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Misbehaving: The Making of Behavioural Economics by Richard H. Thaler, 432 pp., W. W. Norton Company (2015), US$ 27.95

Economic agents, whose actions drive macroeconomic outcomes, are often assumed to be rational, but forecasting models, in the past, that did not question this assumption of rationality, failed to predict the Great Depression of 1929, Stagflation of the 1970s and, in more recent times, the dot-com bubble of the 1990s and the Great Financial Crisis of 2008. In his book, *Misbehaving: The Making of Behavioural Economics*, Richard H. Thaler demonstrates the limitations of traditional economic models that assume completely rational but imaginary 'econs', and offers a new perspective on the way actual humans behave or rather 'misbehave'. The first example he gives is of students in his microeconomics class who were angry on receiving a score of 72 out of 100 but were perfectly fine on getting a score of 96 out of 137. This is among the long list of anomalies that he provides in the book.

Thaler became the first economist to receive the well-deserved Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel, in 2017, for "contributions to behavioural economics".

As expected, the discovery of 'misbehaviour' by economic agents and the consequences of this 'misbehaviour' for existing economic models, resulted in resistance from traditional economists. One criticism, which can be attributed to Milton Friedman, was that people may not be explicitly optimising but they often behave 'as if' they are optimising. For example, an expert billiard's player, while making a shot, does not explicitly calculate the angles and speed required to make the pocket, but nevertheless does it implicitly. Other criticisms were that people will usually behave rationally in the real world as they are aware of facing higher risks associated with irrational actions. Hence, they are more likely to rectify any irrational behaviour through learning over time. The most recurring criticism was that competitive markets, guided by the 'invisible hand', would check any misbehaviour, which in turn will lead to maximisation of welfare. Unlike the treatment of the 'invisible hand' argument in *The Wealth of Nations*, Adam Smith's other book, *The Theory of Moral Sentiments*, highlighted how 'passion' could come into conflict with rationality and it thereby laid the foundation for a behavioural approach to

economics. A similar view was also adopted by John Keynes in his magnum opus *The General Theory of Employment, Interest and Money*, where he proposed investments to be driven by 'animal spirits' and not by mathematical optimisation. Yet the economists who followed Keynes, starting with Milton Friedman to Franco Modigliani and Robert Barro, assumed cleverer and more rational 'econs' who were extremely foresighted, well-versed with economic theory, completely rational and in perfect self-control, as opposed to investors who were driven by the Keynesian 'animal spirits'. Therefore, somewhere along the way, in a bid to add mathematical rigour to economic models, economics profession ignored human behaviour and transformed the subject of economics from a study of human behaviour to a study of mythical 'econs' who are completely rational, all-informative and free from all human biases.

A major part of the book focusses on how economic models, with humans back in the driving seat, should be formulated and analysed. Thaler discusses the prospect theory propounded by Daniel Kahneman and Amos Tversky, which was proposed as an alternative to the expected utility theory. It argues that people dislike losses more than they like gains though there is diminishing sensitivity to both gains and losses. The prospect theory has become a cornerstone of behavioural economics and has been instrumental in explaining many of the anomalies in traditional models.

The author combines insights from prospect theory with the way people frame choices to arrive at the phenomenon of 'myopic loss aversion', where they, in a bid to avoid short-term losses, do not undertake risk-rewarding options. This concept has been used to explain the equity premium puzzle, a phenomenon of anomalously higher historical returns on stocks over bonds. Myopic loss aversion can also be used to explain why people continue to invest in illiquid assets like real estate over more liquid assets available in financial markets, as the short-term losses in real estate are not easily perceptible and hence less painful than losses from investment in stocks.

Another example of how people tend to 'misbehave' is seen in the differential treatment of money that has been kept in real or mental baskets. One such partition that has been observed is the 'house money effect', where people partition their gains from their initial investment and are more willing to take risks on this house money. The 'house money', in combination with prospect theory, can be used to explain why business cycles get amplified.

During the boom period, people treat the existing excess gains as 'house money' and thus they take more risk-taking. Thus, investors buoyed by the initial high returns in the stock market in the 1990s and the housing market in the 2000s started taking riskier bets. On the other hand, during a downturn, when people are facing high losses, they are more likely to take more risky positions to balance off their earlier losses and thus avoid the pain associated with incurring a loss. This only leads to further losses, aggravating the crisis.

The slow resolution of non-performing assets under the Insolvency and Bankruptcy Code in India can also be attributed to what Thaler calls the 'endowment effect' and 'status quo bias', where people tend to overvalue the asset that they currently possess. Thus, the sellers of bad assets may often demand higher prices while the buyers may be willing to pay lower prices than what may be the true market price of an asset.

Thaler also discusses how people tend to view prices set by companies. People are more concerned whether a price seems fair than whether it is determined by a competitive interplay of demand and supply. People often enjoy what Thaler calls 'transactional utility', which is the difference between the prices they expect to pay and the price they end up paying. This concept is being effectively employed by retailers while announcing sales/discounts to increase the transaction utility of a customer and thereby drive up overall sales. Banks can also employ this to increase customer satisfaction, by declaring banking service charges upfront and offering better terms, if possible, later.

The latter part of the book is devoted to behavioural finance. Finance was thought to be the last domain to witness anomalies and misbehaviour, as the agents are expected to be highly rational and any misbehaviour is likely to be punished by highly competitive financial markets. Thaler, however, demonstrates that financial markets too misbehave often. He highlights, as an example, the wide fluctuation in stock prices on a daily basis, even in the absence of any underlying rationale.

In the final part of the book, Thaler discusses how behavioural economics is impacting policy-making, such as the 'Save More Tomorrow' program aimed at increasing savings for retirement and the work of the Behavioural Insights Team which is advising the U.K. government on designing policies.

Thaler makes a strong case for assigning greater importance to the behavioural approach in policymaking by respecting people's choices and emphasising the need to re-evaluate highly complex mathematical models built on the premise of sophisticated 'econs'.

In short, the book highlights that error-prone economic agents with certain biases could explain the failure of conventional economic models, but it does not elaborate on how the economic models should account for the 'misbehaving' agents. The book is an interesting read with thought-provoking real-life examples and personal experiences of the author. While reading through it, one is most likely to recognise one's own biases in behaviour in specific, real-life events of the past; however, one would also get a sense that all others around us are also subjected to rational 'misbehaviour'.

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