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Traditional Economics to Behavioural Economics: Towards a new Paradigm Shift?

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Abstract

Homo economicus, or Economic human, is the concept in some economic theories of humans as rational and self-interested actors who have the ability to make judgments toward their self-interest. The prediction of behavioural economics happened when the economics started to embrace the influences from the parallel social sciences like psychology, sociology and cognitive science often prevent people from making rational decisions, despite their best efforts. Behavioural economics is therefore a branch of economics that challenges traditional economic assumptions look at the social, emotional and psychological factors that influence the decision making, hence it does not give emphasise to the rule of optimum utility and people always have psychological bias that individuals make decisions based on 'unbounded rationality' accurately processing all the information at their disposal. Once behavioural economics was a challenges to the traditional theories, but now it has matured into a growing field that tries to understand how psychology affects economic decisions.

Keywords- Behavioural Economics, Rational, Satisfaction, Cognitive, Utility, Homo economicus

Introduction

Homo economics an outdated idea?

The tension between traditional and behavioural economics is centralised on the fundamental issue of human behaviour. Economists have long built their disciplines around a view of humans as rational actors who well known to maximise their own happiness - homo economicus. The term homo economicus or 'economic man' denotes a view of humans in the social sciences particularly in economics where economic agents who seek optimal and utility maximising outcomes. The key assumptions under traditional economic theory are that economic agents are utility maximises and rational in their actions. Economic agents always compare the cost and benefits of alternative choices which gives them maximum satisfaction (Journalist, 2012). At the same time traditional theory assumes that everyone seems to have perfect knowledge and they have the ability to use the information to make a rational decision (Sinha, 13, August 2019)

Behavioural economists formulate precise reservations to the *homo oeconomicus* and question the legitimacy of the traditional model in economic analyses. Behavioural economics always look at the social, emotional and psychological factors that influence the decision making, hence it does not give emphasise to the rule of optimum utility and people always have psychological bias that individuals make decisions based on ‘unbounded rationality’ accurately processing all the information at their disposal. The use ‘unbounded willpower’ to transform wants into actions and have absolute self-control when challenged with choices. And they are backed by ‘unbound selfishness’ to achieve maximum benefit for themselves. The simplified assumptions of full rationality were useful in the development but failed to reflect the behaviour of real people. Similarly, the simplified homo oeconomicus assumption was also powerful and served its functions which was widely applied in economic models but is becoming outdated day by day. These assumptions are being replaced with the model of a real man, which incorporates the features absent from the *homo oeconomicus* model. (Samson, 2019). The model of behavioural perception affirm that decisions are not driven by the desire to maximize or optimize choices but by attempts to neutralize between strict constructs and flexible options where choices are made selectively within a framework defined by the existing constraints. Once behavioural economics was a challenges to the traditional theories, but now it has matured into a growing field that tries to understand how psychology affects economic decisions. (Ariely, 2009)

Old Behavioural Economics: A tragedy of missed opportunity

Old Behavioural Economics Herbert Simon (1916–2001), was one of the earliest critics of rational choice in economics. Simon suggested a more programmatic critique, as part of the broader contribution he made to the so-called cognitive revolution: a paradigm shift in the post-war psychology from behaviourism to the computational modelling of internal cognitive processes. A fundamental idea is that we need only concrete rationality to anticipate the behaviour of the system if both its goal and environment are simple; but since these factors and their interaction are in fact complicated, Simon argued, we have to explicitly consider the procedural rationality of the system (Roger frantz, 2014). From this bounded rationality perspective, economic models of choice are deficient because they assume substantive rationality when in fact these conditions are not satisfied, requiring the explicit modelling of the inside workings of the agent, be it a human being or a firm. Simon’s impact on mainstream economics, however, was limited. Although he received the Nobel Memorial Prize in Economics in 1978 for his pioneering research into the decision-making process within economic organizations and his proposal that individual procedural rationality should be explicitly modelled and contemporary economists of alternative methods and theories that drew on psychology and other social sciences was not accepted by mainstream economics, Neither were his. (Nagatsu, 2015)

History and Principles of New Behavioural Economics

Behavioural economics originated a time when microeconomics was closely complimentary to psychology. Adam Smith was the first Economist to recognise in the eighteenth century that human economic decision-making is imperfect and is affected by values of fairness and justice. Also, Jeremy Bentham recommended psychological foundations for the concept of utility. Bentham equals utility with pleasure and disutility with dissatisfaction or pain. He clearly states that utility refers to the property of an object to produce –prosperity, gain, advantage, pleasure, good or happiness or to prevent disadvantage, mischief, pain, evil or unhappiness to the individual. Furthermore, even neo-classical economists managed with reasonable psychological explanations of economic behaviour. For example, Irving Fisher promoted the idea of inter-temporal choice in markets which is the decision between the present and future consume is determined not only by objective factors but also by personal factors (Diacon, 2014)

In1979, Kahneman and Tversky published a paper, which presented their "prospect theory" that individuals undergo cognitive biases that affect their economic decision-making. The success of Prospect Theory inspired a number of young economists to evaluate and challenge the standard models of rational choice. The advancement of behavioural economics between 2002 and 2017 Nobel Prizes reflects the materialisation of behavioural economics from a largely theoretical subject through to a subject that now has enormous relevance for public and commercial policy makers. The first breakthrough was the award of the 2002 Nobel Prize jointly to economic psychologist Daniel Kahneman, alongside Vernon L. Smith an experimental economist even though experimental economics is not behavioural economics, his insights and techniques indeed inspired other economists. The second turning point was the award of the 2017 Nobel to behavioural economist Richard Thaler, who has written colourfully about his contributions in his book 'Misbehaving'. Thaler is most famous for his work on behavioural finance and behavioural public policy commonly known as 'nudging'. Two foundations, the Sloan Foundation and Russell Sage Foundation, also played a key role in establishing behavioural economics as a thriving subfield of economics, through financially supporting the behavioural economics program including projects such as non-residential working groups, the visiting researchers program, and the Russell Sage Foundation Behavioural Economics Books Series and a former Harvard cognitive psychologist, who had a clear goal to apply cognitive science to economics, played a pivotal role as a director of the behavioural economics program at both foundations. (Nagatsu, 2015)

