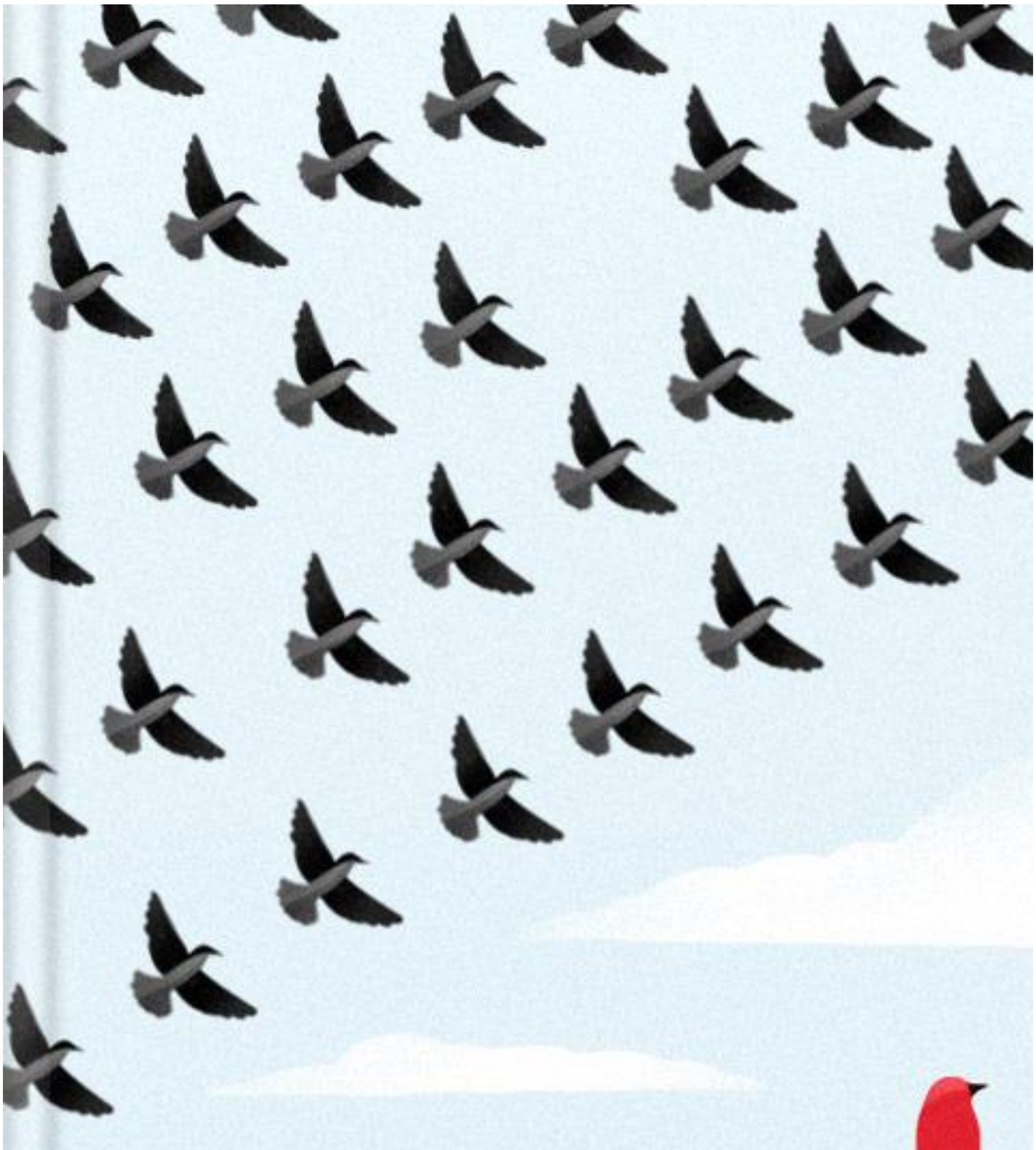

MISBEHAVING

The Making of Behavioral Economics

Summary of “Misbehaving” by Richard Thaler

The making of behavioral economics

Written by Bookey

About the book

In this book, misbehaving refers to the behaviors that contradict the basic assumptions of traditional economics. These are often the research subjects of behavioral economics. Traditional economics assumes that people are rational and that they make decisions that benefit themselves the most. To behavioral economists, however, such assumptions ignore the irrational side of people. This book reviews how behavioral economics has developed throughout the years, and also introduces some important research findings in the field of study.

