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Misbehaving: The Making of Behavioral Economics by Richard H. Thaler: Critical Evaluation & Review

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Abstract: Thaler's ability for writing has resulted in a book that is a mix of his experiences as a faculty member, anecdotes from other economists he encountered along the journey, and a background in Behavioral Economics. Richard Thaler provides an analysis of how subjective factors influence decision-making in matters related to the economy and personal finances. The subject of "Misbehaving" is one of dominance and special interests; its power that economists were refusing and defending against the possibility of being irrational. Reading "Misbehaving" is recommended for those who want to understand how psychology influences decision-making with money and the economy, and for those who want to understand Behavioral Economics. This review will look further into evaluating the concept of irrationality and decision-making in behavioral economics.

Keywords: *Behavioral Economics, Irrationality, Misbehaving, Decision-making, Nudging, Self-interest.*

Background: Richard H. Thaler is an American economist who received the Nobel Prize in Economics in 2017 for his work in Behavioral Economics. The author discusses the content of 447 pages with very good humor and personal and didactic examples that make the reading quite dynamic and understandable. He analyses the implication of the Neoclassical Economic premise that almost everyone in the economy is rational, rather than the reality that individuals are often irrational and emotional. To illustrate the differences, the author always makes a comparison between a person at risk of failure and irrationality and a fictitious person who makes decisions solely and exclusively rationally, called by him Homo Economic us, or Econ. The didactic examples are, in the majority, realized from the comparison between the actions of an irrational and those of a rational individual, in similar situations.

Misbehaving is structured across 8 chapters, which bring readers historically throughout Thaler's educational life, beginning as a graduate student at the University of Rochester with a deep interest in how humans act in the real life. Readers are exposed to Thaler's reflections about how he and well-known economists in the area, such as Daniel Kahneman and Amos Tversky, founded Behavioral Economics along the journey. Thaler has set for himself the mission of filling the gap between theoretical concepts and reality. His ideas spread widely in 2008 with the publication, of Nudge, a book he co-authored with Harvard attorney Cass Sunstein that quickly became a political phenomenon used as a kind of guide to manipulating people to behave in a certain way.

Beginnings 1970–78: In his book "Misbehaving," Richard Thaler claims that economists replaced homo, sapiens with a fictitious species named "Homo Economic us." Thaler will shorten "Homo Economic us" to "Econ." Economists always make the best reasonable judgments when all relevant facts and options are considered. Thaler believes that Econs do not accurately represent human beings, since our self-interests can drive irrational decisions. Irrational decisions occur because people are always discovering something new, and this influences their judgments, leading to errors and predictions that impact decision-making. Thaler referred to economic models designed by Neo-classical economists, as “optimization theories”. Although economics is perceived as the most sophisticated of the social sciences.

Due to its mathematical and logical foundations, however, Econs do not reflect real-life practices; chances are that optimization theories ought to make bad predictions. A clear example is the failure of economists to predict the financial crisis in 2007-2008. The poor prediction of the financial crisis by the economic theories is driven by its assumptions that financial bubbles are impossible to occur. Too often, economists reject this criticism and errors by referring to them as Supposedly Irrelevant Factors (SIFs). Examples are The Endowment Effect and The Sunk Cost. Experiments and studies have proven that individuals give huge value to what they feel attached to (or their “Endowment”) more than what could be part of their endowment. Nevertheless, sunk costs are costs that have already been paid.

For a certain project or activity that cannot be recovered. Economists' emphasis that decisions should not be influenced by sunk costs. However, Thaler emphasizes that individuals repetitively reflect on what they spent, by simply using the rules of thumb known as "heuristics" to make decisions. Expecting people on daily basis to occupy complex analysis in situations (even in business-related issues) is an unrealistic vision for humans who are obviously "irrational". Thaler states that we might not throw the optimization theories away, but we must eliminate their logic in our predictions. Optimization theories can be a good starting point for more realistic theories. Optimization Theories may work if problems are basic or the people in charge have full attention when approaching the problem (these circumstances remain exceptions). Eventually, economic models consistently remain behind when personal decisions are involved.

Loss Aversion (Prospect Theory): To consider these "SIFs", Thaler introduces "Prospect Theory" by both Kahneman and Tversky. Prospect theory is based on the following points:

Diminishing Sensitivity: The frequency of receiving something can make its impact fall down.

