

Kiel Institute for the World Economy



Rationality, Morals and Ethics in Economics (8-12 October 2018)

**Professor Sanjit Dhami
University of Leicester**

INTRODUCTION

1.1 Neoclassical economics and behavioral economics

The neoclassical framework in economics provides a coherent and internally consistent body of theory that offers rigorous, parsimonious, and falsifiable models of human behavior. Augmented with auxiliary assumptions, it is flexible enough to analyze a wide range of phenomena.

In actual practice, the neoclassical framework includes, but is not restricted exclusively to, consistent preferences, subjective expected utility, Bayes' rule to update probabilities, self-regarding preferences, emotionless deliberation, exponential discounting, unlimited cognitive abilities, unlimited attention, unlimited willpower, and frame and context independence of preferences. Neoclassical economics is also typically underpinned by optimization-based solution methods, an equilibrium approach, and the use of Nash equilibrium and its refinements in solving problems in strategic interaction. We may term the fictional analogues of humans in the neoclassical model as *homo-economicus* (or just ECONs for short).

Neoclassical economics is a logically consistent and parsimonious framework that is based on a relatively small set of core assumptions, and it offers clear, testable, predictions. However, extensive empirical evidence that has accumulated over the last few decades reveals human behavior that is inconsistent with the typical neoclassical models.

There has been a parallel growth in rigorous theoretical models that explain better the emerging stylized facts on human behavior. These models have borrowed insights from psychology, sociology, anthropology, neuroscience, and sociobiology. Yet, these models maintain a distinct economic identity in terms of their approach, rigor, and parsimony. Collectively, these models form the subject matter of *behavioral economics*, which is possibly the fastest growing and most promising area in economics.

Any falsifiable theory that replaces/modifies any of the core features of neoclassical economics, by alternatives that have a better empirical foundation in human behavior is a potential member of the class of behavioral economic theories, if it can pass stringent empirical tests.

This course examines the following main aspects of neoclassical economics that underpin all predictions that it makes.

1.2 Morals and Ethics in economics

ECONs in neoclassical economics are assumed to be amoral and entirely self-regarding, devoid of any intrinsic morality, or any desire to behave in an ethical manner. ECONs do not exhibit an intrinsic preference for honesty; truth-telling; keeping promises; trusting others and being trustworthy; reciprocating kind and unkind behavior of others; and caring about the fairness of procedures. ECONs also have no feelings of remorse or guilt from letting down the expectations of others. ECONs strive solely to maximize their own material well-being (self-regarding preferences) without regard to the well-being of others, i.e., they lack other-regarding preferences.

To be sure, neoclassical economics can be amended to include some forms of other-regarding preferences, such as "keeping up with the Joneses" or engaging in "snob or conspicuous consumption". However, these features play, at best, a peripheral role in the actual practice of neoclassical economics, which is the benchmark that we are interested in.

Contemporary economics focusses, almost exclusively, on the behavior of ECONs. The validity of this model is often taken as an article of faith among economists, which is likely to be surprising to other social scientists. However, when pressed, many economists are likely to express the view that they do not believe in the 'literal truth' of such a model, but that such a model provides a 'good approximation' to the real world. However, the 'good approximation' part is never formally demonstrated.

Several decades of research in behavioral economics have shown that if the aim is to better explain and understand human behavior, then *homo-behavioralis*, the fictional model of humans in behavioral economics, is a superior candidate to replace *homo-economicus*. *Homo-behavioralis* cares for material interests and for extrinsic incentives (just like *homo-economicus*), but it also exhibits a strong sense of morality, considers the ethicality of alternative options, responds to intrinsic incentives, and is conditionally reciprocal. *Homo-behavioralis* has been central to the development of behavioral and experimental economics. We consider two kinds of evidence here. First, and briefly, evidence on social preferences. Second, and in more detail, evidence on lying behavior and the interaction between markets and ethicality.

1.3 Nature of Rationality in economics

In common discourse and in the other social sciences, rationality often means something completely different to what economists have in mind. Thus, in order to facilitate conversation with economists, we need to first understand what they mean by the term. It turns out that economists use rationality in several senses, depending on the underlying model/situation that they are interested in. For instance, the axioms of rationality in decision making under risk/uncertainty are different from those under time discounting.

Furthermore, there is a great deal of confusion even among professional economists about what exactly rationality means. Does it, for instance, mean that people should have purely self-regarding preferences (i.e., care only about themselves)? Or does it mean that they must always optimize?

One cannot evaluate the usage of rationality by economists purely in terms of its logical or philosophical merit. In science, we judge theories by the relevant empirical evidence. This is how we intend to do proceed.

1.4 Optimization or heuristics?

Many economists (incorrectly) identify rationality with mathematical optimization and appear to believe that in the absence of optimization, economics will have very few predictions. However, there is a well-developed research program, the heuristics and biases research program, of Daniel Kahneman and Amos Tversky that shows how people make fast and frugal decisions (in terms of time and information required).

The heuristics and biases research program establishes that people do not behave in a manner that would make their behavior consistent with neoclassical theory even on “as if” grounds. I shall cover several judgement heuristics. Many biases arise from the tendency to believe that small samples possess the statistical properties of large samples. This gives rise to the law of small numbers, which is the basis of the representativeness heuristic, the gambler's fallacy, and the hot hands fallacy. Other heuristics do not necessarily invoke the law of small numbers. The conjunction fallacy arises from inadequate attention to the set inclusion relation; the availability heuristic arises from drawing inferences based on readily available information; the affect heuristic arises from attention to the emotional dimension of a decision; the anchoring heuristic arises from tying one's inferences to anchors that are often irrelevant to the problem; base rate underweighting arises from giving inadequate attention to the base rate in Bayes' rule; conservatism arising from underweighting the likelihood of a sample; hindsight-bias arises from discrepancies between predictive and postdictive guesses; confirmation-bias arises from selective attention to events that is biased towards confirming one's initially held position; false consensus arises when people overestimate the extent to which others share their beliefs. Biases also arise from ignoring statistical phenomena such as regression to the mean and the distinction between necessary and sufficient conditions.

In addition, we have the research program associated with Gerd Gigerenzer. We outline the various heuristics that people use in this program, and the debate between the Kahneman-Tversky and Gigerenzer approaches to heuristics.

2. READINGS

2.1 Core Readings

- Sanjit Dhami (2016). Foundations of behavioral economic analysis. Oxford University Press. [Note: You will only need to read selected sections from Parts 1-3 and 7 that I will point out]
- Sanjit Dhami and Ali al-Nowaihi (2018) Human Ethicality: Evidence and Insights from Behavioral Economics. Forthcoming in Handbook of Ethics and Economics. Oxford University Press: Oxford. [Note: I will use the longer version of this article]

that can be freely downloaded: Sanjit Dhami (2017) Human Ethics and Virtues: Rethinking the Homo-Economicus Model. CESifo Working Paper No. 6836.]

- Sanjit Dhami and Ali al-Nowaihi (2018) Behavioral economics and rationality. Forthcoming in Handbook of Rationality. MIT Press: Massachusetts. [Note: I will use the following freely downloadable version of the article: Sanjit Dhami (2018). Rationality in Economics: Theory and Evidence. CESifo Working Paper No. 6872].
- Sanjit Dhami, Cass Sunstein, and Ali al-Nowaihi (2018) Heuristics: Decision making under bounded rationality. [Note: I anticipate a working paper version of this article to be available by the time your course begins].

Note: Many of the references listed at the end of each of the four core papers are of great importance to this course. I shall flag up the most important ones during the lectures.