About the author

Richard Thaler is one of the pioneers in the field of behavioral economics. He was awarded the Nobel Memorial Prize in Economic Sciences in 2017 for his contributions to the field. In addition to Misbehaving: The Making of Behavioral Economics, he's also written The Winner's Curse: Paradoxes and Anomalies of Economic Life and Nudge: Improving Decisions About Health, Wealth, and Happiness, another best-selling book co-authored by Cass Sunstein. Currently, Thaler teaches at the University of Chicago Booth School of Business as a professor of Behavioral Sciences and Economics. He is also a board member of the school's Center for Decision Research.

Chapter 1: Overview

Hi, welcome to Bookey. Today we'll unlock the book Misbehaving: The Making of Behavioral Economics. What is misbehaving? Let's start with a two question survey. Question one: Imagine there is a deadly disease spreading around the world. Those who contract the disease typically die within a week, and there is a one in ten thousand chance that you might get infected. If there is a medicine that can reduce your infection risk to zero, how much would you be willing to pay for it? Question two: Now, your boss wants to send you to the infected regions for investigations. Your chance of contracting the deadly disease is still one in ten thousand. How much would your boss have to pay in order for you to agree to the assignment? People that took the survey had very different answers to the two questions. For the first question, the respondents were willing to spend very little money on a life-saving medicine. For the second question, however, they demanded huge compensation for such work. From the eyes of traditional economics, the core of these two questions is the same—both are asking people how much it is worth to take on a one-in-ten-thousand chance of death. Nevertheless, the answers turn out to be very different. This can be identified as misbehaving. In this book, misbehaving refers to the behaviors that contradict the basic assumptions of traditional economics. These misbehaviors are often the research subjects of behavioral economics. In the past, traditional economists assumed that people are rational and that they make decisions that benefit themselves the most. But behavioral economists believe that this assumption is fundamentally flawed. If economists try to study market behavior or make economic forecasts based on such assumptions, the results would be flawed as well. People in real life are not always rational. In fact, they often make decisions that seem quite the opposite. Behavioral economists believe that in order to have a more accurate understanding of human behavior, they need to take the irrational side of people into account as well. This book reviews how behavioral economics has developed throughout the years, while introducing some of the important research findings in the field of study. Through this book, you'll have a comprehensive understanding of the interesting field of behavioral economics.   The author, Richard Thaler, is one of the pioneers in the field of behavioral economics. He was awarded the Nobel Memorial Prize in Economic Sciences in 2017 for his contributions to the field. In addition to this book, he's also written "The Winner's Curse: Paradoxes and Anomalies of Economic Life and Nudge: Improving Decisions About Health, Wealth, and Happiness, another best-selling book co-authored by Cass Sunstein. This book is available on Bookey as well. Currently, Thaler teaches at the University of Chicago Booth School of Business as a professor of Behavioral Sciences and Economics. He is also a board member of the school's Center for Decision Research and serves as co-director of the Behavioral Economics Project at the National Bureau of Economic Research.   In this bookey, we’ll learn about behavioral economics in three parts.　Part One: How misbehaving leads to the birth of behavioral economics；　Part Two: Basic theories of behavioral economics；　Part Three: How behavioral economics helps us make better decisions.　Let’s go through them one by one.

Chapter 2: How misbehaving leads to the birth of behavioral economics

When Thaler first became a teacher, he was not liked by his students. It's not because his classes were not good, but due to how his exams were designed. In order to group the students into different levels, some of the exam questions were very difficult so only the top students knew the answer. The scores varied greatly as a result, and the average was just 72 points. It's not hard to imagine why the students hated Thaler and his exams. Although Thaler wanted to be liked by his students, he did not want to make the exam any easier. What should he do? Finally, he raised the total score from 100 to 137 for the next exam, and not surprisingly, the average score of the class also improved from 72 to 96 points. Although their percentage score did not change, the students were much happier. In the eyes of traditional economists, the students' behavior was very unusual. 96 points out of 137 and 72 points out of 100 should make no difference, but clearly, that's not how the students felt. Thaler noticed many similar examples of this, so he made a list of all of the behaviors that seem irrational. For example, Thaler and his friend Jeffrey bought two tickets for a basketball game. On the day of the game, there was a huge blizzard and the game was an hour and a half drive away. Thaler thought they should just stay home, but Jeffrey felt that since he had already bought the expensive tickets they should go and watch the game no matter what. According to traditional economics, the money spent on the tickets is the sunk cost, that is the effort or capital that has already been spent and cannot be recovered. Theoretically, a rational person should ignore the sunk cost and it shouldn't affect their decision about whether or not to watch the game. But obviously, in real life, people often don't act in the ways economists expect.

