

Richard H. Thaler, *Misbehaving: The Making of Behavioral Economics*

New York, NY: W.W. Norton & Company, New, 2015. xiv + 432 pages

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Misbehaving is the story of behavioral economics as a field with Richard Thaler as its protagonist. A fitting title – describing both the human condition, and Thaler’s maverick academic choices – for an articulate book laying out important and contested topics in economics.

Thaler is a master storyteller, and takes the reader on a journey of the emergence of a new, relevant, and interesting field of economics. Behavioral economics itself is non-sterile, and the topics picked by Thaler for inquiry are quirky, interesting, and full of wonderful examples.

Following Pareto’s prophesy, that all laws in the social sciences will eventually be deduced from psychology, Thaler hopes to bring more psychology into economics to make economics more human and improving the accuracy of predictions using economic theory (p. 9). Thaler distinguishes between the abstract *Econ* – the abstract homo economicus individual used in rational choice axioms – with the more realistic *Human*. He argues that economists get into trouble when they make highly specific predictions by assuming the world is inhabited by *Econs*. *Humans* frequently violate the predictions by being, well, human.

The book then takes us through the various deviations from the economic model caused by this human-ness. He discusses endowment effects, the inability to understand and ignore sunk costs, or to only choose on the margin, prospect theory, lack of will power and self-control, to name a few. In each of these cases, these *Humans* deviate much from *Econs* and throw a spanner in economists smoothly turning wheels. The predictions are no longer true, and policies based on these economic models are defunct at best, or worse, dangerous.

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This is where the field of behavioral economics enters policy-making. By analyzing the deviations of *Humans* from economic models, behaviorists can recommend better policies, and more often than not, nudge us towards “better” choices. The last part of the book is devoted to policy relevant insights of behavioral economics, as well as Thaler’s experiences advising policy-makers.

The scope of both behavioral economics and Thaler’s scholarship is ambitious – to bring back the human in economics. However, in this quest there are three serious shortcomings in the book.

First, the literature in behavioral economics, as well as Thaler’s book, pay scarce attention to a very rich history of thought on the subject of human rationality, with important implications for behavioral economics. The idea that humans are not *Econs* or robots as modeled in traditional neoclassical economics has its origins centuries before modern behavioral economics, starting with the writings of Adam Smith describing the moral sympathies of individuals in their social interactions.

Carl Menger, one of the marginalists contributing to the bedrock of modern economics, conceives of individuals within the market process, more as *Humans* than as *Econs*. Jaffe (1976, p. 521) summarizes Menger’s individual as “...a bumbling, erring, ill-informed creature, plagued with uncertainty, forever hovering between alluring hopes and haunting fears, and congenitally incapable of making finely calibrated decisions in pursuit of satisfactions.”

This idea of individual behavior is very prevalent in the Austrian tradition. Yet the richer view of individuals in economics, making him more *Human* and less *Econ*, does not imply the individual is not rational. Mises clarifies that rationality does not require some robot like perfection, or to use Thaler’s words, cognition and calculation like Mr. Spock. “It is a fact that human reason is not infallible and that man very often errs in selecting and applying the means. An action unsuited to the end sought falls short of expectation. It is contrary to purpose, but it is rational, i.e., the outcome of a reasonable – although faulty – deliberation and an attempt – although an ineffectual attempt – to attain a definite goal” (Mises 1949, p. 44).

In attempting to make economics more human, it is important to incorporate these insights. Because this important and richer idea of rationality is ignored – the organizing principles Thaler uses in the book – and by extension in behavioral economics, is rational choice theory in its normative sense. In other words, the right or logically consistent optimizing model. Thaler accepts the normative and/or prescriptive aspects of the rational choice theory while criticizing and rejecting the descriptive accuracy of rational choice models.

In other words, though Thaler’s behavioral economics inhabits the word of *Humans*, the normative standard of how we “should” act is to mimic *Econs*. He envisages a world of aspiring Mr. Spocks. This becomes clear in the title itself. As *Humans* we are misbehaving, against the standard “good behavior” of *Econs*. But why is the normative standard one of *Econs*?

In more recent intellectual thought, Vernon Smith’s insights are not fully incorporated in the behavioral economics discourse. Vernon Smith split the Nobel Prize in 2002 with Thaler’s intellectual hero Daniel Kahneman. Smith (2008) distinguishes between constructivist and ecological rationality in economics and in human behavior. Ecological rationality, deals with “adaptive human decision and with group processes of discovery in natural social environments” (Smith 2008, p. 25). Simply put, it is the

idea that context matters in individual choice. That context includes both interpersonal interaction and the social environment.

Smith's ecological rationality has important consequences for both neoclassical and behavioral economics models. Smith (2008, p. 40) argues that "if people in certain contexts make choices that contradict our formal theory of rationality, rather than conclude that they are irrational, some ask why, reexamine maintained hypotheses including all aspects of the experiments (procedures, payoffs, context, instructions, etc.) and inquire as to what new concepts and experimental designs can help us to better understand the behavior."

