Behavioral Economics v. Traditional Economics: What is the Difference?

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New York Times best-selling books like *Nudge* and *The Undoing Project* have brought the subject of behavioral economics to the forefront of popular discussion and debate. However, as this subject has infiltrated our popular culture, a few misconceptions have begun to be propagated.

A big misconception is that behavioral economics is about controlling people’s behavior, but it is not. Behavioral economics is about understanding common decision mistakes that people make and why they make them. In particular, a large aspect of behavioral economics is concerned with the gap between intention and action. For example, your client may intend to save a lot for retirement, but things happen and your client never gets around to taking action.

Another big misconception is that behavioral economics is about irrationality. This misconception stems from the fact that traditional economic theory assumes all people are rational, while behavioral economics does not make this assumption. Acknowledging that people are not always fully rational does not mean that they are irrational or crazy. It just means that people make systematic mistakes and that they do not always make choices that consistently maximize their own happiness or success.

Traditional economic theory is predicated on three fundamental assumptions: 1) all people are rational, 2) individual choices are consistent with expected utility theory, and 3) people correctly update their opinions and beliefs based upon new information that is received. However, these assumptions do not always hold in the real world. In a seminal paper, Kahneman and Tversky (1979) lay the foundation for behavioral economics by proffering that psychological phenomena affect decision-making and must be incorporated in economic and financial models. Specifically, psychological phenomena like biases, heuristics, and framing effects should be incorporated into these models. Two of the foundational principles of behavioral economics are: 1) people make systematic mistakes due to psychological blinds spots that most people have, and 2) the context in which a decisions is made has an enormous effect on the decision.

**Biases (Decision-Making Blind Spots)**

A good example of a bias that affects financial decisions is overconfidence. Overconfidence is not a rational behavior. Overconfidence is a situation in which people
believe that they are better in terms of skill or ability than they actually are. It is not saying that they are bad at something; it is just that they overestimate their abilities. For example, if you take any room of adults and ask individuals to raise their hand if they are an above average driver, almost everyone will raise their hand. Similarly, each semester when I anonymously survey my behavioral finance class of students and ask them who believes that they are of above average intelligence relative to the group of students in the class, over 90% of them say they are when in fact only 50% of them can be above average.

Overconfidence has been shown to influence decisions that are more significant than assessments of driving or intelligence. Barber and Odean (2001) propose that overconfidence influences trading and investment behavior in a way that causes monetary losses. They find that overconfident men think that they know more about financial markets than they actually do. Consequently, they churn their investment portfolios more than women, and as a result earn lower overall returns after trading commissions and fees are taken into account.

**Context and Framing**
With regard to the importance of framing, suppose the S&P 500 is currently at the 2,200 level and consider two different market scenarios:

(1) The market surges up by 25% over the next year to get to 2,750 before falling by 40%.
(2) The market is stagnant for the next year and then falls 25%.

**Which scenario is worse for your client? Which scenario would your client prefer?**

In fact, both scenarios end up with the same exact result for your client. However, the first scenario would probably be considered more painful by your clients because it was framed in terms of your client experiencing gains that do not get locked in and then your client experiencing a huge loss. In the second scenario, there is a much smaller market correction, so your client experiences less of a loss. In both scenarios, the S&P 500 ends up at 1,650. However, the different manner in which the scenarios are framed can influence how your client would feel about the situation.

**Key Take-Aways**
- Behavioral economics differs from traditional economics by incorporating insights from psychology. By combining concepts from these two different disciplines, we can obtain a more realistic picture of what people actually do.
- Behavioral economics takes into consideration that people make systematic mistakes due to psychological blinds spots that most people have.
Behavioral economics assumes that the context in which a decision is made has an enormous effect on the decision or preference.

References