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Roundtable on Behavioural Economics and Public Policy

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Keynote dinner address*

Ross Gittins,
Economics Editor,
The Sydney Morning Herald

Behavioural economics is economists satisfying themselves intellectually of truths about economic agents' behaviour that are readily understood by marketers and politicians. It is the scientific study of intuition which, because of the way the human brain has evolved, heavily influences our decision making. Behavioural economics reveals conventional economics to be normative rather than positive. Economists' belief in individualism, freedom of choice and a limited role for government rest more heavily on the assumption of rationality than most realise. The insights of behavioural economics may be used to reframe essentially unchanged policy prescriptions to make them more politically palatable, or to change the policies being prescribed. Progress towards the latter could involve greater study of forms of consumption, acknowledging the influence of the pursuit of social status, rethinking the model of labour supply to acknowledge the utility derived from work and the extreme disutility of unemployment, and recognition of the pervasiveness of self-control problems.

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Productivity Commission Roundtable on Behavioural Economics and Public Policy

Dinner speech, Melbourne, Wednesday, August 8, 2007

Ross Gittins, Economics Editor, The Sydney Morning Herald

'Economics has not only become boring but also threatens to become irrelevant. Therefore I do not feel embarrassed about being unorthodox. In fact, I rather enjoy it!'
Frey (2001)

One of my favourite economist jokes is the one that says an economist is someone who can't see something working in practice without wondering whether it also works in theory. There are two professions that possess an intuitive understanding of the propositions economists have come to call 'behavioural economics'. They are the marketers and the politicians. So what is behavioural economics? It's economists satisfying themselves intellectually that there is a logic - as opposed to a rationality - to the intuitive behaviour of economic agents. It's economists laboriously disabusing themselves of the mistaken beliefs they have acquired about the way agents behave as a result of their internalising the assumptions on which neoclassical economics is built.

Behavioural economics is the scientific study of intuition. It involves accepting the power of intuition - that people are much more intuitive than rational - and understanding the reason why this is so, which gets back to the way humans have evolved and, specifically, the way their brains have evolved. Neuroscience tells us that the primitive, more instinctive and emotional part of our brain often overrides - or beats to the punch - the more recent, more logical part of our brain. This leads to a strange dualism in our minds: we're often motivated to do things by considerations the more intellectual part of our brain knows to be unwise. This dualism explains why we have 'present selves' and 'future selves' which, in turn, helps explain the self-control problem humans have - a major topic of study for behavioural economists - and the misprediction of utility, time-inconsistent preferences, myopia and procrastination this involves (Stutzer and Frey, 2006). I guess what I'm saying is that, for a full appreciation of the intellectual power and fascination of behavioural economics, it helps to take in some neuroeconomics (Camerer et al, 2005).

Let me also say that I use the term behavioural economics to encompass the closely related field of research into happiness - or subjective wellbeing, if you prefer a more scientific-sounding label. Lest you feel that happiness is taking your newly acquired tolerance of behavioural economics a bridge too far, let me just point out that happiness is the subject that brought Professor Frey's name to international prominence (Frey and Stutzer, 2002) and that when Daniel Kahneman, the psychologist who won the Nobel prize in economics for his role in founding behavioural economics, had finished with prospect theory and heuristics, he moved on to the study of utility and wellbeing (Kahneman et al, 1999).

Conventional, neoclassical economics is widely held to be positive, not normative. But one of the things you soon realise when you study behavioural economics is that this is the wrong way round. Behavioural economics is the study of the way the world actually is, whereas conventional economics is the study of the way the world should be. That is, we're not rational, but in many circumstances we'd be better off if we were. The study of self-control problems involves reaching an understanding that the seemingly irrational things people do in their search for commitment devices - such as failing to claim tax rebates in fortnightly PAYE tax instalments so as to maximise the size of their annual tax refund cheque, which the person is more likely to save - have their own logic; that they represent fallible agents trying to make themselves more rational. The study of self-control problems also leads you to the view that there may be a new role for economics in helping to make the world more rational by imposing prohibitions on certain disadvantageous behaviour. In fact, governments already do this extensively - and with widespread public acceptance. It's just that no one sees it as having anything to do with economics and often economists would be quietly disapproving of such interventions.

As an economic journalist I'm supposed to keep my remarks practical, but I do want to say something theoretical and controversial. I believe that the assumptions on which the neoclassical model is based pervade the beliefs and policy preferences of economists far more than most of them realise. Economists generally have a strong commitment to individualism, freedom of the individual, the benefits of choice and the value of personal responsibility and, hence, a bias against government intervention and a desire to keep governments small and taxes low. This characteristic of neoclassical economics gives it a great affinity with the libertarian political philosophy, which to me explains why the right wing of economic rationalism is a lot more heavily populated than the left wing. (Who's on the left wing of economic rationalism? Mike Keating, Fred Argy, Bob Gregory and a few others.)

But my point is this: I believe conventional economics' commitment to individualism and suspicion of government intervention rests heavily - more heavily than most economists realise - on the assumption that economic agents act rationally. We doubt that governments could ever know better than the individual how that individual's income could best be spent. Why? Because we assume the individual is rational in all things - that she can accurately predict utility, never does things she comes to regret and never displays time-inconsistent preferences. When you accept that individuals are far from rational you open up the possibility that governments may well be better judges of what's best for the individual. We assume agents are rugged individualists and are happiest when treated as such, whereas psychology tells us humans are group animals, whose preferences are heavily influenced by those around them, who care deeply about what others think of them, who are anxious to fit in but also conscious of their status within the group and desirous of raising that status. In other words, I believe conventional economics' exaltation of individual freedom is simply scientifically outdated - a hangover from the 18th and 19th centuries, when we knew far less about human behaviour than we do today.

