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Behavioral Economics FOR DUMMIES®

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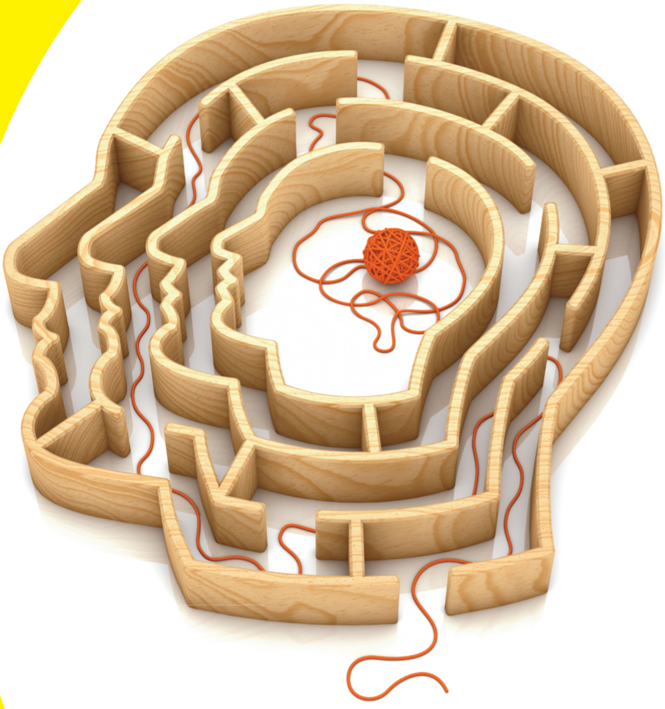
- Grasp how governments and experts influence our choices
- Avoid making impulsive and uninformed decisions
- Appreciate why ethics are important to our choices



Morris Altman, PhD

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Behavioral Economics

FOR

DUMMIES®

Behavioral Economics FOR DUMMIES®

by Morris Altman, PhD

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About the Author

A former visiting scholar at Cornell, Duke, Hebrew, and Stanford universities, **Morris Altman** is currently professor of behavioral and institutional economics and head of the School of Economics and Finance at Victoria University of Wellington. He is also professor of economics at the University of Saskatchewan, where he was head of the Department of Economics from 1994 to 2009. Recently, Morris was elected Visiting Fellow at St. Edmund's College, Cambridge University, and was a Visiting Scholar at Stirling University in Scotland and an Erskine Fellow at the University of Canterbury, Christchurch, New Zealand.

Morris was elected and served as president of the Society for the Advancement of Behavioral Economics (SABE) from 2003 to 2006. In 2009, he was elected president of the Association for Social Economics. He is editor of the *Journal of Socio-Economics* (Elsevier Science) and former Associate Editor of the *Journal of Economic Psychology,* where he remains on the editorial board.

Morris has published over 80 refereed papers on behavioral economics, economic history, methodology, and empirical macroeconomics and four books in economic theory and public policy and has made over 150 international presentations on these subjects. He is currently completing three books on related subjects and is researching endogenous technical change, the linkages between economic justice (human rights), power, and economic growth and development, as well as the importance of altruism, ethics, and reciprocity in economic theory.

Morris is also leading major projects in experimental economics. One examines the role of prices, incomes, and social variables in determining consumer demand. Another investigates the conditions under which improved working conditions affect effort inputs and how this might impact unit costs and profitability.

He currently lives in Wellington, New Zealand, with his wife, Louise, and their daughter, Hannah.

Dedication

To my wife, Louise Lamontagne, and our daughter, Hannah Altman, for their love, inspiration, and patience.

Author's Acknowledgments

I am very grateful to Robert Hickey of John Wiley & Sons, who got me involved in this exciting project. He carefully helped me work through a detailed template for this book, which has become its backbone. I would also like to thank Elizabeth Kuball, my project editor, for keeping me on my toes throughout my tight schedule and making very helpful suggestions that have contributed to improving the rhetoric, style, and content of this book. I'm sure that without Elizabeth's interventions, there would be no book. I'd like to thank my technical editor Nathan Berg of the University of Texas at Dallas for his many helpful comments and suggestions. Louise Lamontagne, my colleague and collaborator of over 30 years, read through the manuscript, making critical comments and suggestions that added much to this book's value. Hannah Altman played a critical role, always encouraging me to tackle this difficult but exciting project and adding a few hot tips of her own.

