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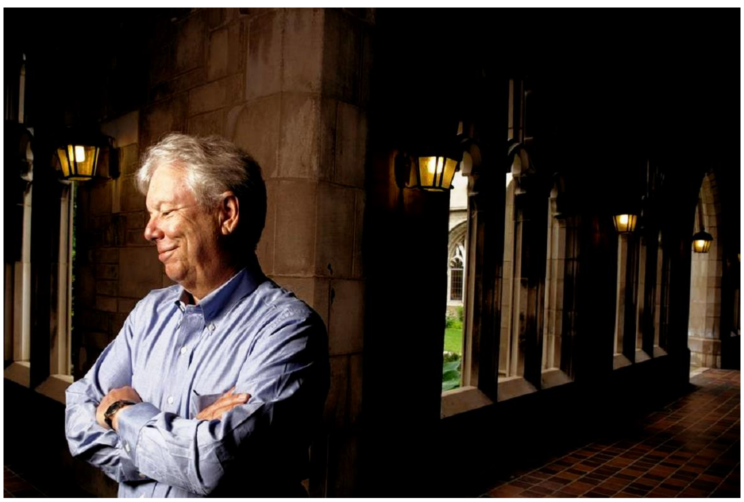
ARTS | BOOKS | BOOKSHELF

How Homo Economicus Went Extinct

Consumers and investors don't act rationally, but for generations economists have pretended they do.



Richard Thaler in 2014. *PHOTO: © ANDY GOODWIN/FORBES COLLECTION/CORBIS OUTLINE*

By CAROL TAVRIS

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As a social psychologist, I have long been amused by economists and their curiously delusional notion of the "rational man." Rational? Where do these folks live? Even 50 years ago, experimental studies were demonstrating that people stay with clearly wrong decisions rather than change them, throw good money after bad, justify failed predictions rather than admit they were wrong, and resist, distort or actively reject information that disputes their beliefs. In recent years, a new field has emerged—"behavioral economics"—to propose an alternative to the rational man of traditional economics. A spate of popular books and empirical studies have been published exploring human irrationality—in decision making, beliefs and actions. Researchers in this field are making up for lost time, or perhaps realizing that they are social psychologists after all.

As the offspring of traditional economics and experimental social psychology, behavioral economics shows remarkable hybrid vigor, and Richard Thaler, one of the new field's founders, acknowledges its debt to psychological science throughout his highly enjoyable intellectual autobiography, "Misbehaving." Indeed, his opening aphorism is Vilfredo Pareto's 1906 claim that "the foundation of political economy and, in general, of every social science, is evidently psychology. A day may come when we shall be able to deduce the laws of social science from the principles of psychology." That day is here, as Mr. Thaler explains.

MISBEHAVI

By Richard H. Thaler
Norton, 415 pages, $27.95

For all of his creative career spanning 40 years, Mr. Thaler, who is a professor of behavioral science and economics at the University of Chicago Graduate School of Business, has been studying "the myriad ways in which people depart from the fictional creatures that populate economic models." As human beings who arrogantly and often wrongly consider ourselves "sapiens," we simply don't match the model of human behavior favored by economists, one that "replaces homo sapiens" (whom Mr. Thaler calls Humans) with "a fictional creature called homo economicus" (whom he calls Econ). "Econs do not have passions; they are cold-blooded optimizers," he says. "Compared to this fictional world of Econs, Humans do a lot of misbehaving"—thus the book's title.

The problem, Mr. Thaler argues, is that although economists “hold a virtual monopoly” on giving policy advice, the very premises on which that advice rests are deeply flawed. That is why “economic models make a lot of bad predictions”: some small and trivial, some monumental and devastating. “It is time to stop making excuses,” he admonishes his colleagues. Mr. Thaler calls for an “enriched approach to doing economic research, one that acknowledges the existence and relevance of Humans.” By injecting economics with “good psychology and other social sciences” and by including real people in economic theory, economists will improve predictions of human behavior, make better financial and marketing decisions, and create a field that is “more interesting and more fun than regular economics.” In that way, Mr. Thaler believes, economists will finally produce an “un-dismal science.”

That enriched (and fun) approach is on display in “Misbehaving.” Mr. Thaler’s goal in this conversational, informative book is to “tell the tale of how it all happened, and to explain some of the things we learned along the way.” He tells us that he began having “deviant thoughts” about economic theory as a graduate student in the 1970s—an unsettling experience for a not-yet-professor, comparable to having deviant thoughts about Freudian theory when it dominated clinical psychology.

The book’s organization is both chronological, describing Mr. Thaler’s discoveries over time and productive collaborations with scholars from other fields, and topical, devoting long sections to findings from four areas of particular interest to him. These are “mental accounting” (with chapters on bargains and sales, sunk costs, budgets and gambling), self-control (the difference between people who plan and people who impulsively act), finance (including the irrationality of people’s behavior in the stock market), and fairness games (why people often prefer fairness to self-interest). In a two-person game in which one person must allocate, say, $50, most recipients would prefer to walk away with nothing than accept an offer they consider “unfair” (such as $5).