There are two broad approaches economists can adopt towards the lessons of behavioural economics. One is to use insights from behavioural economics to reframe essentially unchanged policy prescriptions from conventional economics so as to make them more politically palatable. We know, for instance, that people react differently to essentially the same propositions depending on how they are framed. We know that more people would decline consent for a medical operation with a 10 per cent failure rate than they would an operation with a 90 per cent success rate. We know from Kahneman's asymmetric value function, for instance, that people weight losses more heavily than gains of the same amount. From this Richard Thaler (1985) developed four rules for reframing gains and losses: segregate gains (don't wrap all the Christmas presents in a single box), combine losses (because this reduces aggregate pain), offset a small loss with a larger gain and segregate small gains from large losses.

The second approach we can adopt is to use the lessons of behavioural economics to change the policies we pursue. I have no objection to the first approach - indeed, I think it would repay the close attention of econocrats. But I'm more excited by the second, more radical approach. So let me suggest some very general policy implications I draw from behavioural economics.

First, I believe the profession needs to return to its original goal of maximising aggregate utility rather than maximising consumption possibilities. We now know it is possible to measure utility - to some extent at least. We also know that revealed preference is far from foolproof. People are not good at predicting their utility and they often come to regret their decisions - even to wish someone had stopped them doing what they did. We know people get locked into behaviours they wish they could control. Neuroscience makes it easy to see how people's consumption decisions can be influenced at a semi-conscious level by advertising that appeals to their emotions. Among other implications, a switch of emphasis from consumption back to utility would require economists to abandon their see-no-evil approach to advertising. Many of the points that follow flow from a recommitment to maximising utility.

Second, economists need to study consumption. It never ceases to amaze me that economists can exalt consumption in the way they do and then take so little interest in it. The happiness literature makes it clear that people find some forms of consumption more satisfying than others (Seligman, 2002; Van Boven and Gilovich, 2003).

Third, economists need to acknowledge the importance people attach to social status and social comparison. Conventional economics is good at helping the community maximise its income, but it can do nothing to maximise people's <u>relative</u> income. And yet we know that people are more interested in increasing their income in relative terms than absolute terms. From a community-wide perspective, a status race is pointless and wasteful. It's likely that, as real income rises over time, a higher proportion of income is devoted to the purchase of positional goods. Is this why we pursue efficiency? It's also likely that efforts to minimise the role of government and limit the growth of taxation have the effect of allowing people to maximise their spending on positional goods at the expense of the provision of public goods that would yield them greater utility (Frank, 1999).

Fourth, the simple model of labour supply is misleading and needs rethinking. In practice, economists tend to underplay the one thing the model gets right: that leisure yields utility. In the unfavourable comparisons of rates of economic growth and levels of GDP per capita made between America and Europe, there is little acknowledgement that much of the difference is explained by the Europeans' preference for leisure over work. On the other hand, the model is quite wrong in assuming that work yields disutility. The happiness literature makes that clear - even if it wasn't obvious. Like you and me, most people derive great utility from their work most of the time. It follows that much could be done to increase utility by policies encouraging job enrichment. That is, when your goal is to maximise utility rather than consumption, you see for the first time that the issue of job satisfaction - which may be enhanced by such practices as team work or giving workers greater autonomy - is part of the economist's brief.

We know, too, that unemployment is a major source of unhappiness in peoples lives - or, if you prefer, of disutility (Clark and Oswald, 1994; Layard, 2003). This fact creates a conflict between measures to increase efficiency and maximising utility that reformers rarely acknowledge. This may be partly because their model assumes full employment, but I believe it's also thanks to a hidden assumption that the unemployed are to be envied for all their leisure time.

Fifth, policy makers undervalue the utility people derive from security and predictability. We give too little weight to the utility workers derive from job security, for instance. We need to learn that efficiency isn't everything.

Sixth, self-control problems are ubiquitous, but susceptible to policy remedies. Some self-control problems may be regarded as minor (television watching, for instance), but many constitute significant social and economic problems: obesity, smoking, drinking, drug taking, gambling, speeding, the overuse of credit and the inability to save. Economists aren't as conscious as they should be that government intervention - and often, outright controls - to assist people conquer their self-control problems and to protect the community from negative externalities are widespread, of longstanding and uncontroversial. Consider all the regulation governing the consumption, sale and advertising of alcohol and tobacco. Consider all the controls - speed limits, seatbelts, random breath-testing - that have succeeded in reducing the road toll. Consider the way employees are compelled to save 9 per cent of their wages and how little opposition that relatively recent measure encountered. It's clear to me that the public often <u>wants</u> governments to impose these external commitment devices on it - and that this attitude makes considerable sense. The insights of behavioural economics should help economists to be much more receptive to proposals to use intervention to alleviate self-control problems, including the newly recognised problem of obesity.

Economics doesn't have to be boring, stuck in a rut and open to the charge of being based on out of date science. But to make economics more interesting and relevant to the solution of a wider range of the community's problems, economists have to be willing to learn new tricks.

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