Teaching behavioral economics over the past decade has contributed immensely to the quality of this book. It gave me the opportunity to read deeply into the literature. Difficult and sometimes seemingly simple questions from my students forced me to think through concepts in behavioral economics in much more nuanced fashion than I might otherwise have done. Also, many of students' research papers in behavioral and experimental economics helped enrich my understanding of the field.

I've been thinking about and researching behavioral economics since the early 1980s, when I was working through, deconstructing, and reconstructing x-efficiency theory in my doctoral work in economic history. I'll always be appreciative to the late Harvey Leibenstein of Harvard University, the pioneer in this line of theoretical reasoning, for his mentoring and encouragement even though I was clearly heading for a road that he was not a great fan of. I also owe thanks to Professor Harold (H. R. C.) Wright, my McGill University teacher and mentor, who gave me the freedom to think and develop my own thoughts. Also of foundational importance from my McGill days are Paul Davenport, Chris Green, Jack Weldon, and Athanasios (Tom) Asimakopulos. It was Tom who enticed me out of political philosophy into economics where, he insisted, you really can make a difference. I must also thank John Tomer, a close colleague and friend on the behavioral economics bandwagon for 20 years, whose pioneering research pushed me into thinking about behavioral economics from different and interesting perspectives.

Publisher's Acknowledgments

We're proud of this book; please send us your comments at http://dummies.custhelp.com. For other comments, please contact our Customer Care Department within the U.S. at 877-762-2974, outside the U.S. at 317-572-3993, or fax 317-572-4002.

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Contents at a Glance

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Introduction

Behavioral economics is all about making our *economic models* (the tools we use to understand and explain economic behavior) more rigorous and realistic, by building them on solid empirical foundations. It brings into the analytical mix psychological, sociological, neurological, and institutional factors. It adds breadth and depth to economic analysis. Although behavioral economics has grown in prominence over the past two decades, many conventional economists still smirk when it's mentioned. They see behavioral economics as a bunch of mumbo-jumbo, pop psychology — but nothing could be farther from the truth.

Unlike conventional economics, behavioral economics is devoted to understanding economic phenomena based on actual human behaviors. Behavioral economics doesn't assume that people must or even should behave in a way that's deemed rational by conventional economics. The fact is, more often than not, people behave in ways that *aren't* consistent with the conventional wisdom.

From the perspective of behavioral economics, people aren't expected to know everything, to calculate everything in any great detail, or to be narrowly selfish. They *are* expected, however, to be influenced by the world around them — especially by friends, family, past decisions, culture, and religion. People also are expected to be influenced by how the brain is structured: People's decisions are affected by their limited abilities to acquire and process information and, therefore, by the need to develop decision-making shortcuts (known as *heuristics*). Behavioral economics recognizes that people are not all the same. They have different tastes, wants, desires, and bargaining power, all of which can have important implications for the choices they make. It is in this unconventional world that people make decisions — and this is the world that behavioral economics is interested in understanding.

About This Book

This book introduces you to a wide array of important economic issues, in a refreshingly new light. From business cycles to asset bubbles, from savings to investments, from ethical behavior to fairness, from how choices are made to economic outcomes, from emotions to stoic calculating in decision making, from overconfidence to underconfidence, from love of money to the importance of certainty and status, behavioral economics has something important to say.

This book introduces you to the theories of behavioral economics. It fills you in on how behavioral economics differs from conventional economics, as well as where the two overlap. Economics isn't an either/or situation — plenty of what conventional economics has to say is valid and useful. Behavioral economics just adds some more tools to the economic toolkit, helping you make sense of why people make the decisions they make.

Keep in mind that this book is a reference, which means you don't need to read the chapters in order from front to back. It also means that you aren't expected to commit what you read to memory — you can return to this book again and again, to find the information you need.

