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BOOK REVIEW

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Book review of: Misbehaving: The Making of Behavioral Economics (2015). By Richard H. ThalerW.W. Norton Company, Inc. 500 Fifth Avenue, New York, NY 10110, 434 pages, ISBN 978-0-393-08094-0, ISBN 978-0-393-24677-3 (e-book)

According to the classical economic theory, people behave rationally and logically. In reality, human beings are sometimes irrational, driven by emotions, but are also sometimes unable to solve complicated problems. Instead of studying "Humans", the most of economic models study "Econs". It is unrealistic to expect people to use complex analysis and behave as if they were experts, so unlike Econs, Humans use heuristics to help them make decisions and economists consider that as Supposedly Irrelevant Factors (SFI). To deal with that how people actually make, rather than ought to make decisions, behavioural economics has arisen as the new field of economy. The point of behavioural economics is to highlight behaviours that conflict with the standard rational model. "Humans do not have the brains of Einstein (or Barro), nor do they have the self-control of an ascetic Buddhist monk. Rather, they have passions, faulty telescopes, treat various pots of wealth quite differently, and can be influenced by short-run returns in the stock market. We need a model of these kinds of Humans." "A theory of the behavior of Econs cannot be empirically based, because Econs do not exist." (Thaler, 2015)

Richard Thaler divided the book into eight chapters that take us chronologically through the history of behavioural economics as well as of him as a critic, but also through his career as a research professor and stories of other economists he met such as Daniel Kahneman and Amos Tversky. More than a book about the making of behavioural economics, this book is a personal history. The book includes many concepts such as prospect theory, transaction utility, self-control, sunk costs, endowment effects, mental accounting…

Thaler introduces the prospect theory with a statement: "Build descriptive economic models that accurately portray human behavior". According to this theory, people's happiness increases as they get wealthier, but at a decreasing rate changes in wealth matter more than levels of wealth. Humans will be risk-averse for gains, but risk-seeking for losses. "People who are threatened with big losses and have a chance to break even will be unusually willing to take risks, even if they are normally quite risk averse." It is well known in the psychology and motivation theory that people estimate unpleasant feelings as much stronger than positive and unpleasant moods impact people more than pleasant, so we feel the loss more strongly than the gain.

Acquisition utility is a surplus remaining after the utility of the object gained is measured and then the opportunity cost of what has to be given up subtracted. Humans perceive the quality of the deal, transaction utility. It is defined as the difference between the price paid and the expected price.

In the classical economy, preferences are defined by what we choose and there is no distinction between what we want and what we choose because we do not have enough self-control. The author offers this dialogue:

"ECON: Why did you remove the cashews?
HUMAN: Because I did not want to eat any more of them.
ECON: If you did not want to eat any more nuts, then why go to the trouble of removing them? You could have simply acted on your preferences and stopped eating.
HUMAN: I removed the bowl because if the nuts were still available, I would have eaten more.
ECON: In that case, you prefer to eat more cashews, so removing them was stupid."
We have more self-control when it comes to the future than the present. Thaler proposes that an individual consists of two selves - a forward-looking "planner" who has good intentions and cares about the future, and

a devil-may-care "doer" who lives for the present, and he formulates this problem using principal-agent model from the game theory.

If Humans paid for tennis lessons in advance, he or she will think that it is necessary to attend classes so as not to waste money, but when some money has been spent and it cannot be retrieved, that is considered a sunk cost. Playing tennis cannot help their financial situation. Thaler has mentioned one other example of sunk cost describing his friend who was fighting with her six-year-old daughter about what she should wear to school. The girl decided not to wear dresses, but her mother insisted that she had to wear three dresses that had been already purchased. Thaler said that money was gone, and wearing the dresses would not get it back and would not help their financial situation. But this is not completely true. If the girl would not wear dresses, she would wear down the rest of her clothes and she would need new clothes earlier.

Experiments have shown that Humans value things that they already own or feel connected to (their endowment) more than things before they own them and this is endowment effect. People tend to stick to what they have because of loss aversion, but also because of inertia - they stick to what they have unless there is some good reason to switch.

Thaler introduces the idea of "narrow framing" which is related to a mental accounting question: "when are economic events or transactions combined, and when are they treated separately".

The book can be very useful for people who do not know anything about behavioural economics because it is well structured, easy to read and understand, and very entertaining. At the same time, it seems too extensive because of a lot of anecdotes and personal memoirs. On the other hand, behaviour economics has nowadays gained wider acceptance. Some of the concepts become mainstream and this book does not offer new results of research, so for people who are familiar with behaviour economics, the recommendation is to read only some specific chapters they are interested in. The book does not provide a new economic theory or new economic models either.

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