Principles of Behavioral Economics

This book is unique among modern contributions to behavioral economics in presenting a grand synthesis between the kind of behavioral economics popularized by Richard Thaler, earlier approaches such as those of the 1978 Nobel Laureate Herbert Simon, evolutionary psychology, and evolutionary economics from Veblen and Marshall through to neo-Schumpeterian thinking. The synthesis employs a complex adaptive systems approach to how people think, the lifestyles they build, and how new production technologies and products are gradually adopted and produce changes. Using a huge range of examples, it takes behavioral economics from its recent focus on ‘nudging’ consumers, to the behavior of firms and other organizations, the challenges of achieving structural change and transitioning to environmentally sustainable lifestyles, and instability of the financial system. This book will be of great interest to academics and graduate students who seek a broader view of what behavioral economics is and what it might become.

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Principles of Behavioral Economics

Bringing Together Old, New and Evolutionary Approaches

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Preface

Behavioral economics has not yet arrived at the point at which a standard formula for its textbooks has emerged, let alone its own superstar textbook author. Publishers and authors are at the high-stakes stage of making investments in experiments aimed at producing the winning formula that will be the behavioral equivalent of conventional economics texts such as those by Mankiw or Varian. This means that it is not too late to offer a fresh alternative vision of behavioral economics that instructors and students might find more interesting and of wider practical relevance than what has so far been offered. This book presents such a vision, and it has been written so that it can be used as a textbook. However, although I have also created an archive of online support materials that can be viewed at my personal website (https://shredecon.wordpress.com), this book is a work of scholarship rather than one that follows the pedagogical strategies of today’s big textbook publishers. It is much bolder than previous attempts to package a vision of behavioral economics in a single volume. To get a sense of what makes it different and why the differences matter, it is useful to know how it came to be written.

I am not a recent convert to behavioral economics, or even someone who got interested in the field when it began to take off around the turn of the twenty-first century. Rather, I’ve been viewing myself as a behavioral economist since the late 1970s, having been introduced to the field as an undergraduate a couple of years earlier by Ajit Singh, my director of studies at the University of Cambridge. After completing my BA with first-class honors in 1977, I stayed on at Cambridge to work on my doctorate, which I eventually finished while working in my first academic position, a lectureship at the University of Stirling in Scotland. There, Professor Brian Loasby, the UK’s most eminent behavioral economist of the time, had been my mentor and external PhD supervisor. His influence permeates this book, not merely when I refer to his work explicitly but also via the book’s emphasis on the processes by which people come to know what they know and change how they view the world. Decades later, it had become very clear to me that where I had got to as a behavioral economist was very different from the perspective arrived at by others who were calling themselves behavioral economists. When I began to write this book, I envisaged the end product as my magnum opus, a legacy volume in which I would bring together everything I had learned about behavioral economics. It would be a means for sharing my vision of behavioral economics, which I felt had much more to offer than the approach that had become popular.
A few years before I started to write this book, I had merely envisaged writing an update to a pair of books that I had written either side of my 1984 Cambridge doctoral dissertation on “A Behavioral Analysis of Choice,” namely *The Economic Imagination: Towards a Behavioral Analysis of Choice* (1983c) and *Lifestyle Economics: Consumer Behaviour in a Turbulent World* (1986b). That book would have been called “Consumer Lifestyles and the Economic Imagination.” After the release of the copyrights of the old books had been granted, I started trying to figure out how to merge and update them. I soon realized that, even though many of their ideas would be carried forward, I was going to need to write a new book from scratch. This was partly because one of the things that I wanted to achieve was to get modern behavioral economists interested in taking a behavioral view of the firm, via the literature through which I had first been introduced to behavioral ideas. What had been known as the behavioral theory of the firm back in the 1970s had failed to become part of modern behavioral economics and had instead morphed, via Nelson and Winter’s seminal 1982 book *An Evolutionary Theory of Economic Change*, into part of modern evolutionary economics. Bringing it in required a much bigger book, and this was what I mapped out and started to write in July 2017.

