Book Review: Behavioural Economics and Finance

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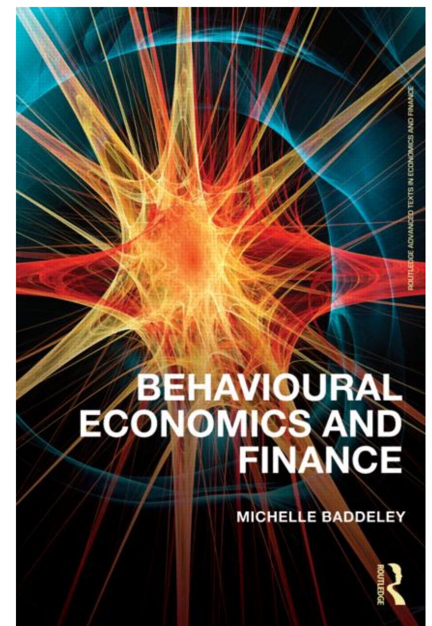
Standard models in economics usually assume that people are rational, self-interested maximisers, effectively co-ordinated via the invisible hand of the price mechanism. Whilst these approaches produce tractable, simple models, they cannot fully capture the uncertainties and instabilities that affect our everyday choices. ***Behavioural Economics and Finance*** *brings economics and finance together with psychology, neuroscience and sociology, aiming to introduce the reader to some of the key concepts and insights from this rich, inter-disciplinary approach to real-world decision-making. Reviewed by* ***Anna Grodecka****.*

Behavioural Economics and Finance. Michelle Baddeley. Routledge. 2013



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Is nicotine addiction a completely irrational phenomenon? What should we think about the behaviour of NYC cab drivers who tend to come home earlier on busy days rather than exploiting the large wave of passengers? Why do gym clients pay more on average for a yearly health club subscription rather than opting for a less expensive pay-as-you-go system?

In *Behavioural Economics and Finance,* Michelle Baddeley, a Fellow and Director of Studies in the Cambridge University, invites us to have a closer look at recent developments in behavioural economics that can rationalize the above examples under an economic framework. This twelve chapter textbook provides the basics of behavioural economics and finance, covering a wide range of subjects from psychology and neuroscience, through to the impact of mood on economic decisions, ending with a summary of research on happiness.

A general understanding of this popular and fast growing field is of an economics that "takes insights specifically from one branch of psychology – behavioural psychology, which involves the experimental study of observed choices and decisions" (p.3). Baddeley, however, looks at behavioural economics from a broader perspective and also discusses the impact of psychology and neuroscience on economics. Behavioural finance constitutes only a minor part of the book and is presented in the two last chapters.

The first chapter, 'Foundations: Psychology', provides a short description of basic psychological concepts that may be useful in the field in focus. While behavioural economics concentrates on observable actions, psychology touches more on the unobservable personal drivers of our decisions. This is of course a disputable point since economic models are usually employed to compare data, relying on observables. Can a discussion of personalities improve our understanding of economics? According to Baddeley, yes. This chapter summarizes some insights from personality theory and available personality tests, such as the Myers-Briggs Type Indicator (based on Carl Jung's theory of archetypes) and The Big Five personality test (a test initially developed in the 1960s that focuses on five dimensions of personality: openness, conscientiousness, extraversion, agreeableness, neuroticism). People with defined personalities will tend to have the same behavioural patterns, thus the study of their personality traits may be useful in constructing versions of more sophisticated economic models. Social psychology allows for a useful enhancement of mainstream economics, taking into account social influences and pressures that alter our behaviour. Solomon E. Asch's study 'Opinions and Social Pressure' (published in *Scientific American* in 1955, PDF available here) is the most known example. Asch asked participants to judge the length of the lines shown on two cards. In some groups a number of participants (the majority) were collaborating with the experimenter and made deliberately false judgements about the length of the lines. Real participants, feeling social pressure and the urge to conform, made mistakes in 37% of cases while matching the lines. Without group pressure they made mistakes less than 1 percent of the time.

One of the most interesting chapters, 'Time and Plans', discusses inconsistencies when it comes to planning our economic or everyday decisions. A usual macroeconomic model assumes time consistency with respect to decisions, meaning it should make no difference to consider whether to consume something today or tomorrow or in one year's time or one year plus one day. In reality, it turns out that such an assumption is not correct, because people tend to change their decisions with time; they also misjudge their own patience. Usually we capture the impatience of an agent in an economic model by assuming that he has a positive discount rate, meaning that he values things that occur now more than things that occur in the future. It might seem that the assumption about a constant discount rate over lifetime is a harsh one and indeed, empirical studies show that discount rates are not constant among people – they tend to decline with age, they also differ depending on personal characteristics, such as educational level or owning a house. It turns out that small changes in the usual assumptions of the economics models (such as hyperbolic discounting and quasi-hyperbolic discounting instead of widely used exponential discounting or allowing for habit formation in the utility function) may capture some of the 'anomalies' found by behavioural researchers and make the models consistent with the assumption about the rational homo economicus.

When making decisions, people very often tend to use some kind of bracketing that makes their decision simpler and independent from past or future outcomes. Knowing that, we may be able to understand the decisions of NYC cab drivers who choose not to maximize their lifetime utility by finishing work sooner on busy days and working longer on quiet days. The explanation is simple: if taxi drivers use daily income targeting as their decision device then their apparently irrational choices become completely rational. Visceral factors capturing basic instincts may explain the fact that some people, although wanting to quit smoking, decide to smoke the 'one last cigarette'. Instant tangible reward (pleasure from smoking) convinces them more than long-term intangible reward (improving the health) and this can be captured by non-standard forms of utility functions with slightly changed discounting rule.

Behavioural Economics and Finance is interesting mainly due to the number of topics covered in the volume. It should be seen, however, as an introductory text for undergraduate students that can lead interested readers on to further references. The book itself is written in a rather dry style. Baddeley tends in some chapters to provide summary after summary of academic papers, or lists results of many experiments, and if read at once this can tiring and uninspiring. A scattering of boxes or graphs would be welcome and would certainly enhance the reader's experience; many experiments covered have the potential to be presented in a visually interesting form. This is ultimately a reliable text with many useful references.

Anna Grodecka is a PhD student in macroeconomics at Bonn Graduate School of Economics and a visiting researcher at the LSE. She obtained her Master's Degree in Finance from Warsaw School of Economics and Johannes Gutenberg University in Mainz. In her research, she focuses mainly on monetary policy, the financial and housing markets, and their role in the recent crisis. Read more reviews by Anna.