

# Foundations

## BEST BEHAVIOUR?

**PAUL ORMEROD explains how behavioural economics relates to orthodox thinking.**

In 2002 Daniel Kahneman was awarded the Nobel Prize for his work in behavioural economics. His *Thinking, Fast and Slow* is an international best-seller. The foundations of Kahneman's work were built in collaboration with the late Amos Tversky as long ago as the 1970s. Four decades later, behavioural economics is finally becoming incorporated into economics teaching both at university and, increasingly, school level.

### What's it all about?

Behavioural economics involves the application of the insights of experimentally- based behavioural psychology to the analysis of economic decision-making. It has had a substantial impact on policy making. For example, in 2010 the UK's newly elected coalition government set up the Behavioural Insights Unit. The unit has claimed several policy successes. For example, sending personalised text messages to people to persuade them to pay fines promptly is believed to have saved the Courts Service £30 million a year. The tax authorities (HMRC) were persuaded to write to late payers of tax to tell them that most people paid on time. This is believed to have increased payment rates by at least 5 per cent. The team discovered that people's lofts were full of junk, and provided low-cost labour to clear them; this caused a fivefold increase in the proportion of installed insulation.

A defender of traditional economic analysis could argue that these examples are compatible with mainstream theory. Economists have long recognised the importance of information in decision-making, and each of these initiatives increased the amount of information available to people so that they could make better choices. The individuals in the examples were not acting irrationally before they received the prompts; their information was simply incomplete.

**Highlighted quotation: "Behavioural economics involves the application of the insights of experimentally- based behavioural psychology to the analysis of economic decision-making"**

### Bigger claims

More dramatic claims for the policy impact of behavioural economics insights are made by two leading American behavioural economists, Cass Sunstein and Richard Thaler. In 2009 they published a best-seller entitled *Nudge: Improving Decisions About Health, Wealth and Happiness*. In an interview on amazon.com, they suggested that behavioural economics can solve almost any problem, by giving 'nudges' to people by designing the way their choices

are structured – for instance by offering people the opportunity to ‘opt out’ of something (such as organ donation) rather than simply the choice to ‘opt in’. The following dialogue illustrates :

Amazon: ‘What are some of the situations where nudges can make a difference?’

Thaler and Sunstein: ‘Well, to name just a few: better investments for everyone, more savings for retirement, less obesity, more charitable giving, a cleaner planet, and an improved educational system. We could easily make people both wealthier and healthier by devising friendlier choice environments, or architectures.’

Big claims, though we might wonder whether policy-makers can be trusted to be any more rational than the consumers and investors they seek to nudge.

To be fair, Sunstein and Thaler have carried out very distinguished work in behavioural economics - for example Thaler’s 1980 article ‘Toward a Positive Theory of Consumer Choice’, described by Daniel Kahneman as ‘the founding text of behavioural economics’. Thaler argues here that ‘in certain well defined circumstances, many consumers act in a manner that is inconsistent with economic theory. In these situations economic theory will make systematic errors in predicting behaviour’.

This is the scientific aspect of the concept of behavioural economics. Many nudges used in practical contexts by policy makers, and described as being ‘behavioural’ can, as we’ve seen, be [potentially](#) reconciled (~~at a pinch~~) with mainstream economic theory. From a scientific perspective, behavioural economists are claiming much more. That are saying that, in certain contexts, the standard theory of economic behaviour does not tell us how the world actually operates.

### **What’s wrong with orthodox theory?**

The orthodox theory of decision making in economics is based on utility maximisation. Like any scientific theory, it needs to make simplifying assumptions about the world. Some key assumptions are that the tastes and preferences of each individual are fixed, and are not susceptible to being altered by the preferences of others. When making a decision, people are able to gather and process all available information about the various alternatives. Comparing these with their personal preferences, and subject to any constraints such as income, they make the best possible decisions. The theory is both a description of how rational individuals ought to behave, and at the same time one of how people actually behave in practice.

Behavioural economics, by contrast, identifies situations where people take decisions deviating systematically from those predicted by standard theory. It does so by using

experimental techniques lifted from psychology. An experiment is set up, in which the decision which would be taken by a rational agent is known. People are then paid small sums to take part in the experiment. Decisions which they actually make are contrasted with the predictions of economic models.

The conclusions drawn from such experiments can be criticised. The participants are not paid very much to take part, and so their incentives to arrive at the 'correct', rational choice are not very high. They are often recruited from the academic researcher's students, and so may not be representative of the population as a whole.

These are fair points. However, the sheer volume of empirical findings which have now been obtained within behavioural economics suggests that, whilst any individual study might be criticised, it is hard to dismiss the overall findings. An example is work by British economists Graham Loomes and Robert Sugden on the assumption of standard theory that choices are transitive (consistent). In other words, if I prefer A to B and B to C, then I prefer A to C. It sounds very plausible, but Loomes and Sugden have shown repeatedly that individuals may not behave like this at all.

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**But rational behaviour is still the benchmark**

A potentially more important point is that behavioural economics remains firmly anchored in the rational choice model of economics. This is still deemed to be able to identify the best decision, and the purpose of experiments is to observe deviations from it, such deviations being deemed irrational.

In 1955, Herbert Simon (a subsequent Nobel Laureate), published one of the most brilliant papers in economics in the whole of the 20<sup>th</sup> century. The subject matter was rational choice theory, and the paper inspired the entire corpus of work on behavioural and experimental economics. Yet the key theme of Simon's paper was an attack on the very principle of maximising behaviour. Simon argued that in many circumstances, people cannot gather or process the sheer amount of information required in order to make the best possible decision. Even after the event, it is often impossible to identify what the optimal choice would have been.

The literature has been inspired by Simon, but behavioural economics does not take on board this point. It is, for all its interesting results, ultimately based upon the rational, optimising model of decision making of mainstream economics. Experimental behaviour

which deviates from this model is seen as irrational, with the orthodox model still being seen as the way one ought to make choices.

Simon's work does not tell us whether free market approaches to economic problems or other approaches might be better – after all, politicians, voters and regulators come from the same stock of humanity as consumers. However, it should lead us to consider whether behavioural economics poses as many questions as it provides answers.

## References

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