



# Behavioral Economics - A methodical observation

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**Abstract:** There are various ways a theory might react to a set of data that contradict its central assumptions. Neoclassical economics has made a number of different attempts to address the problem raised by Behavioral Economics. This essay briefly reviews various responses before making a case for one of them.

**Keywords:** Behavioral economics, Neoclassical Economics, Economic theory, Rational behavior, Economic Methodology

## INTRODUCTION

There are various alternatives for how a theory might react when faced with evidence that contradicts its central tenets. They are all being used to address the threat behavioural economics (BE) poses to neoclassical economics. I briefly review these comments before turning to support one of them.

One solution is to consider BE findings as ancillary. Many economists, according to Tim Harford's study in the Financial Times, believe that BE "merely reveals certain fascinating but relatively small faults." When it comes to the majority of judgements that truly count, he continues, "I have long been convinced that the data suggests that we are inherently rational beings" (2008). Yet, many of the fundamental findings of BE are difficult to dismiss since they demonstrate that persons have congenital cognitive limits that are visible in a variety of decision-making contexts.

Several economists contend that although many people behave in ways that appear to go against the rational, utility-maximizing assumptions, as a whole, they behave as though they were optimizers. For instance, Gary Becker contends that it is irrelevant because 90% of individuals cannot perform the intricate analysis necessary to calculate probabilities. The 10% of people who can land occupations that demand it (quoted Stewart, 2005). Nevertheless, Becker does not present any evidence to support his claims that 10% (or even 1% of economic players) are optimizers or that markets as a whole behave rationally as opposed to, for example, varying between times of irrational exuberance and greed and irrational fear and panic (Shiller, 2005).

A different response relaxes the criteria that define rationality. This response takes several forms:

(a) (A) Some people use tautologies, using the same action to show the actor's preferences and the best approach to satisfy them. Neoclassical economics contend that if a person who never drank alcohol and had no intention of doing so suddenly bought a bottle of wine, his decision must have been logical else why would he have done so? (Tagliacozzo, cited by Kirzner, 1976: 169–170). Some people use tautologies, using the same action to show the actor's preferences and the best approach to satisfy them. Neoclassical economics contend that if a person who never drank alcohol and had no intention of doing so suddenly bought a bottle of wine, his decision must have been logical else why would he have done so? (Tagliacozzo, cited by Kirzner, 1976: 169–170).

(b) In contrast, the concept of information costs being introduced is much more beneficial. It is reasonable to stop seeking or processing more information when the expected costs of doing so outweigh the expected utility to be received from it, even if doing so causes one to act without all the necessary information — to act "irrationally," as it were (Downs, 1957, chap. 11–13; Stigler, 1961).

The main empirical challenge from a BE perspective is whether people can accurately (i.e., rationally) evaluate the costs and benefits of knowledge they have not yet gathered or processed (Elster, 1986: 25–26). One can question whether this is conceivable given the results of BE.

(c) Neoclassical economics also advocates the use of heuristics as a sort of prefabricated rationality in an effort to rationalize the irrational. They save people from having to take in and analyze information, which is thought to enable them to function optimally despite cognitive limitations. No one has, as far as I can tell, taking a random sample of heuristics and demonstrated that the vast majority, even a majority, or even a small portion of them result in rational behaviour or that their selection does not experience the same cognitive challenges that other information processing

reveals. The same concerns highlighted concerning information costs are relevant here: how can one decide which heuristic to use?

Define what is meant by being rational in order to try and make the conclusions of BE and neoclassical economic theory compatible. Herbert Simon specifically used the idea of "bounded rationality" to argue that even if people's actions may appear to be unreasonable, they actually act rationally since they planned to do so. Simon claims that "bounded rationality is not irrationality." Contrarily, I believe there is ample evidence to suggest that people are typically highly reasonable, that is, they typically have reasons for their actions (1985: 297). Others interpreted the phrase to mean that individuals made reasonable decisions as a result of full use of all available knowledge (Cipriani & Guarino, 2008: 48).

These discussions, in my opinion, indicate that it is very beneficial to see rationality as a continuous variable rather than a binary one. As a result, one might speak of levels of rationality. A dichotomous variable may be sufficient if one only wants to use BE to disprove the validity of the optimization model. Yet, degrees become important if one wants to create a different model. They first allow one to communicate the important discovery that most people in many circumstances are far closer to the other end of the continuum than just a few percentage points from optimality, such as 96% reasonable. Second, such a concept emphasizes the value of figuring out what elements, such as training, education, modern culture, or self-control, raise a person's level of rationality, rather than assuming that anything can make someone an optimizer or even a highly rational chooser.<sup>1</sup>

The utilization of a one-dimensional continuum does not seem to be very suitable, a coworker commented. It appears to include placing several "subnational" behaviour or belief categories on the same continuum. In a totally different way than, say, failing all three items on the Cognitive Reflection Test, eating a wafer and believing it to be the flesh of some long-dead character seems terribly "sub rational." Despite the fact that both people would utterly fail the criteria of perfect rationality, their blunders do not seem comparable.