Part II: Mental Accounting 1979–85: Thaler investigated in Part II how individuals think about income. He initially called it "Psychological Accounting," but after consulting with Kahneman and Tversky, he renamed it "Mental Accounting."

Opportunity Cost: For Econ, decisions are being taken by examining all possibilities. However, Thaler argues that it is not realistic to compute infinite alternatives by human beings. Usually, humans select a couple of options to choose from. People who are occupying the Econ will need to meet their ends and spend extra time questioning opportunity costs and money allocation.

Transaction Utility: People take into account not just the quantity and utility maximization, but also the entire quality of the transaction. When you spend three times the usual cost on food during a football game, the meal has a negative trade utility (i.e., a thief). Similarly, individuals are willing to pay different prices depending on where they buy an item. People are fine with paying higher rates in a luxury hotel, for instance, since individuals realize the costs have increased there, the ambiance may be better, and they may even be pleased with the expenditure. Transaction utility describes why individuals rarely acquire anything that would provide them with happy times for the rest of their lives. Perhaps people, unconsciously, believe it is not a great price and would not want to carry the burden of being overcharged. However, on the other hand, we frequently purchase items that we will never use since they appear to be a fair deal. That is why stores constantly adjust sale prices to give consumers the impression that they will be getting the best deal. Econs, on the other hand, will never enjoy transaction utility.

Sunk Costs: Individuals wear something that they no longer enjoy, but they ordered them and feel robbed if they do not utilize them. This is an illustration of sunk cost. Humans incur sunk costs as a result of mental accounting. When you purchase something else and utilize it, your mental accounting becomes neutral. However, if you end up spending money on it and then do not use or appreciate it, it seems like you wasted your money. If, on the other hand, you need what you paid for, it seems like you got a great price, and people prefer that. Certainly, the more we spend on anything, the more we strive to keep it underutilized and avoid throwing it out. Obviously, classical economists could never consider sunk costs.

Delayed Consumption & Mental Accounting: Whenever people purchase anything to consume afterward, their mental accounting is thrown off. Thaler states that ordering pricy wine that we might use later sounds like such an asset to several individuals instead of expenditure. But then when people use it subsequently, it appears as if they did not spend a penny on it. "Invest now, drink later, and spend never." Holiday timeshare businesses use the same mental inconsistencies to make consumers believe they will invest in potential vacations.

The House Money Effect: The house money effect flips most people's risk aversion on its head. People who have won millions or received money unexpectedly are referred to as having the "house money effect." In such a circumstance, proper mental accounting is thrown out of balance, and individuals pause for a moment to sling cash around again, taking additional risks and gambling that they would never undertake with their own money. As a result, when non-professional gambler begins to gain, they get considerably greedier and take rather more risks using the new "house money". Individuals who have earned money in the stock market engage extra aggressively, believing that they will not lose their own money.

Break-Even Effect: Additional SIF, not only for Econo-based models but also for broader psychologically focused prospect models, are the actions that people display while they lose but still have the ability to break even. In that case, people are willing to take on greater risks in exchange for the chance of recovering earlier losses. Whenever people lose yet have the opportunity to break even, this is referred to as the Break-Even Effect. People are prepared to take more risks to recover from their loss, even if the risk may not be a wise decision.

Part III: Self-Control 1975-88: Economic models implicitly assumed that self-control difficulty did not exist. That would be yet another inconsistency between economic theory and actual practices in life. In this chapter, Richard Thaler criticized economists and their more sophisticated conceptual frameworks, indicating that people have become more logical and intelligent as well. Economic theories lack self-control; they essentially presume individuals are completely rational and optimized for the long term. The recent trend in the economy is to employ complex mathematical models that do not take human psychology into consideration. Humans would eliminate enticing signs to deter poor behavior, and this cannot be understood by traditional theories of the economy. Thaler emphasizes self-control and notes that numerous SIFs have been formed. Humans appear to be unable to restrain themselves, in contrast to the previous economy, which assumes that people are logical creations. That was because, as Adam Smith observed, humans are tormented by a conflict between desire and logic, feeling and reason. With the current theoretical perspective being unable to explain human issues with self-control, Thaler aimed to create a theoretical approach to manage such difficulties.