Choice of focus: Behavioural analysis of consumer choice

The Neoclassical economic analysis assumes that humans are rational and behave in a way to maximise their own self-interest. Even though the 'rational man' assumption yields a powerful tool for analysis yet, it has many shortfalls that can lead to unrealistic economic analysis and policy-making. Behavioural economics is therefore a branch of economics that challenges traditional economic assumptions and seek to broaden and improve traditional ideas with decision-making models borrowed from psychology and through its multidisciplinary approach. However, it abandons some traditional ideas, mainly the ones related to the foundation of the economic rationality in neoclassical design (Diacon, 2014). The key principles which highlight the main shortfalls in the neoclassical model of human behaviour

a. *Other people's behaviour matters*: Most of the behaviour is strongly influenced by other people's behaviour. The neo-classical theory assumes that we independently knows what we want and our preferences are fixed in which people carry out a full rational analysis of all their available options. But in reality this is not what we do, instead we just copy other people and perhaps adjust our strategy according to the feedback we receive.
b. *Habits are important*: When we do something out of habit, we use little or no cognitive effort because such daily routines quickly become ingrained habits, Even when we consciously think about what we do, it can be difficult to change our behaviour, In neoclassical economics the assumption is made that, given their particular preferences, people act rationally to maximise their utility -do a full analysis of all the available- neoclassical theory does not recognise the existence of habits, it does not acknowledge the effort we need to expend in overcoming them.
c. *People are motivated to "do the right thing"*: In cases where we are naturally motivated to 'do the right thing' we feel bad and have a guilty conscience when we fail. A standard neoclassical analysis would add up the financial costs and benefits, so financial rewards would always be expected to

encourage and financial fines would always be expected to discourage. A standard neoclassical analysis would add up the financial costs and benefits, so financial rewards would always be expected to encourage and financial fines would always be expected to discourage.

d. *People are loss-averse*: In neoclassical theory people are expected to have a preference on risk either risk-takers or risk avoiders but it is usually assumed that people are neutral to loss or gain- Kahneman and Tversky's Prospect Theory developed in 1979 shows that people are not impartial to whether a loss or a gain is involved: they put more effort into preventing a loss than winning a gain. They also show that people generally use a relative assessment of losses and gains (rather than considering their total wealth position) and that they value losses more than gains.

e. *People are bad at computation*: Standard neoclassical theory the assumption is made that people act rationally and logically. As well as having all the necessary information at their fingertips, they are fully capable of making the complex calculations to compute their optimum best choice from the many possible choices available to them- Psychologists have long established that people do not make decisions in the way assumed by neoclassical economics. In particular, David Kahneman – who went on to win the Nobel Prize in Economics – showed that people use 'rules of thumb' to make decisions, and these give rise to the internal biases. (economics, 2017)

Understanding the Misconceptions

In traditional economics, the main matter is an imaginary character which is called the 'economics man' or 'Homo economicus'. He is selfish and a rational maximise of his own utility. However, in traditional economics the divergence between actual humans and the economic man has not been considered an important factor in the advancement of the study of economics. But then in the 1970s, the psychologists Daniel Kahneman and Amos Tversky made a big discovery and from there exists a fallacy that human beings deviate from the ironclad rationality of Homo economicus in all sorts of ways. A big conception is that behavioural economics is about controlling people's behaviour, but it is not, it is all about understanding common people's behaviour that people make and why they make. In particular, a large aspect of behavioural economics is concerned with the gap between intention and action (Bogan, 2018). Another misconception is that behavioural economics is about rationality, this misconception stems from the fact that the traditional theory assumes that all people are rational, while behavioural assume that individuals are not always rational. If people are not rational it doesn't mean that they are irrational, it just means people make systematic errors due to psychological blind spots that most people have. If, on one hand, homo-economicus model is a powerful analysis tool, on the other hand, it has many shortcomings that can lead to unrealistic economic analysis and inconsistent policies. In these conditions, behavioural economics may help explain why people do not always behave selfishly, why they do not always act in the most economically or logical possible way, and why they assign a higher value to some objects than other objects that have the same real value. It therefore seeks to provide relevant answers to the non-selfish behaviours such as altruism, justice, tastes, ethical spirit etc., which have been quite enough ignored in traditional economics (Diacon, 2014)

Conclusion

In the world, all individuals are utility maximisers, which is actually a fancy statement that people always choose the alternative that gives them optimum satisfaction. Moreover people scale the benefits and cost and they are fully informed and aware about the different implications of choice. People are not backed by emotions or other personal feelings, hence they make rational choices which are optimal for them. Unfortunately so called 'rational people' doesn't exist. In reality people are always influenced by bounded rationality and they don't choose what is best for them rather tend to make decisions with a satisficing behaviour. Thus Behavioural economics is trying to change the way economists think about people's perceptions of preferences. According to Behavioural economics. Most of our choices are not the result of careful deliberation. We are influenced by readily available information in memory, automatically generated affect, and salient information in the environment. We also live in the moment, in that we tend to resist change, are poor predictors of future behaviour, subject to distorted memory, and affected by physiological and emotional states. Finally, we are social animals with social preferences, such as those expressed in trust, reciprocity and fairness.

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