The point made here is well taken. In response, it should be noted that most of the studies I am analyzing and drawing on treat reason as a monolithic idea. But, there is no reason why one couldn't use several dimensions in theory (e.g. factual errors as distinct from beliefs that are inherently untestable). The next step would be to either grade each dimension or create an index.

Those who advocate splitting the social world between domains of conduct that follow the principles of neoclassical economics and those that are governed by alternative norms imply a far bigger deviation from the neoclassical model. This strategy is demonstrated by the research on preferences. Neoclassical economics frequently makes the assumption that preferences are stable and that changes in income and price are the cause of changes in behaviour (and other information). Nonetheless, it is challenging to justify the idea that preferences are fixed, particularly when one considers how children are educated. In fact, many neoclassical economists have a tendency to view economic man as a biological-psychological marvel who was born completely formed, say in his mid-twenties, with his preferences having been "immaculately created" (Maital & Maital, 1984: 65).

Adults' tastes also appear to be constantly changing as a result of social and cultural shifts that have an unnoticed impact on their beliefs and emotions as well as their choice of information sources and how they absorb it. As a result, some economists proposed that the study of preferences be divided into two areas: social sciences should examine how preferences are formed, and neoclassical economics should treat preferences as givens. For instance, Paul Samuelson recommended that psychology and sociology examine how preferences are created rather than economics (Samuelson, 1983: 90). After that, economics can treat them as givens and fixed, and proceed to analyze how people alter their spending and saving decisions based on their income and price levels while maintaining their preferences. So, it is claimed that BE (and socioeconomics) only apply to these exogenous regions.

This strategy implicitly presupposes that exogenous changes occur prior to endogenous ones. For instance, it is assumed that as people mature, their preferences develop, and they are then prepared to enter the market and make decisions about the type of work they want to do, the things they want to buy, and other things (Stigler & Becker, 1977). Indeed, both types of changes—those in preferences and those in income and prices—occur concurrently and both have an impact on behaviour (Stern (1984, 72), for instance, showed the separate effects of values and prices in studies of energy use). So, when comparing behaviour at two or more points in time, it is important to identify the mix of factors at play and the degree to which the changes are the result of shifting preferences (and the forces that drive them) or shifting income, prices, or other relevant economic variables.

Paradigm reformulation or shift?

Due to its emphasis on intra-individual skills, processes, and biases, particularly on cognitive variables, BE's challenge is constrained.<sup>3</sup> The majority of research on how societal and cultural influences affect decisions has not yet been included into BE. Sociologists and socio-economists, such as Max Weber, Talcott Parsons, Amartya Sen, Albert O. Hirschman,

Harvey Leibenstein, Neil Smelser, Viviana Zelizer, Paul Dimaggio, Wayne Baker, Victor Nee, and Amitai Etzioni, among others, performed and continue to perform a significant portion of this work.

There is also opportunity for ideas that deal with the types of variables that macroeconomics rather than microeconomics covers. Neoclassical economists frequently make the assumption that the major actors in the economy are a group of people whose collective decisions shape the economy. In contrast, a new paradigm might profit from the premise that people are not autonomous agents but rather constituents of many different groups, and that the characteristics and dynamics of these groups have a significant influence on people's decisions. Emergent macro-traits, of which the individuals are frequently uninformed and which are not the focus of their debates, in turn, shape said group attributes and dynamics. Collective dynamics, such as social movements, including religious and political ones, cultural shifts (such as the rise of consumerism as a core value), and structural ones influence and affect these characteristics (e.g. the effects of massive immigration). Therefore, a paradigm that treats non-aggregated macro-variables (those that cannot be reduced to collections of individual choices) as independent variables is necessary for the study of individual choice. This strategy was best demonstrated by Max Weber's investigation into the relationship between Protestantism and other religions in order to discover which predated and helped to explain the birth of capitalism.

The challenges that macroeconomics researches are analogous to those highlighted by the fact that people are socially embedded. Neoclassical economists frequently treat the economy (also known as the market) as a separate entity with its own set of laws, in contrast to the state (also known as the government), which occasionally interferes with the market. While governments (and societies) supply the laws, institutions, and values that both contain and permit the operation of the markets, markets themselves can be seen as sub-systems that are contextualized by these states.

The main difficulties faced by attempts to develop a new paradigm of choice are that thus far

- (a) There are many factors that have been recognized as being involved, and
- (b) No consensus has been reached regarding the variables that should be included. According to two prominent economists, "research attempting such a task has practically infinite latitude to explain any observed behaviour *ex post facto* given the large diversity of psychological theories from which to select" (Levitt & List, 2008: 909–910).
- (c) As a last point, the majority of the variables that influence economic and other choice behaviour are poorly modeled and lack reliable measures. In conclusion, despite several attempts to create a new paradigm, no one has been able to combine them into a single overall design, similar to how neoclassical economics has done for so long.

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