The approaches he and his colleagues build are centered on the “planner-doer” concept. An individual is made up of two "selves". The first one is a forward-thinking "planner" who seeks to glamorize and plan for the long term, while the second is a destructive "doer" that exists in the present time. Consider an institution in light of this well-established paradigm. On a more theoretical level, Thaler believes that relationships with companies resemble a principal-agent problem, which parallels the "planner-doer" on an interpersonal basis. In a principle–agent structure, the principal is the manager (often the shareholders and executives of businesses), while the agent is someone to whom power is given. Stress arises between the principal and the agent since the agent knows information that the principal does not have a clue about, and it is impracticable for the principal to supervise each and every decision of the agent. As a consequence of the principal-agent conflicts, the company implements a system of rules, protocols, and standards meant to eliminate potential conflicts. According to Thaler, all of these results and ideas show that using willpower involves work. People can recognize that they also have self-control issues but drastically underestimate their significance.

Part IV: Working With Danny 1984-85: Daniel Kahneman, author of Thinking Fast and Slow is often referred to as "Danny." Thaler offers further examples and evidence that individuals are not logical decision-makers in this section.

Fairness Perception: What makes a business deal appear "fair"? First, the endowment effect is connected to perceptions of justice. Both buyers and sellers believe they are entitled to particular trading terms and regard any degradation as an "unfair" loss. Persuading individuals to abandon their "status quo" is a difficult undertaking, even with "rationalizing" elements like economics and knowledge. Furthermore, the perceived fairness of an activity is determined not just by who it benefits or damages, but also by how it is presented. Consider the terms "sales" or "discounts." Because they differ from the "actual" asking price, these "good deals" might be viewed as good and highly fair. However, after identifying certain justice relationships, the next issue to address is whether people are ready to punish businesses that behave unjustly. Various experimental findings indicate that consumers detest unfair offerings and are prepared to suffer an economic loss to chastise those who provide them.

Part V: Engaging the Economic Profession 1986-1994: Thaler stated that data was growing drastically for economists to pay close attention to the classical economic theory gap. In Part V, Thaler addresses the equity premium, which is the premium that a riskier asset class, such as stocks, would pay over a less risky asset class, such as bonds. Furthermore, the equity premium cannot significantly be fulfilled by economic theories' assumptions of rational individuals. Therefore, it is ambiguous whether people feel ethically obligated to make fair offers themselves. Ultimately, economists must adopt a more nuanced insight into the nature of humans-one that is not just controlled by reason. To account for such a large disparity, investors ought to be aggressively risk-averse.

Myopic Loss Aversion: Myopic loss aversion is the perception that refusing to gamble frequently may be compensated for by playing a game many times. That, according to Thaler, does not sound right. If your odds are excellent, you must be open to playing at least once. In Part V, Thaler reflects on the early history of behavioral economics. It was now time in 1985 for behavioral economists to challenge and argue against neo-classical economic believers. The argument started with classical economics arguing that rationality is required. The final topic covered was companies and dividend payments. Why would businesses punish stockholders by giving dividend payments? According to neoclassical economics, companies must not pay a dividend, although they do. A behavioral approach also adequately captures the way through which they compensate.

Finally, Thaler investigates the concept of "narrow framing." Narrow framing is related to a mental accounting topic: when are particular events, transactions, and activities considered linked and when are they considered apart? Studies and findings reveal that in businesses, events and activities are very often viewed and portrayed as independent units. Major developments and activities are frequently offered as independent projects. The emergence of several diverse initiatives subtly encourages CEOs to become risk-averse and narrow their alternatives. Both are known as "dumb principal" issues, and they are related to the principal-agent concept. The answer might be to urge managers to treat various projects as a portfolio and to create investment sets to persuade them to view interlinked, if this strategy is not adopted, the company will become overly risk-averse.

Part VI: Finance 1983-2003: According to Richard Thaler, the area where the "homo economics" is most widely employed and most established is the stock industry. Along with all the financial institutions, the capital institutions' effectiveness is at stake. As a result, if psychology and behavioral economics could demonstrate that stock markets are likewise irrational, the findings might no longer be disregarded. "If you can make it in New York (financial markets), you can make it elsewhere," Thaler sarcastically says of Frank Sinatra.

