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Book Review

Misbehaving: The Making of Behavioural Economics, Richard H. Thaler, Allen lane (an imprint of penguin books), 2015, 415 pages, INR 1000/-

'In misbehaving, an economics professor isn't afraid to attack his own', was the title of the book entry made by Johnathan A. Knee in the TheNew York Times on May 5, 2015 about the book "Misbehaving: The Making of Behavioral Economics", written by Richard H. Thaler of the University of Chicago's Booth School of Business. If anyone wants to describe the subject matter of thebook then this description would remain as the most appropriate.In the book Thaler explains how human actions in reality are inconsistent with the facts discussed in the mainstream economic theory. Thaler starts by criticising one of the core premise of mainstream economic theory that 'people are rational'. By presenting perfectly rational people as econs and the irrational misbehaving counterpart as humans he derides this premise. In light of his other academic works he reflects that human behaviour is far away from being perfectly rational and is driven by biases. Economists have a tendency to ignore these biases as 'Supposedly Irrelevant Factors' (SIF's). However, according to Thaler these SIF's have to be studied with greater emphasisin light of the inadequacy and failure of economic models to predict and explain the financial crisis and other recent events. For example, Thaler states that economic models will remain less accurate in the case of 'endowment effect', if people value the things that they already have/own as supreme compared to the things that could be a part of their endowment. Thaler argues that in this case people base their decisions on heuristics as a rule of thumb and this may create a bias in judgement. He supports the propositions of the prospect theory as more appropriate in explaining human judgements in this context compared to economic theory. Further, the rationality assumption discussed in economic theory is supported by the overuse of two fundamental concepts namely: equilibrium and optimisation. However, according to Thaler, the understanding of market and human behaviour derived from the over dependence on these two concepts may mislead.

In order to investigate in detail the behavioural pattern of people, in the second section of the book,Thaler introduces the real motive for spending, saving and financial decisions as mental accounting. People tend to make mental accounting especially regarding spending and are more likely to pay more interest on debt compared to the interest they earn on their saving at a time even if they have enough saving to pay of their debts. According to him, people consider money as non-fungible, especially if set apart for satisfying alternative personal accounts. Contrary to this reality, in traditional economic theory, money was considered as fungible and hence, resulted in inadequate interpretation of human behaviour. Thaler points out that the main reason for these behavioural pattern is due to the two different utility people assign to the purchase of a commodity namely transaction utility and acquisition utility. Based on the traditional economic theory people base their purchasing decisions on the acquisition utility of an object. Acquisition utility mainly is derived from the difference between the utility a consumer actually gainsby consuming an object and the opportunity cost of what has to be foregone. This is similar to the concept of consumer surplus in economics. However, transaction utility is more qualitative and is the difference between the price paid for the object and the price one expects to pay. Negative transaction utility results in rip-offs and positive leads to a bargain. Consumers get mostly misled by the sellers by giving a feeling of a bargain by making a deal price. Thaler argues this occurs mainly due to the inability of humans to segregate sunk costs from other expenses. However, these sunk cost were treated as ignorable costs by economists while advocating economic theories.

Thaler reminds in section three that humans are prone to self-control problem and may tend to value their present consumption spending more compared to the future. Further, money saved is based on the mental accounts set apart by people and not based on principles proposed by various economic theory on consumption behaviour. To understand the psyche of an individual, Thaler divides individual into two halves, a planner and a doer and applies the metaphor on the classic principal- agent model with in an organisation. In addition, Thaler brings in the idea of narrow framing and elaborate it in the context of principal-agent model. He indicate that people gets into trouble by treating events separately at a time rather than as a portfolio.

In section six Thaler explains how behavioural biases influence decision making in the case of financial markets. Professional traders thrive by exploiting the mistakes made by others in the financial markets. He explains that in comparison to other theories on financial markets behavioural inconsistencies of agents cannot be underestimated in evaluating financial markets. He criticises two aspects of Efficient Market Hypotheses (EMH), which are core assumptions made by finance scholars from the time of Eugene Fama namely, (i) the rationality of prices and, (ii) the possibility of "beating the market". The rationality of prices or the principle of one price indicate that any financial asset will sell based on its intrinsic value. However, in reality price of financial assets vary drastically from the underlying intrinsic value and keeps on fluctuating based on the market expectations. The second aspect of EMH was more criticised in the book by Thaler highlighting that human emotions play a significant part in making financial decisions. He borrows the idea of 'animal spirits' from John Maynard Keynes and emphasises that people overreact to the day-to-day fluctuation in the prices of financial assets, which has an absurd and excessive influence on the financial markets. To prove this further, he conducted many investigations on value stocks and growth stocks and identified that value stocks outperforms growth stocks and remains less risky. He argues that "to this day, there is no evidence that a portfolio of small firms or value firms is observably risker than a portfolio of large growth stocks".

In the last two sections of the book,Thaler talks about his career after moving to Chicago and the government initiatives he has been a part of. He argues that the behavioural economics traditionally has had two rolesfirstly, studying and documenting individual and firm behaviour and secondly, developing theory based on the findings. Thalerinsists that the third role of behavioural economics is to help government and firms frame better policies by accommodating the principles of behavioural economics. One of the initiative advised in this context was to increase the savings by people for their retirement by having a 'Save More Tomorrow' programme. The basic idea underlying this plan is that people agree in advance to commit a portion of their future salary increases for retirement savings. He uses the term 'libertarian paternalism' for non-coercive means of encouraging people to save more for the future. For example, in the chapter titled 'Nudging in UK'he

emphasise how the policy making group, of which he himself has been a part of, helped late tax payers to pay their taxes on time. Thaler points out that a positive nudge may result in favourable policy outcomes especially in a world where people behave more irrational and more humanlike.

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