Thaler and behaviorists have an important question to resolve. If people do not act in accordance with the neoclassical construct, it need not mean that there is something wrong with them or that they need fixing. Perhaps it is the opposite, and that it is economists themselves who have failed in their endeavor to explain human behavior by resorting to a standard construct. It very well may be economists who are misbehaving by using the rational choice axioms as a normative standard.

Rejecting rational choice axioms as the normative and prescriptive standard may save both behavioral economics and neoclassical economics. Positive rationality can be narrowly tailored to explain specific instances of behavior, but not all human behavior. Economists will be much less dangerous if they adopt a narrow view of modeling individuals as *homo economicus*, in order use positive rationality without endorsing it as a normative standard.

A second problem in the book is in the wholesale import Daniel Kahneman's two systems of thinking. System 1 – or thinking fast – "operates automatically and quickly, with little or no effort and no sense of voluntary control." System 2 – thinking slow – "allocates attention to the effortful mental activities that demand it, including complex computations" (Kahneman 2011, pp. 20–21). Mapping it to Thaler's vocabulary, the *Econ* would think slow, make calculated decisions by weighing all the costs and benefits. *Humans*, on the other hand, would think fast, use intuition and heuristics, and thereby deviate from the *Econ* and "misbehave."

However, Kahneman's brand of psychology is not the only pertinent literature applicable to problems of economists. Gigerenzer (2008) consistently shows that counterintuitively (and no pun intended) sometimes thinking fast, using intuition and heuristics, etc. are preferred to thinking slow – especially in the face of uncertainty and lack of information. Gigerenzer asks psychologists and economists to replace individuals gifted with an omniscient mind, computing intricate probabilities and utilities, with individuals with a bounded mind – often reaching into an adaptive toolbox and relying on fast and frugal heuristics (2008). With this replacement, one appreciates how the human mind adapts, but also that in the face of incomplete knowledge and uncertainty, thinking fast leads to remarkably good results.

Gigerenzer changes the question from one of computational accuracy and clarity – where an objective answer exists for all individuals, to one of ecology. "What is the subject's perception of the problem that he or she is trying to solve?" With this approach, many of the biases, which are essentially behaviors deviating from the optimal model, disappear once the context becomes clear. Heuristics, instead of the low-tech version of Spock's tools, become the appropriate, or perhaps even the only tools, available under the circumstances. But Gigerenzer's insights have not fully found their way into Thaler's book or behavioral economics. Thaler has no discussion on the

adaptive nature of the human mind, or, on how individuals learn by repeating interactions in a particular context, as demonstrated through experiments (List 2004).

The third problem with the book is in the policy prescriptions to fix the deviations of *Humans* from *Econs*. Can we always rely on policymakers to implement welfare-improving paternalist policies?

In ignoring ecological rationality, the perception is that *humans* are trapped in sub-optimal situations and experts and policymakers external to that situation will help improve outcomes. However, that requires the assumption that those external to the situation – the experts and policymakers – know better. That these individuals are in fact incarnations of Mr. Spock and do not suffer from any “misbehavior” themselves. Rizzo and Whitman (2009, p. 910) argue, “If well-meaning policymakers possess all the relevant information about individuals’ true preferences, their cognitive biases, and the choice contexts in which they manifest themselves, *then* policymakers could potentially implement paternalist policies that improve the welfare of individuals by their own standards.” However, in the absence of such information or ability to make perfect calculations one cannot conclude that actual paternalism will make their decisions better; under a wide range of circumstances, it will even make them worse. Perhaps the fitting question here is if *Humans* are not *Econs*, then why do we assume that policymakers are *Econs*? Are they, perhaps, not human?

Even if experts “know better” in a particular instance, “it is assumed that the momentum for change must come from outside the situation rather than from the self-reflection and creativity of those within a situation to restructure their own patterns of interaction” (Ostrom 2010, p. 648). In this treatment, the context is lost, and policymakers often create situations that are more perverse.

Despite these shortcomings, both Thaler, and behavioral economics in general, has made an important contribution to economics. It has nudged neoclassical economists to re-examine the mathematical rational choice axioms. Challenging these axioms is no longer “misbehaving,” and now there is greater nuance on discussions on rationality and its place in economic models. In the latest issue of the *American Economic Review* Laibson and List (2015, p. 389) summarize – “If you want to boil behavioral economics down for a classroom summary you might say that most people are located somewhere between Mr. Spock and Mr. Simpson (aka Homer). Like Mr. Spock, Mr. Simpson is also an optimizer— he *tries* to choose the best feasible option. He’s just not good at it. We need to study and model all optimizers: the good, the bad, and those in between.”

On one thing we can all agree with Richard Thaler; “The process of developing an enriched version of economics, with Humans front and center, is far from complete.” *Misbehaving* takes a step, but does not go far enough.

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