The Efficient Market Hypothesis: Two assumptions underpin the efficient market hypothesis:
- No such thing as free lunch.
- You cannot outperform the market.

Thaler argues once more that the rational theory structure should not be entirely dismissed and that it provides a good reference point. However, when it comes to describing why events actually operate, the theory is indeed not reasonable.

Financial Markets are Irrational: Stock investment, as advocated by the author of "The Intelligent Investor," Benjamin Graham, can operate and may yield better profits. However, no approach should produce greater outcomes than another if economies were truly rational, proving once again that stock markets are inefficient and irrational.

Part VII: Welcome to Chicago 1995-PRESENT: When Thaler attended the University of Chicago to lecture, he aimed to investigate how well the multidisciplinary areas of law and economics may be altered in the context of modern behavioral economics findings. In general, Thaler advocates a form of "libertarian paternalism" to address classic economic and legal policy considerations. Ultimately, adopting libertarian paternalism would require the development of mechanisms in businesses and government entities that would encourage individuals to think strategically while enabling them to make errors. Several people were opposed to this proposal.

Nevertheless, Thaler contends that all these criticisms overlook the complexities and variations between libertarianism and paternalism, among many other types of it. Furthermore, Thaler lists a number of examples of behavioral economics in real-life practices, such as a mess at the University of Chicago involving professor office allocations, players' choices in the National Football League, and guest selection in a TV game show. These cases give massive support for behavioral theories despite undermining orthodox economics' arguments. SIFs obviously have the potential to become a criterion for individuals to make their judgments, making SIFs more important than classical economic notions in some scenarios.

Part VIII: Helping Out 2004-Present: By the mid-2000s, behavioral findings had gained scientific acceptance, and Thaler began to apply behavioral concepts to practical problems. Thaler's major focus has been on developing strategies to assist individuals in saving for retirement, given that orthodox economic principles and the approach to retirement accounts have significant flaws. Thaler has been criticized for blatant paternalism and compulsion after pushing for libertarian paternalist alternatives. Thaler responds with an essential response to this claim. To begin with, keep in mind that libertarian paternalism provides a complex response. On the one hand, considering the complexity present in almost every choice made in life, individuals can sometimes be allowed to make even similar to optimum conclusions. Yet even though people make mistakes, everyone appreciates the ability to choose.

Thus, libertarian paternalism promotes primarily giving individuals a "nudge" in the correct direction. Such nudges never cure all issues; they merely incentivize humans to come up with solutions in the appropriate way by implementing specific structures and norms. In short, the potential of behavioral economics seems promising. Thaler has formed the Behavioral Insights Team with Rohan Silva of the United Kingdom Conservative Party (BIT). The BIT strives to improve the effectiveness and efficiency of the British government as well as to suggest new policy theories. To this point, the findings acquired from studying the BIT have proven beneficial to the study of behavioral economics overall. Thaler, on the other hand, emphasizes that governments and companies may exploit behavioral sciences for self-serving and malicious agendas. It is critical that behavioral studies be used cautiously within businesses in the future.

Critical Evaluation

The Key Concepts and Structure: This book is a biography of the behavioral economist Richard Thaler. Non-economists may find the content scholarly or overburdened with eco jargon. This book is about how people and organizations make decisions, not in an abstract world of pure rationality, as many economists assumed years ago, but in a real-world where people have emotions, make mistakes, and procrastinate. I like that the book gives numerous insights, which are presented with a good mix of anecdotes and data. Thaler acknowledges that reading scientific research articles is a chore, and his contempt for the complicated content may have motivated him to publish a book in a straightforward manner. The parts on the endowment effect, mental accounting, and the exploration of bubbles and stock market behavior were some of the best parts of this book. The book is fun to read and teaches us a thing or two in simple straightforward English.

For someone who knows nothing about the Economy, I learned key concepts that I can relate to or better understand people around me. Nevertheless, it is great to learn the back stories behind the important growth stages of the field of Behavioral economics. Surprisingly, it took a long time before someone came out and said that not all humans are perfectly rational and capable of making the right economic and financial decisions 100% of the time. One of those who thought this was Richard Thaler, and it led him to be a part of developing the discipline of behavioral economics. The weak side of this book is that the presentation of the examples could have been sharper. To put it into perspective, I wish that Thaler first presents and explains the concepts at the beginning of every chapter and then dives deeper to elaborate on them using various examples. But in Misbehaving, Thaler begins with stories and examples with the concepts intertwined within them. This led me to get engrossed in the stories and forget the concept being discussed at first.

