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BOOK REVIEW

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MISBEHAVING—THE MAKING OF BEHAVIORAL ECONOMICS

By Richard Thaler
Norton, 2015
(*Reviewed by Javier Estrada, IESE Business School, Barcelona, Spain*)

Few people can claim to be one of the founding fathers of a field, but Richard Thaler is one of them. Together with Daniel Kahneman and the late Amos Tversky, as well as a few others, Thaler was there pretty much from the very beginning. And the story of how the field of behavioral economics/finance came to be is what *Misbehaving—The Making of Behavioral Economics* is all about.

This thoroughly-entertaining book does not really aim to be a primer on behavioral economics/finance; rather, it aims to describe Thaler's journey, all the while touching upon many relevant subjects and basic tenets of the field. The book is written in plain English, with few graphs and no equations, and can easily be followed by anyone interested in the subject. Thaler's good writing and humor certainly help.

The book is written chronologically, although the topics discussed are arranged in a coherent fashion. (In Thaler's words, "…the organizational structure of the book is both chronological and topical.") It starts out in the early 1970s with Thaler's first thoughts on the topic while working on his Ph.D. at the University of Rochester; moves on to Thaler's years at Cornell University; and ends with Thaler's current position at the Booth School of Business at the University of Chicago, with a few intermediate stops along the way. During the journey, the book touches upon Thaler's thoughts and contributions to the field, as well as the contributions of many others.

Although the book is not really a primer on behavioral economics/finance, it does discuss the most essential topics at the core of the field. These include the endowment effect, prospect theory, loss aversion, mental accounting, self-control, views on fairness, and many others. Underlying the whole discussion are the SIFs, or supposedly irrelevant factors; that is, those variables considered irrelevant by traditional economists but essential to behavioral economists.

Thaler puts at the center of most discussions the distinction between Econs and Humans. The former are the rational, all-knowing, fully-informed individuals that make decisions in

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the traditional models of economics and finance. The latter simply are normal people that make mistakes, satisfice rather than maximize, and have all sort of behavioral biases that limit their ability to make the choices that rational individuals would make. In Thaler's words, "…Humans do a lot of misbehaving, and that means that economic models make a lot of bad predictions …"

At the beginning of the book Thaler states his view of traditional models in economics and finance, which he clearly perceives as limited and unrealistic. In his words, critiques over these models "…have been brushed aside with a gauntlet of poor excuses and implausible alternative explanations of embarrassing empirical evidence."

Thaler summarizes the traditional approach with the expression "Optimization + Equilibrium = Economics." Then he quickly moves on to describe the problems he sees with this traditional approach, which are, first, that ordinary people cannot and do not really optimize; second, that individuals do not have unbiased beliefs on which to base their choices; and third, that optimization models leave many important factors out. Essentially, the rest of the book elaborates on these three shortcomings.

It can plausibly be argued that at the heart of the book, as well as at the center of behavioral economics/finance, is the utility function proposed in prospect theory, which is very different from the one used in standard models in economics and finance. The latter essentially reflects the idea that the more you consume of something, the lower is the *increase* in your utility. (Technically, this utility function displays decreasing marginal utility and risk aversion.) The former reflects something very different, and in Thaler's view much more descriptive of the way Humans behave. In his words, the utility function of prospect theory posits that "we experience life in terms of changes, we feel diminishing sensitivity to both gains and losses, and losses sting more than equivalently-sized gains feel good."

Having established this basic behavioral framework, Thaler moves on to describe the many shortcomings and behavioral biases that Humans have, all along illustrating them with evidence and experiments. That is what most of the rest of the book is all about. The last part ("Helping Out – 2004-Present"), however, focuses on how the insights of behavioral economics/finance may help design public and private programs that may improve our lives. In this part, Thaler borrows a bit from *Nudge*, his previous book co-authored with Cass Sunstein.

All in all, I found Thaler's book thoroughly entertaining and instructive. My only warning to potential readers is that this book is not really a primer behavioral economics/finance; rather, it is a front-row perspective of the development of a field, with all its basic insights coming along for the ride.

I cannot but finish this review with a recommendation; actually, Thaler's recommendation. "My only advice for reading the book is stop reading when it is no longer fun. To do otherwise, well, that would be just misbehaving." I could not have said it better.

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