Conventions Used in This Book

You don't need a degree in economics to understand this book, but knowing the few conventions I use will help you navigate to the information you need:

- When I introduce a term, I *italicize* it and define it shortly thereafter (often in parentheses).
- I place web addresses in `monofont` so that you can easily spot them. ***Note:*** When this book was printed, some web addresses may have needed to break across two lines of text. If that happened, rest assured that we haven't put in any extra characters (such as hyphens) to indicate the break. So, when using one of these web addresses, just type exactly what you see in this book, pretending as though the line break doesn't exist.
- I tend to use *we* and *our* to refer to economists, and *people* and *their* to refer to the population as a whole. For example, I may say, "We can use this information to study people's decisions." It's not that economists aren't people (although some non-economists may beg to differ); it's just that I want to make the writing as clear as possible.

What You're Not to Read

Technically, you don't *have* to read anything in this book — you won't be quizzed on it. But, assuming that you want to find out about behavioral economics, your understanding of the subject won't be seriously impaired if you skip the following:

- **Material marked by the Technical Stuff icon:** Of course, if you have the time, or if you feel really hungry for juicy technical stuff, you'll find these paragraphs interesting. (For more on this and other icons, turn to "Icons Used in This Book," later in this introduction.)
- **Sidebars:** These gray boxes may contain historical information, more info on particular economists, technical details, and so on. Sidebars are interesting, but they aren't essential to your understanding of the topic at hand, so if you just want to know what you *need* to know, you can skip them.

Foolish Assumptions

I don't assume very much about the readers of this book, but I do assume the following:

- I assume that you're interested in how real people behave in the real world and what we can learn from their behavior.
- I assume that you have an interest in economics and economic events, but that you're a wee bit frustrated by the tall tales often told by economists about economies and economic issues, as well as the predictions that economists make.
- I don't assume that you have a degree in economics, but you may be a student in an economics course or you may be thinking about taking an economics course.
- You may have heard about behavioral economics and wondered what all the fuss was about.
- You may be a businessperson, someone involved in public policy, or an investor, and you want to use the behavioral economics toolkit to make smarter decisions.

If you see yourself in any of these descriptions, this book is for you!

How This Book Is Organized

This book is divided into five parts. Here's an overview of what each part contains.

Part I: Introducing Behavioral Economics: The Science of Making Real-World Choices

In this part, I introduce some of the key concepts of behavioral economics. I also explain why realistic assumptions matter for constructing economic theories and analyses. I fill you in on the importance of psychological, sociological, institutional, and physiological factors for developing these assumptions and models. I talk about the role of the brain's architecture when it comes to model building and decision making. Finally, I cover how behavioral economics enriches the conventional economics toolbox (which focuses on relative prices and income as key determinants of the choices people make). Basic economic incentives matter, but on many important occasions, they tell only part of the story.

Part II: Understanding Choice

In this part, I examine the role and meaning of free choice in economic decision making. Conventional economics assumes that people's choices are made in a vacuum, but behavioral economics says otherwise. Here, I explain the impact that history, culture, norms, peers, gender, family, labels, and the framing of options have on people's choices. I also discuss the conditions that are necessary in order for people to make choices that reflect their true preferences (given the constraints they face). I elaborate on unconventional tools that people have developed to make decisions. I explain how these tools sometimes produce errors and biases in decisions, as well as when and why these tools produce superior results to the decision-making procedures recommended by conventional economics. Finally, I discuss the important role that emotions and intuition play in the decisions people make.

Part III: Growing the Economic Pie: The Economic Importance of Ethics, Well-Being, and Culture

This part deals with the role of a variety of economic variables in the payment of taxes and criminal behavior, but it's not only about economic rewards and punishment. I also discuss why social welfare, unions, minimum wages, and the like don't have to have the negative effects that conventional economics predicts. A lot depends on workers' preferences and how workers are treated in the labor market and inside the firm — both of which are largely ignored in conventional economics. The fact is that the work environment can have a big impact on productivity and, ultimately, on the wealth of nations.

In this part, I also discuss the role of ethics in decision making, productivity, and what's produced in the marketplace. Contrary to what conventional economics says, ethics can stimulate productivity while being consistent with firms competing in a global economy.

Finally, I explain the important role played by institutions and government policy in affecting economic behavior and economic outcomes.

