

Behavioral economics: how psychology made its (limited) way back into economics.

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## Behavioral Economics: How Psychology Made Its (Limited) Way Back into Economics

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**Behavioral Economics:**

How Psychology Made Its (Limited) Way Back Into Economics

# Esther-Mirjam Sent

Behavioral economics and its focus on the interrelations between economics and psychology is attracting increasing attention and recognition. In 1998, the *Journal of Economic Literature* published an article offering an overview of the connections between economics and psychology (Rabin 1998). In defense of his focus on the relevance of psychological findings for economics, the author noted: "Because psychology systematically explores human judgment, behavior, and well-being, it can teach us important facts about how humans differ from the way they are traditionally described by economists" (11).

A year later, in 1999, Andrei Shleifer of Harvard University was awarded the John Bates Clark medal of the American Economic Association, which is a prize granted every other year to an exceptional economist under the age of forty. Shleifer was selected for the award for his research on securities markets and on the role of government in regulating markets and in fostering economic growth. In this work, he presented behavioral finance as an alternative to the efficient market hypothesis that has dominated finance for many years (Shleifer 2000). In particular, Shleifer demonstrated the oversimplification of the efficient **[End Page 735]** market hypothesis both in the common assumption of perfect rationality and in the failure of arbitrage to adjust prices correctly, and he detailed the empirical failings of the hypothesis.

In 2000, another year later, Matthew Rabin of the University of California at Berkeley won a MacArthur Foundation "genius" award, which included a \$500,000 grant, given annually to outstanding scientists, writers, and artists. And one year later again, in 2001, he received the John Bates Clark medal, with the American Economic Association noting: "Matthew Rabin is an outstanding and strikingly original theorist who has enriched economics by rigorously incorporating well-documented psychological evidence about human behavior into economic models" (Uchitelle 2001a). Rabin's contributions to behavioral economics involve digesting large amounts of nuanced psychology, creating simple models capturing that psychology, and doing behavioral economics with those models. He has become known especially for his work on reciprocity, "present-bias" in time discounting, judgment biases, overprojection of current feelings into the future, and how moral rules differ from moral tastes.

In 2001, the same year as Rabin's John Bates Clark medal, George Akerlof, Michael Spence, and Joseph Stiglitz shared the Nobel Prize "for their analyses of markets with asymmetric information." In his Nobel lecture titled "Behavioral Macroeconomics and Macroeconomic Behavior," Akerlof (2001) contended that behavioral phenomena such as reciprocity, fairness, identity, money illusion, loss aversion, herding, and procrastination explain poverty, unemployment, and the business cycle. Hence, he argued, macroeconomics must be based on behavioral economics. According to Louis Uchitelle (2001b) of the *New York Times*, Akerlof was doing some pioneering work in the field "more than 25 years ago, before behavioral economics had a name or critical mass."

Stepping forward yet another year, the 2002 Nobel Prize was shared by Daniel Kahneman of Princeton University "for having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty" and Vernon Smith of George Mason University "for having established laboratory experiments as a tool in empirical economic analysis, especially in the study of alternative market mechanisms." Kahneman, along with Amos Tversky, has used insights from psychology to demonstrate how human decisions may systematically depart from those predicted by standard economic theory and to formulate prospect theory as an **[End Page 736]** alternative. He has further analyzed how human judgment may take heuristic shortcuts that systematically depart from basic principles of probability. Vernon Smith has been instrumental in establishing experiments as a tool in empirical economic analysis by developing an array of experimental methods and by setting standards for what constitutes a reliable laboratory experiment in economics.

We will end our sketch of the increased attention for and recognition of behavioral economics yet one year

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Correspondence may be addressed to Esther-Mirjam Sent, Nijmegen School of Management, University of Nijmegen, P.O. Box 9108, 6500 HK Nijmegen, The Netherlands; e-mail: e.m.sent@fm.un.nl. I wish to thank Gregory Besharov, John Davis, Neil De Marchi, Crawford Goodwin, Shauna Saunders, Roy Weinstein, and participants at a Duke History of Political Economy workshop for their valuable feedback. I am grateful for the support received from the Netherlands Institute for Advanced Study in the Humanities and Social Sciences.

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