

Book Review

Misbehaving: The Making of Behavioral Economics

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Misbehaving: The Making of Behavioral Economics
Richard H. Thaler
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INTRODUCTION

Richard Thaler is best known to a general public as a co-author of the best-selling book “Nudge: Improving Decisions about Health, Wealth, and Happiness” and his contribution to a creation of the Behavioral Insights Team aiming to improve public policy in the UK. Financial professionals see Thaler as a pioneer of psychological explanations for financial markets anomalies and as a co-author of “Save more tomorrow” program designed to encourage retirement savings. Academic literature considers him as one of the founding fathers of behavioral economics and finance (Sewell, 2007; Nagatsu, 2015 among others) while media eager to include Thaler in the list of contenders for Nobel prize in economics¹.

To his readers, Thaler is also known to have a rare quality for an economist of being a brilliant writer. Therefore, it should come as no surprise that I start this review with the quote:

Behavioral economics is now a growing branch of economics, and its practitioners can be found in most of the best universities around the world. ... I was around at the beginning and have been part of the movement that created this field. ... my main goals are tell the tale of how it all happened, and to explain some of the things we learned along the way. Not surprisingly, there have been numerous squabbles with traditionalists who defended the usual way of doing economics. Those squabbles were not always fun at the time but ... the necessity of fighting those battles has made the field stronger.

This quote serves as a fairly accurate description of what one should expect from the book, namely, there are several intersecting main themes heavily spiced with personal stories and humor. Misbehaving is at the same time a biographical sketch, a historical and methodological guide and an entry level textbook in both behavioral economic and behavioral finance. It is also a graduate

level textbook in the inner workings of science as well as a manual on high-level academic debates. The recurring theme of field development through debates and squabbles makes the book a definite must-read for graduate students and early-stage researchers. It teaches the benefits of patience and creativity, respect for opposing views and above all the crucial role of developing convincing and sound arguments.

Since *Misbehaving* tells a story rather than presents an argument this review will follow the book's structure. I will focus on major events and connect them to the seminal works which created the field.

THE BEGINNINGS: 1970-1985

In Thaler's own words, he began to have deviant thoughts about economics while he was a graduate student in the early 1970s. Despite his Ph.D. thesis (Thaler, 1975) was in-line with a standard way of doing economics, Thaler started to develop now famous "the list" documenting examples of deviation from a model of rational behavior. However, at that time he had little understanding of what to do next: "I knew it [endowment effect] was real, but I had no idea what to do with it." This confusion was about to change in 1976 when Baruch Fischhoff encouraged Thaler to take a look at the works of his advisors Daniel Kahneman and Amos Tversky. When Thaler managed to get a Tversky and Kahneman (1974) paper on heuristics and biases and an early draft of Kahneman and Tversky (1979) paper on Prospect Theory, he found a powerful framework with which to pursue this new research agenda. The future events proved themselves to be decisive. Thanks to Victor Fuchs, Thaler got an opportunity to spend 1977-78 academic year at Stanford along with both Kahneman and Tversky while they were finishing writing a paper on Prospect Theory. It was during that year when Thaler decided to go "all in" on his new and risky venture and moved to Cornell University which he thought will tolerate some "heresy".

The new endeavor started with two papers which were written during the year at Stanford. First was expanding on the psychology of spending, saving, and other household financial behavior (Thaler, 1980), what has now become known as mental accounting and was finalized in Thaler (1985). The second paper was taking the idea of unbounded self-control (Thaler and Shefrin, 1981) and was co-authored with another future star of behavioral finance Hershey Shefrin. This work had a major impact on studies of time-inconsistent intertemporal choices and hyperbolic discounting.

The success of the behavioral enterprise starts to become apparent after one more year of collaboration with Daniel Kahneman, this time during the 1984-85 academic year in Vancouver. In Thaler's words, along with 1977-78, it was a most productive year in his life. Apart from contribution to a Kahneman and Knetsch project on fairness (famous "dictator's game") Thaler played an important role in developing a decisive experimental evidence for the existence of the endowment effect (Kahneman, Knetsch and Thaler, 1991), which later became an important cornerstone in the development of behavioral law:

By the time I returned to Cornell from my year in Vancouver, I had been working full time on my risky behavioral economics endeavor for eight years. And either despite or because of this endeavor ... I had managed to get tenure at Cornell and had several papers in the pipeline to be published in top journals. ... The biggest problem was that ... Amos, Danny, and I were mostly talking to one another.

