**<u>Misbehaving</u> by R. Thaler**

A review by

Andrew J. Oswald, Professor of Economics, University of Warwick, UK.

The temperature is rising; it is your final semester; your major courses are done. To complete your undergraduate degree, you still have to take one damn course in psychology and one damn course in economics. Then, disaster! Having got to the first day of semester, you discover that there is a perfect clash in your timetabling, so that it is necessary to leave halfway through every economics lecture to go to the psychology classroom for the remaining half an hour – and, having alternated in this bewildering way through the entire semester, you have to take a single exam in what you know. Your answer book turns out to be arresting, intellectual, open-minded about different kinds of methods, human, full of ideas, sometimes muddled and inconsistent, thought-provoking, broader than it is deep, wide-ranging, and in some ways, though not every way, better and more interesting than either straight psychology or straight economics. Welcome to behavioral economics.

Although optimistic, Richard Thaler believes that most of economics is in a mess. First, it treats people as though they are cold-blooded optimizers like Mr Spock in Star Trek. It neglects especially the horrible errors of passion. Second, it cannot predict important events like the financial crash of the 2000s. Third, it should spend more time on inductive research, as Darwin (though he is not mentioned) did on molluscs.

To give you a flavor of the field, and of this author, "the single most powerful tool in the behavioral economist's arsenal is..." [p.34] "the idea of loss aversion". If something is taken away from you then that hurts far, far, far more than the pleasure of getting it. By contrast, Thaler argues, standard economics thinks of people as reacting smoothly, and fairly symmetrically, up and down. Thaler also believes that economics is described by *Economics = Optimization + Equilibrium*, which, although not a meaningful equation, does actually convey the spirit of conventional economics. He is right that such an equation is hard to square with house-price booms and stock market crashes. In the words of Colin Camerer of Cal Tech, who in 1999 wrote a pithy and still-valuable introduction to the field in the Proceedings of the National Academy of Sciences in the USA, the subject of behavioral economics seeks to reunify psychology and economics. To the typical economist, according to Camerer, a theory is a body of mathematical tools and theorems, whereas to a psychologist a theory is a verbal construct that organizes experimental regularity. I know many psychologists who use mathematical models, so I do not agree with the details of this characterization, but there is something to it. I am Thaler's age and in my PhD in economics at Oxford it is true that I was taught a great deal about fixed-point theorems and nothing whatsoever about experiments or the scientific method.

This book is an effervescent polemic. Given the writing style, it is not surprising to learn that Thaler's first published article (in 1980) was repeatedly turned down by famous journals and became hugely cited in a then new and little-known journal. If you buy this book, turn initially to the last page. Thaler explains that he thinks most economists stubbornly "cling to an imaginary world", and that one day it will not be necessary to have a field called behavioral economics because all of economics will fall under that heading. He is largely right.

If I were asked for criticisms, I might point gently to the fact that George Katona, a real founding father of behavioral economics, who worked three decades before Richard Thaler, is not mentioned; none of his 100 writings is referenced [some are given below]; so the subtitle of the book is not as accurate as some will wish. Moreover, as behavioral economics is meant to be the marriage of psychology and economics, one might wonder what psychologists will make of the fact that in the book's bibliography the ratio of economics-journal references to psychology-journal references is something like 20 to 1. Apart from one brief nod to Dutch television, the book is also American-centred, in a way that will worry readers from the other 95% of the world's population. Perhaps, finally, the book might have been even better if it had explained, Spock-like admittedly, that battles between orthodox scholars with a theoretical framework that does not fit the facts and look-this-is-how-we-should-do-it youngish turks is normal in science. Viewed from a distance, nothing unusual is going on in modern economics. It is bending to the data. The tetchiness, and the howls one hears, and the misbehavior of those whose ideas are out of date, are just as has been happening for centuries in other disciplines. Scientific progress hurts.

Thaler talks sense and is to be admired. This is a valuable book.

<u>References</u>

G. Katona, Contribution of psychological data to economic analysis. *Journal of the American Statistical Association*, 42, 449-459 (1947).

G. Katona, Rational behavior and economic behavior. *Psychological Review*, 60, 307-318 (1953).

K-E.Warneryd. The life and work of George Katona. *Journal of Economic Psychology*, 2, 1-31 (1982).