"Article Review: 'Calculating the Irrational In Economics', by STEPHEN J. DUBNER"

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Abstract:

The article talks about the invitation extended to Cape Cod golf resort by the Federal Reserve Bank of Boston in order to prove their case. This indicated that behavioural economics was being taken seriously by the policy makers.

It mentions that in the last decade behavioural economics consisting of different branches of sciences such as psychology and neuroscience along with economics have put forth a very convincing argument stating the importance of emotion in economic decision making in a closed group, placing little emphasis on few practitioners.

Introduction:

It is a very recent thing that behavioral economics is really taken into consideration. But this field has grown for several reasons. For instance, thanks to Alan Greenspan when he acknowledged in 1996 that the average investor usually could not be compared to the super-rational "homo economicus" traditionally depicted by the economists, to the behaviourist Matthew Rabin who won the John Bates Clark Medal in 2002 or to the psychologist Daniel Kahneman, a forefather of behavioral economics. That is how the policy makers of monetary economics realised it is fairly related to people and their being. The article has mentions about the well-deserved accolades of noted behaviourists such as Matthew Rabin, Daniel Kahneman, etc.

It reported that Cathy E. Minehan, conveyed a hope that research on human brain or the way humans make decisions may supplement the mathematical models in informing the policy makers.

Ms. Minehan and her team put their best foot forward to find out the reason as to why the people of America have little savings and are inclined towards too much liabilities by performing dissatisfactory portfolio management.

The article also has a mention of Eldar Shafir, a renowned professor of psychology and public affairs at Princeton started with a primer of behavioural economics. Although it was full of anomalies, it included a number of fields including the popular ‘6 jam v/s 24 jam’ experiment. In a reputed grocery store a group of researchers set up a booth for tasting jams. It started with a total of 6 jars and gradually rose to 24 jars. In the first set up (6 jars) 40% customers tasted the jam and 30% bought it; whereas in the second case 60% customers tasted the jam but only a small amount of 3% customers bought it. The conclusion being made that larger number of options causes increased confusion. The conclusion derived from this data was then compared to the case of having thousands of mutual funds options to decide from for the purpose of investment. However, some strands of standard economics still argue that more the options, more the people are engaged and involved. But when it comes to behavioural economics, the premise is still binding that people behave subjectively and not on the basis of a mathematical model.

It also talks about the feeling that the behavioural economists have about math ruining economics and that the fact that neo-classical economists left out emotions and passions from their model as they were complex and regarded as unknowable. It goes on to say that it is impossible to predict the emotions but when indulged with money, it may be more dominating than math.

Mr. Thaler, a professor at University of Chicago, reached the conclusion that more the number of people, more confused and poorly planned the investment. He proposed a solution according to which all financial institutions should guide their investors positively on more subtle and clear choices.

His most concrete idea is Save More Tomorrow (SMarT), a savings plan whereby employees pledge a share of their future salary increases to a retirement account. This plan is a smart way to lure people away from their fear of losing but since it covers a future profit, the loss is never really felt and the investors also seem to have fulfilled their desire of having money into different fields of investments.

The article reported that although the mainstream did not hail it as a saviour but at least the horizon had been broadened to let in unconventional ideas.

The article ends with an apt statement by Frederick S. Breimyer, chief economist of the State Street Corporation in Boston, who said, "We're looking outside the box because the box we've been looking inside is empty."

Previously considered theories:

The idea of an impact of emotions on economics and rationality is not new. In his book The General Theory of employment interest and money published in 1936, John Manyard Keynes not only marked a rupture with the scientific law of markets, the cornerstone of classical and neoclassical economics, but also relaxed the assumption of rationality dear to neoclassical theorists by integrating the role played by psychological factors responsible for large fluctuations in economic activity. Preference for liquidity (the choice of keeping the money for herself), the propensity to consume increasing with income but less rapidly than the latter, and especially the incentive to invest (fruit of an arbitration subject to uncertainty), are calculations that are beyond the perfect mathematical foresight and lead sometimes to non-economic motives. As a proof, many economists like George A. Akerlof (2001 Nobel Prize in Economics) and Robert J. Shiller who published in 2009, incorporate human behavior with all its quirks and irrationalities in their theories to explain the current financial crisis. This kind of consideration can also be applied in the workplace where emotions and feelings also play an important part. Indeed, like any other field of activity, workplace is also the scene of different emotions: fear of having an accident, of getting sick because of work or of losing his job, satisfaction and pride of a well-done job; anger relative to injustice at work; joy and surprise due to a promotion, etc... It has been proved that taking a better account of emotions on the workplace would be able to increase efficiency. The unproductivity due to poor management of emotions is estimated at 30%. This loss is the result of the time wasted in conflict, rumors or change management due to absenteeism or accidents related to stress.

Conclusion:

We can relate this to our knowledge that humans are not always rational, a fundamental assumption of economics, while making decisions of any sort. Their decisions are moderated by biases like Escalation of Commitment in which is defined as the tendency for individuals to continue to support previously unsuccessful courses of action. They are further guided in their decisions by a Bounded Rationality Model as all the information pertinent to a decision is almost never available and people have to make decisions on the basis of the information they have. The decisions are further distorted by the Attribution Error. Rule of Thumb is another heuristic guiding our decisions. All these along with biases like Stereotyping are mental shortcuts we use to make sense of the complex phenomena around us. They also compromise the criterion of rationality.

As a conclusion, we can see that it seems impossible to totally suppress emotions as far as the process of financial decision or workplace are concerned. Instead of trying to deny this human particularity, it is therefore necessary to better understand and manage emotions to avoid the difficulties they can bring.

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