Part IV: When Bubbles and Busts and Inefficiencies Are Possible: Some Behavioral Insights into the Strange World of Economic Reality

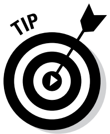
This part deals with topics that are near to the hearts of many behavioral economists and always hot in the press. Here, I delve into the reality of inefficient markets and asset bubbles and busts. I also discuss the causes and importance of these bubbles and economic inefficiencies for the economy. I explain the importance of psychological and institutional variables to the generation of business cycles, recessions, and depressions. I also fill you in on labor market behavior over the business cycle. Finally, I explain what behavioral economics has to say about happiness. Conventional economics would have you believe that happiness is simply a product of more income and wealth, but behavioral economics recognizes that factors other than wealth and money are critically important to a person's happiness.

Part V: The Part of Tens

This wouldn't be a *For Dummies* book without a Part of Tens. In this part, I discuss some of the implications of behavioral economics for public policy. I fill you in on experiments that provide insight on how and why people behave in certain ways and what this implies for economic theory and our understanding of decision making and decision-making environments. Finally, I point out some insights that behavioral economics has for consumers to help them make better decisions.

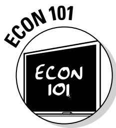
Icons Used in This Book

Icons are the little images in the margins of this book. Their purpose is to draw you to certain kinds of information. Here's what the icons mean:



The Tip icon marks anything that'll help you understand a concept more easily.

You don't have to commit this book to memory — there is no final exam at the end of this book — but when I tell you something that's important for you to remember, I flag it with the Remember icon.



When I discuss core economic concepts that are important to behavioral economics (or to the subject at hand), I mark the material with the Econ 101 icon.

Throughout this book, I illustrate key concepts with examples from the real world, and when I do, I flag those paragraphs with the Real World Example icon.

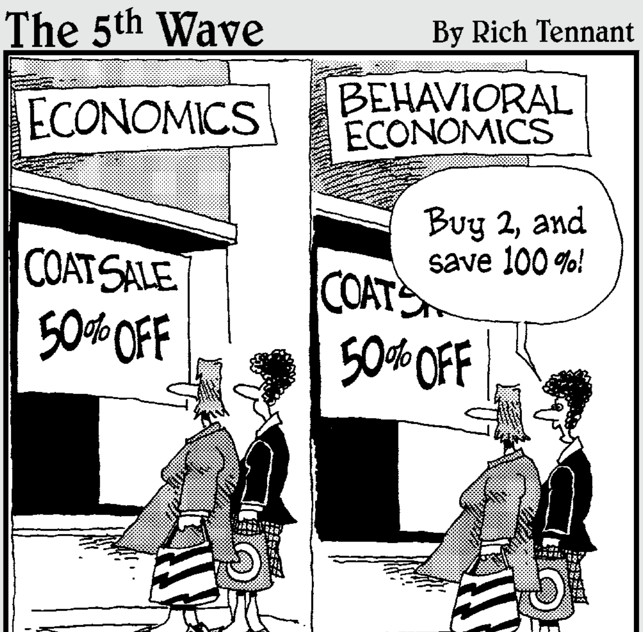
When I have a go at some more complex, technical material, I flag it with the Technical Stuff icon. If you're the sort who reads instruction manuals from cover to cover, you may find this material particularly fascinating. Otherwise, you can safely skip anything marked with a Technical Stuff icon, confident that you aren't missing anything essential to the topic at hand.

Where to Go from Here

You can start reading this book pretty much anywhere — let curiosity be your guide. Use the table of contents to pick a chapter that grabs you, or turn to the index to find subjects you've always been interested in. Chapter 1 is a good starting point, because it provides a road map for the rest of the book. Chapter 4 is particularly useful if you're interested in the connections between conventional economics and behavioral economics. For some background on the neurological underpinnings for decision making, check out Chapter 3. Chapter 2 is a good launching pad if you're interested in how economic models are built and how these analytical engines function (and sometimes fail). Wherever you start, you'll find useful information on how psychological, social, and institutional factors affect people's economic decisions.

Part I

Introducing Behavioral Economics: The Science of Making Real-World Choices



In this part . . .

Behavioral economics is about understanding how real people behave in real-world settings. In this part, I examine the role that assumptions play in developing robust economic theories and economic analyses.

I also discuss the role of the brain's architecture in this part. The decision-making process and people's choices are hugely impacted by how the brain is structured and how it evolves into adulthood.

Finally, I consider the role of incentives in motivating people's behavior. In behavioral economics, as in conventional economics, economic incentives matter — the difference is that in behavioral economics, what affects people's decision making is much more complex and nuanced.