

## **1. Introduction**

Under these conditions, the erotic relation seems to offer the unsurpassable peak of the fulfillment of the request for love in the direct fusion of the souls of one to the other. The boundless giving of oneself is as radical as possible in its opposition to all functionality, rationality, and generality. It is so overpowering that it is treated “symbolically”: as a sacrament. The lover realizes himself to be rooted in the kernel of the truly living, which is eternally inaccessible to any rational endeavor. He knows himself to be freed from the cold skeleton hands of rational orders, just as completely as from the banality of everyday routine. [Max Weber 1958]

Even Max Weber – one of the early proponents of the social analysis of rational man – recognized the essential irrationality of emotions such as love. Today it has become so very fashionable to criticize economic theory for focusing too much on rationality and ignoring the imperfect and emotional way in which decisions are reached in the “real world.” Psychologists and other social scientists have been especially vocal in their dismay. A bright new group of behavioral economists has picked up the criticism:

Economics traditionally conceptualizes a world populated by calculating, unemotional maximizers that have been dubbed Homo economicus. The standard economic framework ignores or rules out virtually all the behavior studied by cognitive and social psychologists. This “unbehavioral” economic agent was once defended on numerous grounds: some claimed that the model was “right”; most others simply argued that the standard model was easier to formalize and practically more relevant. Behavioral

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economics blossomed from the realization that neither point of view was correct. [Thaler and Mullainathan 2010]

The authors go on to point out how modern economics is based on a foundation of sand.

The standard economic model of human behavior includes three unrealistic traits—unbounded rationality, unbounded willpower, and unbounded selfishness—all of which behavioral economics modifies.

Those who have read about – and who has not? – the current economic crisis may wonder indeed just how rational an economic man or woman might be. Behavioral economics has become the modern rage. So is rational economic man – *homo economicus* – dead? Has the economics profession moved on to recognize the true irrationality of humankind? Nothing could be further from the truth.

Strangely, the criticisms that have caused behavioral economics to blossom are nothing new. Writing in 1898 Thorstein Veblen wrote sarcastically of rational economic man as

a lightning calculator of pleasures and pains, who oscillates like a homogenous globule of desire of happiness under the impulse of stimuli.

Students of economic history can argue about whether Veblen's description of *homo economicus* is an accurate reflection of economics as it was practiced then – it is definitely not an accurate reflection of economics as it is practiced today. For starters, while mainstream economics does indeed presume unlimited self-

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control, it does not presume unlimited rationality or unbounded selfishness. The paradigmatic man (or more often these days woman) in modern economics is that of a decision-maker beset on all sides by uncertainty. The central focus of economics is on how successful we are in coming to grips with that uncertainty.

Remarkably, for a long period of time during the 60s and 70s, irrational economic man dominated economics. It was the abysmal failures of the “neoclassical synthesis” leading to absurd and costly failures of economic policy – I am old enough to remember waiting in long lines to buy gasoline – that led to the modern and much-criticized theory of rational expectations. The fact is that irrational economic man is a poorer description of how we behave than that of a “lightning calculator of pleasures and pains.” As Robert Lucas wrote in 1995, in many ways the rational expectations model was a reaction to

[t]he implicit presumption in these ... models [of irrational man] ... that people could be fooled over and over again.

Modern economics is not the theory imagined by critics – including apparently some Nobel Prize winning economists – who are unfamiliar with it. The theory used by working economists is far more sophisticated and successful than is generally imagined. The fact that policy makers choose to ignore our warnings does not make us wrong. Weaknesses in economic analysis exist – but bear little connection to those cited by critics. My objective in this volume is to set the record straight by explaining some of the true successes and failures of both economics and behavioral economics.

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To understand whether or not behavioral economics is doomed is to first ask the question whether mainstream economics has failed. If it has not, then surely behavioral economics is doomed. And mainstream economics has not failed. Existing economic theory in those situations of greatest interest to economists makes strong and robust predictions. Those predictions are borne out by the facts – in the laboratory as well as in the field.

In some situations less central to economics the theory makes weak predictions. These are also borne out by the facts – but the theory is less useful as it fails to narrow down the range of possibilities. It is here – in strengthening existing theory – that there exists a potential for behavioral ideas. Indeed – long before the term “behavioral economics” existed – many of the ideas discussed by “behavioral economists” had already been incorporated into mainstream economic models. Here I will tell the story of both the successes and failures.

Wait! you say. Does not the inability of economists to forecast the current economic crisis show that all you claim is false? How can you defend a science that has met with such an abysmal failure? In response I ask – do you condemn quantum mechanics as useless because it cannot predict simultaneously the location and velocity of subatomic particles? Because not only can it not do so – according to the theory it is impossible for it to do so. Just so: according to economic theory – for reasons I will elucidate – it is equally impossible to predict the timing of economic crises. Does that make us useless? If we can – and we can – tell how economic crises can be avoided, how they can be mitigated, and how best to

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recover from them – then surely you ought to listen to what I have to say.