The Author and the Field: This book is much more about Thaler's professional life and the name-dropping of famous people with whom he has worked. I have about as much respect for the field of "Behavioral Economics" as I do for Psychology in general, both are pseudoscience that does not result in effective/useful models of real-world problems and offer misleading solutions that are grossly inadequate. I do not see any incredible leaps in economic policy resulting from behavioral economics, just as I do not see significant improvement in mental health resulting from psychiatry. When I first heard the term "nudge" – which many believe to be the peak of behavioral economics. I thought it was an intriguing idea, but that these types of nudges are nowhere nearly as prone to changing the world as its passionate proponents claimed. I believe that the field has a propensity to exaggerate and make generalizations based on limited research conducted in quite varied contexts, frequently in educational circles. It's remarkable that Thaler was reporting on what appears to be his perspective as though it were evidence.

We won't realize how important nudging is in governmental decisions till it becomes involved in major economic concerns (e.g., Inflation, taxes). It's no surprise that nudge units throughout the world are crucial to governments' propensity to prioritize nudges above other effective policy options. But small nudges are never enough; they aren't going to eliminate taxes or bring an end to catastrophic risk tolerance. The best empirical studies in the field using Nudge theory leave room for questions such as: why we are still here suffering from a modern financial system and hoping to be perfectly acclimated one day? For a topic that is so influenced by emotions VS facts, this is a problem. Everyone does insane things with money since we are all new to the money game, and what appears insane to one may sound right to another. Nevertheless, nobody is insane; humans prefer to rely on experiences that tend to be reasonable at present. There are very few individuals who would make their financial arrangements on a spreadsheet; most people make up their mind at the dinner table or in a setting with personal background, your unique vision of the world, ambition, and ego all combined to form a storyline that fits for you.

Luck and Risk are both manifestations of the fact that every decision in life is influenced by factors other than the personal effort to act rationally. They are so identical that you cannot believe in one without also engaging the other. These can occur since the universe is too complicated to enable 100% of your choices to determine 100% of your consequences. They are both pushed by the very same dynamics. I believe we cannot be either rational (as the Eco-classical Economist) believe because that would make us like machines, but we are also not irrational (as the Behavioral Economist) believe since we hold reasons for our decisions that are embedded and cannot be explained since the economy has a random pattern. I believe that people, in general, build different levels of risk (averse or tolerance) based on the following reasons:

- People that grew up poor and people that grew up in affluent families do not have the same perspective on decisions related to money (risk).
- People that were born during a period of high inflation & taxes will not make the same economic decisions as people that were born during a period of stable pricing.
- Our lives have been molded by diverse backgrounds, but yet in extremely convincing situations.

This living experience that Thaler called irrationality is like the gyroscope of our own life because we can simply see that we would not understand the experience that Thaler called involuntary action and irrational decisions being in control and being ourselves unless, in opposition to that, there was something else we could not realize and control and instead of will, we won't. When people are living unwanted things, it is hard to believe that they have been given free will and that their choices are being honored because it is hard to believe that someone would choose something horrific or horrendous. People justify that by denying that they are not making those choices. Thus, it feels like it is something that is being done to them; because not one of us who would acknowledge that "I would do these unspeakable things to myself" thus it makes us believe that there must be some other factors involved, some source of darkness or badness.

We come up with all kinds of reasons in our explanation of the unwanted things (e.g., irrationality). For instance, a universal rule as, when you squeeze something that comes out of it, is what inside it. (e.g., when you squeeze an orange, what will come out of it? AN ORANGE JUICE) Not too difficult, does it matter if you squeeze an orange in the financial crisis or in making decisions related to the stock market? The same principle will work here. Once the economic forces squeeze us into making decisions, what comes out of us is what is already inside us, it might be anger, greed, happiness, disappointment, but it is never irrational decisions. Few implications of Behavioral Economics study results are discussed in this review, which can leap the focus on extreme volatility in economic trends and the appropriate level of government expenditure.

While Behavioral Economics may give greater justification for gambling restrictions, an absolute banning is not always the best option.

References

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