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Book Review

How We Misunderstand Economics and Why It Matters:
The Psychology of Bias, Distortion, and Conspiracy

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How we Misunderstand Economics and Why It Matters: The Psychology of Bias, Distortion and Conspiracy
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David Leiser is a Full Professor specializing in Social and Economic Psychology at Ben-Gurion University of the Negev, Israel, and his focus is on studying lay conceptions of the economy. Between 2011 and 2014, he served as the President of the International Association for Research in Economic Psychology and since 2014, he is President of the Economic Psychology Division of the International Association of Applied Psychology. Yhonatan Shemesh focuses on analyzing how evolutionary cognitive endowment influences how people think and behave in the modern world, holding a MA in cognitive science at Ben-Gurion University of the Negev, Israel.

The primary aim of this book is to explain, from a behavioral perspective, how people understand, or more precisely misunderstand, broader economic and financial issues, as well as the consequences of these misconceptions on economic and social environment. The authors start from the idea that a vast majority of people does not grasp economics as much as they should, and, unlike other domains (e.g. medicine: what you think about your spleen does not affect how it works), this limited knowledge has practical consequences both on individual's personal finances and nation's economy, in general. The book addresses a general audience, though I believe this work is a helpful tool especially for economics and behavioral economics students through its crisp exemplification of how people interact with economics and how their mental models and cognitive biases influence their economic and financial decisions.

In the first two chapters of the book, Leiser and Shemesh introduce folk-economic beliefs and propose an answer for why economics is so hard to understand by ordinary people and, sometimes, even by economics students. The difficulty in mastering the principles of economics lays in the fact that "people have poor understanding of causal theories in all domains" (p. 10), not only in economics, together with an extent of ignorance they are unaware of. A main reason for this limited horizon and poor causality that people manifest in everyday financial and economic decisions is that they tend to rely too much on their System 1 (i.e. the intuitive thinking mode, cf. below), using the information that comes easily to mind to construct their answer. "Economics is misunderstood by the public because of the mismatch between central features of economic theory and the human cognitive endowment" (p. 22).

In Chapter 3, the discussion centers on the cognitive structure of individuals; the focus is on cognitive failures, biases and heuristics, analyzing how people unconsciously base their decisions and perceptions on those mental limitations. Therefore, cognitive psychologists view the human memory as being the association of two components (namely, working memory and long-term memory) and two modes of cognitive functioning (namely, intuition and deliberation); moreover, the correlation between them is that the intuitive thinking mode (also called Type 1 or System 1) relies on associative processing in long-term memory, whereas the deliberate, analytic thinking mode (also called Type 2 or System 2) involves working memory. Regarding these concepts, previous research showed that, in several everyday activities– economics makes no exception –, people rely on the associative systems in long-term memory and System 1 appears to be "the thinking mode of choice when answering inference questions in economics" (p. 30). Furthermore, the intentionality bias (i.e. instinctive assumption that someone intentionally did something) is related to the limited functioning of System 1, an extreme expression of this bias being the tendency to see conspiratorial or occult causes behind economic events. Another manifestation of cognitive limitations is the opportunity cost neglect, which refers to the tendency to focus on a single opinion while neglecting the costs and benefit of concurrent alternatives. This has significant consequences on how the population judges national expenses and public policies (e.g. people favor spending more money on most government service, such as health care, national defense, education, social security, etc., but dislike taxes and do not want them raised). Other concepts which are discussed and explained in this chapter include the aggregate effects that people tend to not consider, the so-called "paradox of thrift" (e.g. people save more and spend less), as well as uni-dimensionality and halo effect, the last two concepts blinding people to the "possibility of tradeoffs, where [risk perception and return expectations] are inversely correlated" (p. 36).

Chapter 4 deals with the most important macroeconomic variables laypeople care about, namely unemployment and inflation, which are incorporated in economic models and, consequently, affect people's economic behavior. As human beings, people tend to put the blame on someone or something when a bad thing happens, i.e. the blame instinct (as theorized by Hans Rosling in *Factfulness*). In particular, when it comes to unemployment, people put the blame on individualistic factors (e.g. will-power, effort, etc.), societal factors (e.g. government should be blamed) and fatalistic factors (e.g. luck, chance, etc.). More so, it seems that political affiliation influences the importance attributed to the three factors mentioned above. Unfortunately, when asked about the causes of unemployment, people think at simple and direct causes. Therefore, when they have to come up with solutions for unemployment, their proposals imply direct causation. As for inflation, two widely spread misconceptions are, on the one hand, people's belief that inflation makes them poorer, and, on the other hand, the belief that inflation "provides an opportunity for some economic agents to take advantage of others" (p. 51).

After having discussed unemployment and inflation as two distinct concepts in the previous chapter, the authors concentrate in Chapter 5 on the relation between these macroeconomic variables, which are perceived as the health of economy. Moreover, when people tend to overestimate/underestimate one of them, they tend to overestimate/underestimate the other too. The "good begets good" heuristic is introduced at this point, which tells us that the "economic world is viewed by the public as a largely undifferentiated whole, one that can be in more or less good shape, more or less healthy" (p.59). By contrast, economists consider these variables as elements of a more complex model, where the rate of unemployment modifies the link between monetary mass and inflation.

Chapter 6 is devoted to the economic metaphors that shape people's understanding about this domain: how economy is presented by media (e.g. as an organism, as a machine) and how these metaphors influence people's economic knowledge. In order to understand and make wise decisions in an area in which they know little about, people draw analogies between familiar concepts (i.e. the existing knowledge) and new information. Economic metaphors can be thought of as a kind of heuristic, namely “a mental shortcut that helps us reach a conclusion in a state of uncertainty, with little to no deliberation” (p. 75).

Different perceptions about capitalism and moral-psychological issues derived from it, like greed and inequality, are also found worth discussing by Leiser and Shemesh in Chapter 7, in relation with the misunderstanding of economy. Anti-capitalist people see greed as a force that can motivate individuals to do anything to satisfy their appetite, while pro-capitalist see self-interest as something that can bring overall benefits. Furthermore, biases and cognitive constraints are present in the lay views of capitalism, a leading one being the tendency to moralize economic affairs – since economic policies are not just efficient or not, but also right or wrong, good or bad.

As discussed in Chapter 8, the same misconceptions are present in the way people understand the difference between money and wealth, the truth being that most of non-economists do not make a clear distinction between these two concepts, this confusion leading to an “irrational attachment to the medium”, a difference being made by the medium itself “as some forms are felt to be intrinsically more valuable than others” (p.108). In line with this, “the ways money functions in a modern economy are not clearly differentiated by its users” (p.108) leading to an irrational perception of the real economy and to a misconception about how financial markets work in general.

In the last two chapters of the book, the debate concentrates on if and how financial and economic literacy could help cover the gap in people’s understanding about economics and what are the consequences on public policies. The conclusion of these two chapters is that, over time, “educating people to handle their personal finances better has proven disappointing, because the issue is rarely one of knowledge, and more one of commitment” (p. 121); consequently, those who make public policies must take into consideration the boundaries that human nature imposes upon rationality. Moreover, “policy makers must make sure they learn what people think and want […] to engage them in a true if challenging dialogue”. All of this calls for “more research into people’s conceptions of every aspect of the economic world” (p.136).