BATTLE FOR RECOGNITION AND BRANCHING OUT: 1985-PRESENT

The year of 1985 was an important watershed in the development of behavioral economics. First, publication of De Bondt and Thaler (1985) paper on stock market overreaction created a field of behavioral finance² by providing an empirical evidence against the strong form of Efficient Market Hypothesis³. Secondly, besides devoting two full chapters to a paper on stock market overreaction

and discussion it generated, Thaler points to another milestone: in October of 1985 behavioral camp got its first major public fight with rationalists (including Robert Lucas, Merton Miller and Eugene Fama) at a conference at the University of Chicago. Behavioralists were presenting violations of the rational choice model while traditionalists were explaining why these findings do not matter. The success for the behavioral team was not a victory over the traditional way of doing economics but a successful refutation of popular defensive comments given by traditional camp (Thaler, 1986).

In the following years, Thaler continued to supply examples of violations taking place in the real world. He devotes one of the chapters of *Misbehaving* to show how NFL draft picks data refutes the Gary Becker's argument that it doesn't matter if most people can't do the complex analysis because those who can end up in the jobs where it's required (Massey and Thaler, 2005). In another chapter, Thaler explains how peoples' behavior during some game shows disprove the so-called incentives argument which states that if stakes are high enough, then people will get it right (van Dolder et al., 2015).

Despite the success of public debate in 1985, behavioral economics was a long way short of recognition in wider academic circles. One major opportunity for change came through Thaler's column on anomalies (from 1987 to 2006) in the new *Journal of Economic Perspectives*. This column had an estimated audience of over 5,000 economists and created a lot of buzz in academic circles. The second major opportunity was closely related to the Russell Sage Foundation which became an organizing force behind highly successful Summer Institutes in Behavioral Economics. The succession of these summer schools was responsible for training many further stars in the field and nothing can describe the significance of the impact made by Russell Sage Foundation better than the fact that *Misbehaving* is dedicated to "... and Eric Wanner and the Russell Sage Foundation who backed a crazy idea ..."

THE COMPLETED KUHN CYCLE

Thaler's involvement in the development of behavioral law (Jolls et al., 1998) and collaboration with Cass Sunstein later led to the emergence of a behavioral approach to public policy labeled libertarian paternalism (Thaler and Sunstein, 2003). Thereby, behavioral economics made a full circle: from observations contradicting the standard paradigm of economics to the explanation of these anomalies with the help of new theories and eventually to the application of these new ideas. Behavioral economics maybe does not cause a proper paradigm shift (Berg and Gigerenzer, 2010), nevertheless, it certainly made important modifications to a paradigm core improving descriptive and predictive power of economics.

As a history of the rise of behavioral economics, *Misbehaving* constitutes a triumph of Thomas Kuhn idea of scientific revolutions. Indeed, economics did not progress via a linear accumulation of new knowledge, rather the progress was made by a streak of luck coincidences, risky career choices and countless squabbles with defenders of "Homo Economicus". However, if I will need to choose the single significant lesson from Thaler's history of behavioral economics, it will be the importance of collaboration and the great power of talking to people. The history of behavioral economics may turn out to be very different from what actually had happened if Richard Thaler did not meet Baruch Fischhoff or if Thaler had no opportunity to spend a year with Kahneman and Tversky at Stanford.

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ENDNOTES

- ¹ Source: <https://www.bloomberg.com/view/articles/2014-12-09/five-economists-who-deserve-nobels>
- ² The choice of the date of origin is a matter of preferences and personal background. Those who see history of behavioral finance as an accumulation of anomalies may prefer to count from Shiller (1981).
- ³ It is worth to note two additional seminal papers published in 1985: Shefrin & Statman (1985) on disposition effect and its behavioral explanation, and Mehra and Prescott (1985) on equity premium puzzle which later was explained by behavioral factors (Benartzi and Thaler, 1993). The other major Thaler's contribution to behavioral finance concerns mispricing in the closed-end funds market (Lee et al., 1991).