Dense with fascinating examples, each of Mr. Thaler’s topical areas tells, in a way, the same story: Traditional economics predicted X; evidence failed to confirm X and indeed often contradicted X; establishment explained away the evidence as an anomaly or miscalculation. For example, by the 1980s, investment guru Benjamin Graham’s classic, decades-old work on “value investing”—“in which the goal is to find securities that are priced below their intrinsic, long-run value”—had become passé. Mr. Thaler explains that Graham’s evidence of the benefits of buying cheap stocks rather than expensive, fashionable “darlings” had become inconsistent with the Efficient Market Hypothesis, which said that value investing simply could not work—not that anyone had bothered to refute Graham’s claim empirically.

Therefore, when the accounting professor Sanjoy Basu published a “thoroughly competent study of value investing that fully supported Graham’s strategy,” in the late 1970s, Mr. Thaler writes, he “had to offer abject apologies for the results” in order to get it accepted for publication; indeed, Mr. Basu “stopped just short of saying ‘I am sorry.’ ” When another economist found that the assumption of market efficiency was not supported by his data, he concluded that there must have been a “pricing model mis-specification.” When Mr. Thaler and Werner De Bondt, his psychology-and-economics graduate student, did their own research, using psychological principles to predict market anomalies that occur because of what they called the market’s “generalized overreaction,” the researched showed why the Efficient Market Hypothesis was wrong. Their paper, ultimately published in 1985, got in through the back door thanks to their having an ally on a major journal—without an apologetic conclusion. “Werner was too principled” to write one, says Mr. Thaler, “and I was too stubborn.”

Time after time Mr. Thaler cheerfully reports how many of his most famous papers in behavioral economics, often written with scholars across enemy lines (that is, noneconomists), were “pure heresy” that “got people’s blood boiling.” One article directly attacked the “core principle underlying the Chicago School’s libertarian beliefs,” namely consumer sovereignty: “the notion that people make good choices, and certainly better choices than anyone else could make for them.” By empirically demonstrating that consumers often do precisely the opposite, because rationality and self-control are bounded by human perceptual distortions, their paper undercut this principle. This was “treacherous, inflammatory territory,” he writes. In 1998, Christine Jolls, then an assistant law professor at Harvard, Cass Sunstein, a law professor at the University of Chicago, and Mr. Thaler published their groundbreaking paper, “A Behavioral Approach to Law and Economics,” which infuriated members of both professions in one blow.

Mr. Sunstein and Mr. Thaler then collaborated on another scandalous claim, that human beings are susceptible to cues in the environment that affect their behavior—a fact that governments and businesses can use to promote healthy behavior and wiser choices. Needless to say, many economists and others were outraged by the implication that the authors were promoting “paternalism” and intervention by government bureaucrats. Not at all, says Mr. Thaler. They were simply noting that “the knee-jerk claim that it is impossible to help anyone make a better decision is clearly undercut by the research.” No matter how often they added that bureaucrats are Humans, with their own biases, their critics wouldn’t listen, even when Mr. Sunstein kept repeating that they were not pro-paternalism but rather “anti-anti-paternalism.” Mr. Thaler preferred the term “libertarian paternalism,” but that didn’t catch on either. Eventually they found the right word to capture the gist of their argument, using it for the title of their book “Nudge.”

Accordingly, the final chapters of "Misbehaving" take on the key issue of nudging: "Could we use behavioral economics to make the world a better place? And could we do so without confirming the deeply held suspicions of our biggest critics: that we were closet socialists, if not communists, who wanted to replace markets with bureaucrats?" Yes, he argues, and yes. Because people make predictable errors, we can create policies and rules that lower the error rate, whether it has to do with reducing driving accidents, getting men who use public urinals to aim better or enticing people to save for retirement—and do it in a way that makes people themselves happier with the results.

Reading this book made me think of (one version of) the classic story of Jascha Heifetz's American debut at Carnegie Hall in 1917, when he was 16 years old. At intermission, the violinist Mischa Elman turned to his friend, the pianist Leopold Godowsky, wiped his brow and said, "It's awfully hot in here!" Godowsky replied, "Not for pianists." Mr. Thaler's research doesn't raise my temperature, but that's because I am not a traditional economist. Pianists will enjoy this book, but violinists need it.

It is long past time to replace Econs with Humans, both in theory and in the practice of prediction. Mr. Thaler believes that, soon enough, all economists will be "behavioral," and his field will vanish. But the Econ-oriented theorists who have been major players in (mis)predicting the stock market and consumer behavior will—I predict—continue to resist its message. Psychologists, and Mr. Thaler, know why.

—Ms. Tavris is co-author, with Elliot Aronson, of "Mistakes Were Made (But Not by Me)," forthcoming in a revised edition in the fall of 2015.