The book’s initial working title was “Beyond Misbehaving: An Evolutionary Approach to Behavioral Economics.” I would be offering an “evolutionary approach” not merely by drawing upon modern evolutionary economics but also by exploring links to much earlier strands of evolutionary economics, particularly the late nineteenth-century contributions of Marshall and Veblen, as well as to modern-day evolutionary psychology. The “beyond misbehaving” phrase was there to signal two things. First, I was offering a view of behavioral economics that did not focus mainly on consumers failing to take the decisions that a “fully rational” decision-maker supposedly would take. Second, I was alluding to my intention to show how there is much more to my vision of behavioral economics than is offered in the work of Richard Thaler, the superstar among modern behavioral economists. Thaler is almost ten years older than me, but he, too, began his journey as a behavioral economist in the mid-1970s. However, his starting point was different from mine — he was trying to understand the impact of workplace risks on occupational choices — and it led him to take what I had come to see as a much less radical approach to behavioral economics, one that was based on a much more limited set of influences than mine. In 2015, Thaler had published his intellectual autobiography under the title *Misbehaving* and the subtitles *The Making of Behavioral Economics* (on the cover) and *How Economics Became Behavioral* (on the title page). The initial working title for the present book thus alluded to the title of Thaler’s book. It would help to signal my agenda to anyone familiar with the latter, and I also hoped that, by having a title that had some key words in common with it, some potential readers would end up discovering my book while searching for Thaler’s one on the Internet.

Thaler had called his book *Misbehaving* because it deals with his persistence in portraying many everyday choices as being at odds with what the theories of the economics establishment predicted. He was able to explain such behavior with the aid of a rather simple set of tools that he had developed after getting to know the work of
psychologists Daniel Kahneman and Amos Tversky in the late 1970s. Thaler’s knack for using his simple toolkit to explain how “supposedly irrelevant factors” (SIFs) could be driving people to act in ways that mainstream economists viewed as irrational had eventually brought him great career success. However, I felt that his success partly reflected the fact that he had misbehaved in academic terms far less than I had done. What I had been offering and would be reiterating as I went “Beyond Misbehaving” was a more complex view of human action that raised far bigger questions about the usefulness of mainstream economics as a means for understanding real-world behavior. However, although those who had picked up my contributions had mostly been nonmainstream economists, I was not setting out to dismiss Thaler’s achievements. As it turned out, I soon had to explain elsewhere why I thought Thaler’s contributions had been so significant and offer my critical reflections on his work. This was because, shortly after I began writing this book, I had to take time out from it, for it was announced that Thaler had been awarded the 2017 Nobel Prize in Economics (formally, the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel), and I was commissioned to write what has become a frequently downloaded paper (Earl, 2018) about his life and work.

I had greatly enjoyed Thaler’s Misbehaving and particularly liked how he had managed to write it in a style that would be accessible to the intelligent lay reader rather than merely to an academic audience. Mindful of this, I set out to make this book just as easy to read, though I knew that by writing in this way I would be breaking the norms of professors who expected it to read like a typical research volume. It was a writing strategy that turned out to be crucial for the book’s easy transition into a work that could be used as a textbook by students whose professors found its vision compelling.

From 2016, I had set Thaler’s Misbehaving as the required text for students at the University of Queensland who were taking my course on Behavioral and Evolutionary Economics. Thaler’s book was much more engaging than any of the existing behavioral economics textbooks, none of which delivered anything that better suited what I was teaching. Moreover, because I had long taught that course with a lecture sequence based on the history of the field, Thaler’s account of how he got his ideas and struggled to win acceptance for them fitted very well. It was a great hit with my class. The trouble was that, in the absence of a textbook that matched what I covered, I had to supplement Misbehaving with a long list of primary sources as recommended readings. Such a strategy is risky in an age in which, sad to say, being a “full-time student” typically means “trying to find time to study while holding down a part-time job to pay for my studies.” Hence it was natural that, for the 2018 and 2019 iterations of the course, I not only shared a growing number of draft chapters with my students but also restructured the course around the book’s sequence of contents. These proved to be my last two opportunities to teach the course, for it was then reallocated to a young colleague who, inevitably, transformed it into a narrower course in modern behavioral economics, built around an existing textbook. But the 2018 and 2019 iterations ensured that I got used to the idea that what I was writing could play the
textbook role; they also left me with a new set of lecture slides and other teaching resources that could be useful if anyone else wanted to go “beyond misbehaving.”

