such a wealth of data as finance. One issue requiring behavioural analysis is the development of tax cut policies providing an economic stimulus, since consumer behaviour has to be analysed from a behavioural perspective to establish whether the measure increases spending and to determine the way it has to be implemented (in a lump sum or spread out over a year). Another area that may require behavioural analysis is how to encourage starting new businesses. According to behavioural economics, reducing the price of failure may provide a better incentive than the tax cuts, targeted subsidies and better access to credit recommended by economists.

With respect to the future of economics and behavioural economics, Thaler believes that if economists put aside their prejudices and took into account variables deemed irrelevant by the rational economic model, behavioural economics as a separate discipline would disappear, as all branches of economics would become behavioural to just the necessary extent.