

Richard Thaler's work demonstrates why economics is hard

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Richard Thaler has won the Nobel prize in economic sciences this year for his contributions to behavioural economics. It's a well-deserved prize and a clarifying one, as far as economics is concerned. For a very long time, economists hoped to treat individuals a bit like particles in physics, whose activity can be described by a few well-understood rules, which allow researchers to model and understand complex interactions between particles. The rules, they reckoned, were things like perfect information, forward-looking reasoning and rationality. Of course economists understood that individuals didn't always behave according to those rules, but the idea was that, in aggregate, the rules would allow for a pretty good approximation of reality.

Then came the behavioural economists, who made it their task to find ways in which human activity systematically diverges from models using those basic assumptions. For many of them, the goal was probably to come up with an alternative set of principles describing human behaviour, so that economists could get back to the job of modeling the economy. That new set of principles never really emerged, just a bunch of behavioural oddities. As this week's Free exchange column notes, one of the big achievements of the behavioural revolution has been to get economists as a whole to back away a bit from grand theorising, and to focus more on empirical work and specific policy questions.

Along the way, behavioural economics made some meaningful public-policy contributions; for instance, the way in which nudges can be used to help people save more or use less energy. Nudges probably won't save the world, but whenever economists manage to deliver an actual improvement in real-world policy we should celebrate it. In some ways, however, behavioural economics is underappreciated: as

in the way it reveals how difficult it is to understand all the factors affecting human behaviour—well enough, at least, to have a hope of explaining it.

I'll give you an example. In one of Mr Thaler's famous experiments—the “dictator game” undertaken with Daniel Kahneman and Jack Knetsch—one player (the dictator) is given \$20 and told that he can split the sum evenly between himself and another student or keep \$18, leaving the other player with \$2. A rational utility-maximiser would be expected to keep as much of the money as possible. The authors found, however, that the vast majority of students chose the even split: strong evidence that concerns about things such as fairness can be as important in human decision-taking as cold rationality. That, alone, is a pretty striking challenge to economics-as-usual.

The experiment was subsequently repeated and replicated many times, often using slightly different formulations. One particular version, conducted by John List, turned up a fascinating result. If you expand the options available to the dictator to include *taking* money from the other player, then few participants opt to share the money with the other player—though, importantly, neither do most players exercise their ability to take from the other.

What does that tell us? It means that fairness concerns matter a great deal. But it also tells us that people are constantly looking for social and institutional cues as to what the socially acceptable courses of action are. Present someone with a circumstance in which a very selfish individual could take money from another participant, and the player adjusts his ideas about what sort of behaviour counts as fair. Behavioural decisions are not made independent of the setting; worse, even seemingly fundamental notions of fairness shift depending on the situation.

It's a simple lesson but one which massively complicates the work of economists. Perhaps we can understand how people behave within a particular market. But that understanding does not necessarily mean we have learned something fundamental about human behaviour, because the choices people make within the market reflect their evolving beliefs about what constitutes appropriate behaviour within that narrow setting. A different setting, with different cues, leads to different behaviour. And even in one particular market

slight tweaks to the environment will affect people's judgments about what they should and should not do.

It is as if economists are working to understand the strategies people play within a game. But it is a game in which every player is constantly updating his ideas about the rules and even the objectives in response to what every other player is doing. It's a vitally important job that economists have set themselves. But it truly is a dismally frustrating one.