MISBEHAVING: THE MAKING OF BEHAVIORAL ECONOMICS BY RICHARD H. THALER (NEW YORK, W.W. NORTON & COMPANY, 2015)

Virág Ilyés[1]

If I had to summarize my thoughts about this book in a few words, I would say that it is not a typical one – but take this as a compliment. Due to its suggestive name, "*The Making of Behavioral Economics*", we might assume that we would be facing a well written and well-structured handbook about the discipline of behavioral economics. But after a few chapters and the first personal recollections, we have to realize that we had been fooled a little: this book is definitely not a handbook, but rather a good memoir. And what is more surprising at first is that it is a memoir about Richard A. Thaler's academic career and also the discipline of behavioral economics. The main focus of the book is to introduce the most important conceptions and findings of behavioral economics, but this is done from Thaler's perspective. We can follow his career advancement, from the point he started his PhD in economics to present days. We see how his early ideas – which were not taken seriously at the beginning – developed over time, and started to invade the traditional "economic" view of the world. We see through Thaler's eyes how a new discipline started to emerge – and also, how Thaler contributed to creating it –, and we can read about the milestones that were achieved by its early representatives.

ECONS AND HUMANS

Homo Economicus, or "Econs" are described in the book as mythical creatures which are rarely or never seen by anybody, but are thought to be real. Traditional economic science is built upon ideas about these beings: thoughts about how

1 Virág Ilyés is a Ph.D. student at the Doctoral School of Sociology, Corvinus University of Budapest; e-mail: virag.ilyes@stud.uni-corvinus.hu

they make their choices serve as the basis for core economic theory and for formal economic models. Econs make choices by optimizing: they choose the best possible choice of action based on the information that is available, their preferences, and their calculations of costs and benefits. They are rational, act in their own self-interest, and are perfect calculators. Thus, social behavior (in the most general sense) – what we see, perceive and examine in society – is an aggregation of the behavior of these actors.

This picture may appear to be coherent, but we can sense that something is not right: is it realistic to depict humans as Econs? To answer this question, Thaler starts his book with an old story from the time he was at the beginning of his teaching career. When delivering his microeconomics course, he composed his exams with one aim in mind: to distinguish between those students who had really mastered the course material, a medium-level group who understood the basics, and those who were weakest. In order to do this, he added a few difficult tasks to the exam which could be solved only by those who really understood what they had learnt. This strategy yielded the expected results: there was a wide dispersion of scores – the average result was 72/100, meaning that the average grade was B or B+, because the school graded on a curve. Although these grades were not awful, students were mad because of the low average. To manage this situation (and to preserve his original idea about maintaining the challenging nature of the exam), Thaler increased the maximum total number of points from 100 to 137. This strange step was actually successful: the students' average performance did not change (they still got approximately 70% of all questions right), but the average score moved up from 72 to 96 – and students were happy. However, supposing that these students were Econs, we would have to say that they were somehow misbehaving – for an Econ, the average score would not be important if the average grade was approximately the same. So from a traditional economic perspective, misbehavior such as this would be considered a "supposedly irrelevant factor" (SIF), while as the story illustrates, it actually matters.

In real life, people tend to act differently from the hypothetical version of them: we are not rational optimization machines, we have not got as much self-control as Gandhi, and unlike Econs, our choices can be biased. Considering this, behavioral economics is a good attempt to smuggle some reality back into the world of Econs and make them a little bit more Human.

PREDECESSORS

Naturally, the contrast between Econs and Humans was an issue for debate long before the birth of behavioral economics: in the discipline of economics there is a long tradition of denying the rationalist simplifications of the marginal utility approach – one may refer here to the institutionalist tradition or to Thorstein Veblen, Karl Polanyi and Douglass North for example. Contemporary economic sociology also formulated a more realistic approach to the theory of economic behavior with the conception of embeddedness.

