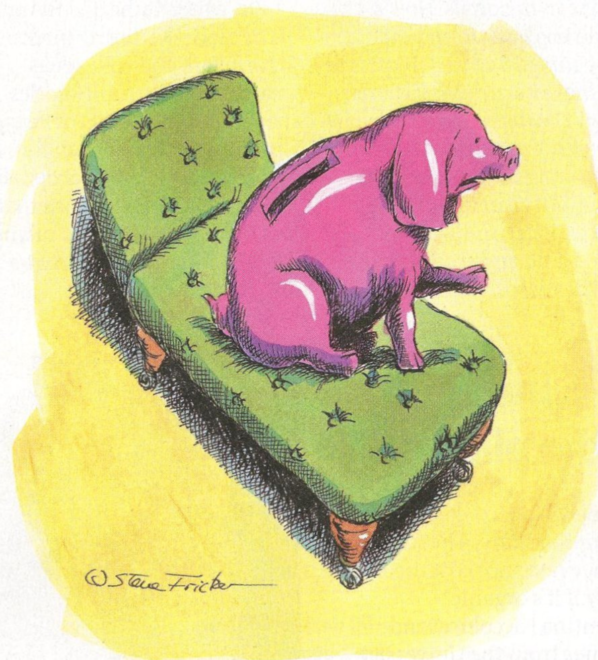
What me, irrational?

When people don't behave the way economic theory predicts, it's time for a serious rethink, says economist **Pete Lunn**

ONE year into the credit crisis, its effects are still reverberating around the world. The housing market has once again duped a generation and the prices of oil and food are breaking records like true Olympians. Why do these things happen?

Turning to an economics textbook for answers would be largely a waste of time. Dive into the dense pages of equations and diagrams and you will discover that economics students are still taught to start with the unquestioned assumption that people and companies are rational, selfish, independent economic agents. These are the core propositions of orthodox or "neoclassical" economics. Yet each of them is now refuted by a body of scientific evidence.



The techniques of experimental psychology combined with economic fieldwork have repeatedly shown that people's basic economic instincts are at odds with the assumptions of orthodox economics. For a start, hundreds of empirical studies have confirmed that economic behaviour fails to conform with what economists define as rational.

Here's an example. Experiments show that we value something we own more than something we don't, even when it is the same object. In other words, we dislike parting with things, and this dislike is reflected in prices we are prepared to pay and to accept. This aversion makes people unwilling to sell houses when prices are falling, influences traders' share portfolios, and explains why consumers react more strongly to price increases than to equivalent cuts.

There is also overwhelming evidence, again from lab and field, that selfishness can be trumped by willingness to cooperate for mutual benefit. Try it for yourself. Imagine that I give you £10 and offer the following opportunity. You can simply keep it, or donate some to an anonymous stranger. I will treble what you give, before allowing the stranger either to return some of the resulting sum or walk away. How much of your £10 would you give? Or if you were in the stranger's position and someone gave you all of their £10, which I trebled, how much of the £30 would you return?

This is called the "trust game". If people were selfish, no money would change hands. But when it is played for real, most people hand money to the anonymous stranger and their trust is usually rewarded with a return donation that splits the proceeds.

In functioning market economies, unselfish cooperation like this sustains relationships between businesses and their customers, cements teamwork in organisations, and explains why we tip waiters in places we will never visit again. We could selfishly not bother, but we are all better off because we do.

> "We value things we own more than things we don't – even if they are exactly the same"

People's economic behaviour is not independent either. One person's valuation of something influences others' – whether among professional traders or consumers telling each other about good value. The origins of the credit crisis offer a perfect example. The financiers who devised the sub-prime mortgage market used a technique for balancing risk that involved tricky mathematics. Supposedly expert traders didn't really grasp it, operating instead on the principle that if such clever people considered these assets to be valuable, then valuable they were.

The evidence tells us, therefore, that people are neither rational, selfish nor independent economic agents. So what should replace these core propositions of neoclassical economics? Though the answer is some way off, we are starting to see the outline of an economic theory more in line with people's behaviour.

Evolutionary psychology might shed some light on the problem. Humans have traded objects and favours long enough for evolutionary forces to matter. The conceptual leap is to ask not just how people behave, but why. Many troublesome behavioural results are particularly striking when people are exposed to uncertainty. Might such behaviours be understood as adaptations to the uncertainty inherent in exchanging things?

For instance, the more uncertain we are about the value of objects we exchange, the more it may make sense to value what is already ours more highly; familiarity makes us more sure of its worth. Similarly, when facing uncertain exchanges, unselfish mutual cooperation and co-dependency may bring higher returns to generous, socially perceptive economic agents than myopic calculation can bring to selfish ones.

From time to time all scientific disciplines encounter observations that do not fit the theories of the day. At first they are treated as curious anomalies, but those scientists willing to face up to them can discover they have to abandon cherished principles.

The pressure to publish does not favour those who take the time to think radically, especially if they come up against referees who may not. But if economics can forge a new framework that truly pits theory against observation, perhaps it will finally enjoy undisputed scientific credentials. ●

Pete Lunn is an economist at the Economic and Social Research Institute in Dublin, Ireland, and author of *Basic Instincts: Human nature and the new economics* (Marshall Cavendish, 2008)