Ultimately, the original working title had to go, in order to signal more clearly the book’s integrative approach and its potential usability as a textbook, at least for more committed or advanced students. In calling it *Principles of Behavioral Economics*, I am not merely trying to signal that it pays much more attention to methodological issues than existing behavioral economics texts do; I am also alluding to its relationship with Alfred Marshall’s (1890) *Principles of Economics*. This relationship comes partly via its use of Marshallian ideas, particularly when considering the evolution of firms and industries, and partly because, as with his *Principles*, this book performs a dual role: it presents an integrative account of the field to academic peers in a way not previously offered, and it provides them with a means of teaching that account without having first to write their own textbook or jeopardize their teaching evaluations in the way that one inevitably does if trying to teach via extensive reading lists of primary sources. The costs of tooling up are also reduced by the teaching resources that are available to instructors via my personal website.

The thinking behind the abandoned “Beyond Misbehaving” title and the book’s eventual subtitle can be better appreciated – along with what makes this book different and why it may be worth using as a teaching resource – if one is aware of the distinction that Esther-Mirjam Sent (2004) has drawn between “Old Behavioral Economics” (OBE) and “New Behavioral Economics” (NBE). This was in a paper that she wrote to try to make sense of growing interest within the mainstream of economics in employing ideas from psychology, which is one of the things that those who call themselves behavioral economics have long been doing. In Sent’s analysis, OBE refers essentially to behavioral economics contributions that were produced prior to 1980 or that have been produced since then by those who have adhered to OBE ways of doing behavioral economics. This is the kind of behavioral economics for which Herbert Simon was awarded the 1978 Alfred Nobel Memorial Prize in Economic Sciences and is the kind that I have practiced. NBE refers to a different kind of behavioral economics that began with an article by Richard Thaler (1980) that was published in the very first issue of the *Journal of Economic Behavior and Organization* and was the first application of prospect theory, a theory of choices under conditions of risk, that psychologists Daniel Kahneman and Amos Tversky had developed and had published in *Econometrica* in 1979. What is currently taught in most behavioral economics courses, and dominates in existing textbooks, is essentially concerned only with NBE. In this book, by contrast, I offer a vision of behavioral economics that blends compatible elements from both OBE and NBE, with a strong evolutionary emphasis. This opens a wider range of research opportunities and areas in which to make novel policy contributions than is possible if one is only focusing on NBE. In doing so, it may help to secure a more sustainable future for behavioral economics.

Those who pioneered NBE or jumped on its bandwagon have done so seemingly without engaging in deep methodological reflection. As a result, they operate in a way that is methodologically quite incoherent (see Dow, 2013). Core to NBE is a focus on
the idea that humans are, by nature, fallible as decision-makers because they have evolved to use a set of simplifying heuristics to cope with the challenges of the complicated world in which they find themselves. Those who practice OBE can accept the part of the preceding sentence that follows “because,” but they have issues with the part that comes before it. The key issue is the alleged “fallibility” of human decision-makers, which in NBE is seen relative to what a “fully rational” economic agent ought to do if the context of choice is viewed from the standpoint of rational choice theory. From the standpoint of OBE, that theoretical benchmark is inappropriate for most of the decision-making contexts that humans must deal with, for rational choice theory focuses on closed problems with well-defined sets of options, preferences, and constraints, thus making it possible to specify optimal choices. Much of the research from which psychologists such as Kahneman and Tversky inferred that humans use a shared set of “bias-inducing” heuristics when taking decisions was undertaken via laboratory experiments that entailed closed-choice problems, such as choosing between lotteries with payoff matrices that were simple and predefined.

From the OBE standpoint, the world outside the laboratory setting is primarily a world of open-ended problems: we spend our lives trying to figure out what problems we are up against, what the potential solutions might be, what games other people are trying to play as they interact with us, what we really want, and what we can afford to pay. To cap it all, the world keeps changing, often in ways that are hard to anticipate. In the real world, it may be impossible even for rational choice theorists to figure out what a “rational” choice is. Indeed, the very notion of optimal choice turns out to be logically problematic if choices are open-ended, as these choices are mired by a set of problems of “infinite regress” that we have to cut off in an arbitrary manner by employing some kind of rule or heuristic.

The fact that NBE has anchored itself to the rational choice reference point and has not challenged the idea of optimization in open-ended choice settings may look very odd in methodological terms, given that NBE emphasizes so much the role of heuristics in decision-making. But it is precisely this that has helped NBE to thrive within conventional economics departments. If empirical anomalies are raised and can be made sense of by NBE, then outsiders are left with the impression that the economics establishment has all bases covered: where conventional economics fails to fit the facts, its NBE arm comes to its rescue. By having NBE research and teaching taking place in its midst, conventional economics shows how open it is to empirical evidence. Meanwhile, its theorists get on with doing what they do, as if, generally speaking, the conventional approaches to economics offer the go-to toolkit for understanding how the economy works.