In his book, Thaler introduces a few powerful ideas that inspired his work. Herbert Simon's concept of bounded rationality is derived from the observation that Humans cannot optimize in the way that is claimed in rational choice theory. Sometimes they fail because problems are too complex, sometimes because of cognitive limitations, and sometimes due to lack of time. Individual rationality is somehow bounded by these factors, so the description of humans as Econs can be misleading. Another important idea is prospect theory. Traditionally, people's utility function was constructed using wealth – this concept suggests that individual utility/happiness increases as people get wealthier, but at a decreasing rate. This latter fact creates what is called risk aversion in the economic jargon: the fact that individuals generally prefer certainty – e.g. would prefer to receive a fixed payment (for example, 40$) – than to take a risk – e.g. to make a binary gamble between getting 0$ or 100$. Kahneman and Tversky provided an alternative to this theory: the scholars propose that individuals derive utility from gains and losses relative to a reference point, rather than wealth, per se. Also, the authors note that individuals are more sensitive to losses than gains – so-called loss aversion – and experience diminishing sensitivity to changes further away from the status quo (the concept of just-noticeable differences). They also tend to overweight low probabilities and underweight high ones.

SUPPOSEDLY IRRELEVANT FACTORS

At the beginning of his career, Thaler started to collect examples of situations Humans departed from the previously described, ideal or rational behavior; i.e., stories about people "misbehaving". At first, this took the form of a long list of simple deviations that could have been swept under the rug by rationalists. But later on, it became obvious that these supposedly irrelevant deviations are in fact critical and systematically embedded elements of economic decision-making. All the SIF's covered in the book come with at least one good story.

LOSS AVERSION AND THE ENDOWMENT EFFECT

Richard Rosett was a professor of economics who loved wines and had a few bottles that he had purchased long ago for a moderate price (10$), but which rose in value to more than 100$. A merchant was willing to buy a few of his bottles at their actual value, so Rosett had two basic options: drink them, or sell them. The interesting thing is that he did not sell any of his bottles, but rather drank from them occasionally, despite having the strong conviction that he would never buy a bottle of wine for 100$. The two latter statements somehow contradict each other. The fact that Rosett preferred to drink the bottles to selling them means that he valued the "wine experience" at more than 100$. But if so, why did he say he would never buy a bottle at that price? Rosett was willing to pay much less for acquiring a bottle – the out-of-pocket cost of buying a new bottle –, than he would require as compensation to sell one – the opportunity cost of not drinking the bottles. So his willingness to pay and willingness to accept differed significantly – which is irrational from the perspective of traditional economic theory. Rosett did not behave like an Econ. How can we explain this?

Thaler's argument is based upon prospect theory and its notion that people are loss-averse. Giving up something (selling a bottle for 100$) can be understood as a loss, and because losses hurt twice as much as gains, we value our belongings more highly when we give them up compared to when we acquire them. This is what Thaler calls the endowment effect: individuals tend to view out-of-pocket costs as losses and weight them more heavily than opportunity costs which are considered foregone gains, and are thus weighted less heavily.

SUNK COSTS

In the world of Econs, sunk costs are ignored. Consider the simple situation that you have bought two tickets for a basketball game. From a rationalist perspective, the purchase – the fact that you have spent money – should not affect whether you go to the match. However, in the world of Humans this is not the case. If we get two tickets from an acquaintance but for some reason we cannot make it to the match we will probably stay home without remorse, but if we have paid for them ourselves we will feel the urge to go – otherwise we get "nothing for our money", we have made a loss. And what people actually try to do is avoid loss.

MENTAL ACCOUNTING

Consider typical Econs. They have clear and stable preferences; they buy exactly what they actually need. From a purchase they obtain acquisition utility (the consumer surplus that is obtained with an object that is acquired if we subtract the cost of getting it) equivalent to their valuation of the object. For a typical Econ, this is the end of the story. But what about Humans? In the world of Humans besides optimal transactions there are also "good deals" which can create acquisition and transactional utility. The latter refers to the difference between the price that was paid for an object and the price one would normally expect to pay for it. A good deal refers to an exchange involving abundant transaction utility which can make possible purchases that would not occur in the world of Econs.

In the fictional world of Econs it is also irrational to create mental buckets ("money jars") for different causes (food, entertainment etc.), because individuals simply buy what they need. However, for Humans (and for different organizations as well) "bucketing" is a viable strategy for organizing and evaluating economic activity and overcoming cognitive limitations. Mental bucketing can help regulate what we buy, and in special situations can change our general behavioral patterns as well. For example, in the case of recently won money people tend to gamble more (i.e., generally risk-averse people become risk-seeking). Newly earned money basically gets placed into a new "bucket" in the individual's mind that is considered both owned and not owned. This is called the "house money effect". We tend to be less risk averse with money and budgets that are in less established buckets.