In another example Thaler's friend Linnea was shopping for a clock radio. She found a model that she liked for $45, which to her is a reasonable price. As she was about to buy it, the clerk mentions that the same radio is on sale for $35 at a grand opening sale of a new branch of the store, ten minutes away. Without hesitation, Linnea went to the other branch for the radio. A few days later, Linnea was shopping for a television set and found one for $495. Again, the clerk tells her that the same model is on sale at another branch ten minutes away for $485. But this time, Linnea chose to stay where she was and bought the television right there. Linnea's behavior shows that she values her time differently depending on the situation. In both cases, she could have saved an additional $10 by spending another ten minutes on the way, but she made different decisions.

Behaviors, or misbehaviors, like these are very intriguing for Thaler. Why can’t they be explained by traditional economics? The problem lies in the most basic assumption of traditional economics, that people are always rational. We’ve talked about this briefly in the opening, now let’s get into the details.

Simply put, traditional

economics assumes that all the participants of in economics are completely rational people. They know exactly what they want and how to maximize their personal benefits. If given $100 to shop at a supermarket, the rational person can always find the product combination that's most satisfactory for them. They will always follow the principle of optimizing when making choices. What's more, when making decisions, the rational person is never prejudiced, impulsive, or overconfident. In other words, they'll never act in an irrational way. But Thaler believes this assumption is flawed. For him, it's almost impossible for people to be completely rational in real life. In the example of Linnea, she could save the same $10 in both cases, but when $10 accounts for a much smaller percentage of the product's total price, she doesn't think it's worth the hassle. It's even harder to achieve the so-called optimization principle. When someone is shopping in the supermarket with a budget, there are so many things to choose from that nobody can guarantee that their choice is the best. If this is the case for shopping the principle is even more true for other more difficult choices in life, such as choosing a career and marriage. Two other economists were already skeptical about the principles of traditional economics. They are Thaler’s lifelong research partners Daniel Kahneman and Amos Tversky. If you are interested in their stories, check out the bookeys of Thinking, Fast and Slow and The Undoing Project: A Friendship That Changed Our Minds to learn more. Kahneman and Tversky have written a paper to show that it’s difficult for ordinary people to be completely rational. Due to the limited time and mental capacity, most people make judgments based on their experience rather than rational thinking. That’s when they are prone to making mistakes. For example, if someone asks you if “Dhruv” is a common name, how would you answer? You’d probably try to think if you know anyone with this name. If you're from India, because many people there are called “Dhruv”, you might think it's a common name. But if you're not from India, you might say it's not that common. In fact, this name is quite common globally. But if you only make judgment based on your own experience, you might get it wrong. Kahneman and Tversky have also proposed the prospect theory to challenge the principles of traditional economics. To understand it, let's look at two interesting experiments. In experiment one, you are given $300 and then have to choose between the following two options. Option one, you are guaranteed to get another $100. Option two, there is a 50% chance of getting $200 and 50% chance of getting nothing. In experiment two, you are given $500 and again have to choose between the two options. Option one, you're guaranteed to lose $100. Option two, there is a 50% chance of losing $200, but 50% chance of losing nothing. It's not difficult to figure out that option one in both experiments should have the same results. You will get $400. Similarly, option two in both experiments are also the same. Both have a 50% chance of getting $500 and 50% chance of getting $300. If people are rational their choices in these two experiments should be the same. But the actual results were surprising. In experiment one, 72% of the respondents chose option one and 28% took option two. In experiment two, however, only 36% of the respondents chose option one, and 64% went with option two. Why was the difference so drastic? The difference lies in the attitudes people tend to have toward different types of risks. When it comes to gains, they often prefer certainty and are more averse to risks. When it comes to losses, however, people hate certainty and tend to take on bigger risks for a chance of losing less. This is the main idea of the prospect theory. You can find more details about it in the bookey for The Undoing Project: A Friendship That Changed Our Minds, which contains many other interesting theories from Kahneman and Tversky. Prospect theory intrigued Thaler' and he decided to devote himself to the study of behavioral economics. But the emerging field was not accepted by traditional economists. Although traditional economists admit that nobody in real life can make completely rational economic decisions, they insist that people can improve their decision-making abilities and approach true rationality through repeated learning and practice. Traditional economists also believe that if a decision has high stakes, people would be more motivated to think carefully, collect information, and make rational decisions. According to Thaler, traditional economists' arguments don't really hold up. If repeated learning and practice could help improve decision-making capabilities, then people shouldn't be making any irrational decisions when buying things like food and clothing. People make these kinds of choices all the days. If people are more careful when making big decisions with high stakes, they should act rationally when buying expensive products like cars, real estate, and financial products, or when they choose a career or spouse. But in real life, that doesn't seem to be the case. This concludes the content of part one. We've learned why traditional economics is flawed and how to explain some customer misbehaviors. We’ve also learned how Kahneman and Tversky’s research has inspired Thaler, and the doubts concerning behavioral economics posed by traditional economists.