Practitioners of NBE seem not to have noticed that they have been allowed to thrive because of the protective role they have been playing for conventional economics, for it was a role they could play while seeming to criticize the latter by exposing the anomalies that they went on to make intelligible. Nor do they seem to have realized that their continuing alliance with conventional economics and acceptance of the “full rationality” reference point put them in a vulnerable position if conventional economics is ultimately recognized as inapplicable to much of real-world economic behavior.
That recognition is long overdue, given that its insistence on building particular kinds of formal models limits it to closed-choice situations and frequently to producing models that cannot be tested. But behavioral economics may now be so well established that it is in a position to break out of this symbiotic relationship and set out to become the dominant way of doing economics. To do this, however, those who have been NBE enthusiasts need to get to see the bigger picture of the limitations of the conventional economist’s way of looking at the world and start to realize the wider potential of a stand-alone behavioral approach. This is what the present book is designed to foster by bringing together elements from both OBE and NBE. Their paths have diverged for the past four decades, but the future for behavioral economics lies in bringing them together.

The lack of engagement that contributors to, and students of, NBE have had with those who have gone down the less traveled road of OBE means that the former are largely oblivious of the dysfunctional impact that the relationship between NBE and the established core of economic principles has on how practitioners of NBE see the world and hence on their capacities for identifying where economics might benefit from taking a behavioral approach. For example, take the fact that most consumers will never buy even a single unit of most products. From the established core position, one would see this in terms of mathematical corner solutions and/or transaction costs that impede the division of access to indivisible products via short-term rental arrangements. The transaction cost point may indeed be worth keeping in mind when we are thinking about the functioning of markets for indivisible products, but the corner solution idea points toward a presumption that relative price changes can, in principle, always induce switching between products. In reality, this may not always be the case; instead, it may be that, for much of the time, people are actually choosing in ways that preclude substitution. The presumption in favor of substitution typically is so ingrained that even those who call themselves behavioral economists do not notice how widespread are cases of unwillingness to substitute. Hence, they fail to reflect on what this means for how economic systems function. If behavioral economists were armed with alternative perspectives from OBE, they would see a far wider range of research opportunities and areas where new policy insights could be needed.

In bringing compatible strands of OBE and NBE together in this book, I aim to promote an approach to economics that involves following the rule that economic analysis should be based on what is known about the nature of the human predicament and how people try to deal with the world in which they find themselves. This methodological rule can accommodate the contributions of both OBE and NBE. It is very different from one that says – as has increasingly become the case despite the rise of NBE – that economic analysis must be done in terms of formal mathematical models, even if this entails making assumptions that are clearly at great variance with what is known about reality. Basing analysis on what is known about reality need not preclude formal mathematical modeling, but such modeling may not be necessary in order to derive logically robust insights of real-world relevance. From the perspective that underpins this book, the analytical strategy is to employ behavioral foundations consistently rather than only reaching for them to address anomalies or when
designing economic policy. Insofar as we do end up labeling some behavior as dysfunctional, we will not be self-constrained to applying such labels with reference to what an idealized economic agent would be expected to do. However, the synthesis offered in this book generally offers a more positive view of human behavior, consistent with the evolutionary success of humans as a species. It turns out that, even where optima are elusive, it can still be possible to identify reliable ways of achieving reasonable outcomes, as well as ways of choosing and/or choices that it would be wise to avoid.

I think that Sent’s NBE/OBE distinction is invaluable for making sense of the history of behavioral economics since 1980. However, despite this, and despite the wording of this book’s subtitle, I will proceed, as far as possible, without referring to NBE and OBE in the chapters that follow. I hope this will help readers to end up with the kind of integrated view of behavioral economics that I am trying to foster. For students who are not used to being taught about contending perspectives in economics, the challenge of having to get to grips with behavioral economics alongside conventional economics will be big enough in its own right. For their sake, and for coherent thinking when working toward new policies, it is better to draw a sharp distinction between behavioral and conventional ways of doing economics, rather than allowing matters to become cloudy due to NBE still really being part of what it seems to be challenging. So, let us now proceed to what I hope is a coherent and constructive blend of old, new, and evolutionary approaches to behavioral economics.
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