The final important notion is "narrow framing". The idea is basically the following: when we make our decisions we sometimes see certain events and payments, etc. as separate things, but sometimes intertwined. A good example involves the decisions of New York taxi drivers about how they set their – flexible – working schedules. Assuming market rationality we might believe that when demand is high, there should be more taxi drivers on the streets, working longer hours. What Thaler actually found was the opposite: taxi drivers tend to work more on quiet days. How can this be? Based on interviews it was found that the main reason is that cab drivers have decided on a daily target income that corresponds to how much they want to earn per month – a reference point. By consistently applying this rule, however, they fall into the trap of thinking narrowly about earnings (i.e., hitting a daily target), which can mean that they work less on busy days and spend much more time on the roads on low-trip days.

OTHER SIFS IN BRIEF

Thaler also shows how concerns about fairness affect the behavior of individuals in consumer and labor markets, with important implications for optimal firm behavior. He demonstrates the potential effect of "defaults" (for example, in the case of organ donations or savings) and deals with the effect of social norms. He also shows how SIFs can actually increase the common good – for example, how the wording of a simple first warning letter can affect the number of people who pay their tax debts.

A LIST OF EXCUSES

Naturally, besides the behavioral concepts described in stories and anecdotes Thaler provides references to good quality papers supported by experiments, and evidence from large-scale datasets. Although there has long been significant resistance from rationalists against these ideas, there are a few arguments that they still employ. The most popular argument in defense of traditional economic theory is that although its assumptions about economic agents sometimes seem unrealistic, predictions based on them are often somehow correct. This means that although people individually misbehave, it is not wrong to use models that suppose they do not. However, based on Thaler's examples it seems plausible that this is not exactly true; the results of formal models can actually be misleading. Another argument is that people misbehave if the stakes are low, but when the stakes are high they will get it right. Moreover, in the real world people are capable of learning. These latter two ideas are somehow contradictory: individuals frequently meet with situations in which the stakes are low, but they encounter relatively few high-stakes situations in their lives, so they have no time to learn. The final claim is based on Adam Smith's famous metaphor of the invisible hand, which suggests that people behave differently when the market is involved. In response to this, Thaler shows that the two basic components of the market efficiency hypothesis ("no free lunch", and "the price is right") are questionable.

CONCLUDING REMARKS

For a long time, traditional economic thinking has been considered adequate: it represented the best possible models of the world and people's behavior. But, as time passed, it became outdated – many anomalies occur that are unexplainable using this paradigm, and have been swept under the rug. When early representatives of behavioral economics started to discover these phenomena traditional economists did not take their ideas seriously. When stronger evidence was introduced they resisted and employed customized excuses. Despite the fact that the new results modelled human behavior more accurately, traditional scholars refused to incorporate this knowledge into the toolbox of economic theory. From the perspective of Econs, this is completely irrational. Why wouldn't we want to understand individual behavior better if the primary goal is to do this? It looks like, in the end, we live in a world of Humans.

The most important takeaway from this book is that the main goal of behavioral economics is not to completely change how modern economics is understood, nor to destroy traditional economic way of thinking. Its main aim is to bring economic theory and the real world closer, to promote the idea that we should use hypothetical agents who are more like Humans than Econs. I believe that this book was not originally written for economists but for the public. It will be interesting for those who have never learnt about the discipline but are interested in knowing more about the world around us and those who live in it: for social scientists, I think it is perfect reading material. The book introduces the discipline of behavioral economics, shows the relevance of the field through various examples and explains the most important debates. Although these goals are achieved, the book's perspective is subjective, somewhat unconventional. Accordingly, the book lacks the clear and logical structure typically found in handbooks – but this is understandable, due to the fact that the book is not only about behavioral economics but about Thaler's life as well. Ideas are introduced in a very enjoyable way, while the presentation of papers behind the concepts is not overly detailed – a full description of methodology, research setting and formal models is usually partly lacking –, but those who are interested in digging a little deeper will find all the relevant references at the end of the book. In my opinion, this is a thought-provoking book that also has a heart.

In the first chapter, Thaler makes an important recommendation: "My only advice for reading the book is stop reading when it is no longer fun. To do otherwise, well, that would be just misbehaving". Fortunately, I did not have to misbehave.