

THE RELATIONSHIP BETWEEN BEHAVIOURAL AND NEOCLASSICAL ECONOMICS

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Abstract: *The purpose of this article is to analyze the relationship between the discipline of Behavioural Economics and the Neoclassical School. On the basis of the available literature, the paper aims to investigate if the two branches are totally opposite, or if the behavioural theories only extend and complement the mainstream economics.*

Keywords: behavioural economics; mainstream economics; economic behaviour.

JEL Classification: D01; D03.

INTRODUCTION

One of the object of the study of economics is the behaviour of the complex human beings; this science examines how people choose to act and to allocate resources in different market situations. The neoclassical approach, which dominates so far the economic analysis, is based on the implications that arise from a series of simple assumptions (which are sometimes cited as unrealistic) regarding the human nature. In this vision, the individual is characterized by unlimited rationality and by the ability to follow time consistent, in every situation, his self-interest. However, in the last decades, the standard neoclassical model, based on the maximization of the expected utility, has become the subject of intense debates and criticism. Although, throughout history there have been many eminent figures that advocated for a greater adequacy of the neoclassical model of *homo oeconomicus* and its assumptions to practice, recently, due to the global economic crisis of 2007, this aspect has become a primary goal in economics. In these conditions, behavioural economics attempts to consider a broader field of analysis in the study of economic phenomena. Although, its name seems to be a pleonasm (because, as it has been noted, economics deals with the study of human behaviour on the market), it highlights the human character of the science and the fact that, besides of all the patterns and models, the analysis refers to the real individual. It is also behavioural because it attempts to combine approaches from several sciences, mainly

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from economics and psychology, and also from sociology, philosophy, anthropology or biology. This is not an easy mission, in the conditions in which these various disciplines have adopted in time different approaches that became, in many ways, contradictory. The essential philosophy of the field of behavioural economics is that a multidisciplinary approach will increase the explanatory power of economics.

1. ARE NEOCLASSICAL AND BEHAVIOURAL ECONOMICS OPPOSITE?

The available literature on behavioural economics is not uniform and there are some divergent points relative to its relation with mainstream economics. If, on one hand, there are specialists who argue that behavioural economics is a field of economics that continues the neoclassical approach, on the other hand, there are others who see it as a distinctive school of thought, which proposes a new paradigm. At a first glance, behavioural economists seem to depart almost completely from the neoclassical vision. They propose a multidisciplinary study, criticize certain assumptions on which the traditional model is built (such as rationality and self-interest, in their unlimited form), recourse to experiments (the classical method of psychology) to validate some assumptions, propose new theories (such as the prospect theory) and advance different interpretations of the economic behaviour (e.g. Simon argues that rather than to maximize consumers satisfy their needs). For example, Thaler (1980, p 39) argues that the prospect theory – one of the fundamental pillars of this new research programme – can represent the basis for an alternative which describes how individuals actually behave on the market, unlike the standard view which is both positive and normative.

Although behavioural economics is often cited as revolutionary when opposed to neoclassicism, many of the behavioural economists remain in fact on the neoclassical pathway regarding the utility functions. They do not leave this pathway, but reshape it and try to improve it. Rabin states, for example, that the empirical content of behavioural economics can help the economic science by describing more realistically the utility functions of the individuals. This field of study is based not on a paradigm shift, but rather it is a natural extension of the basic approach. In this respect, the author argues that “this research program is not only built on the premise that mainstream economic methods are great, but also that most mainstream economic assumptions are great” (Rabin, 2002, p. 659). However, complementary,

it can be claimed that behavioural economics is also built on the premise that psychology methods and assumptions are equally important. The author argues that because of the human nature the preferences do not remain stable, but are inconsistent in time, or, in his own words, that “we are highly attuned to changes in our circumstances, not merely the absolute levels” (Rabin, 2002, p. 659). The models of behavioural economics, allow the utility to depend on the differences between one’s own level and a reference level. People are sensitive to changes and preferences are not stable in time. The vision of behavioural economics concerning the inter-temporal choice (which assumes that individuals prefer immediate gains and delay unpleasant activities) seems to be more appropriate to the human behaviour than the one of the traditional model (which assumes that utility is updated exponentially over time). Also, the assumption of the self-interest was promoted unrealistically by the neoclassical economists in its unlimited (100%) form. Many studies conducted in the behavioural economic area have shown that, in some situation, individuals also care about others.

In the same direction as Rabin, Berg states that this research programme seeks to improve and adapt to reality the neoclassic utility functions, by adding new parameters and arguments (Berg, 2010, p. 870). For example, through *the prospect theory*, behavioural economics adds new parameters to improve the mathematical modelling method, which was advanced by the neoclassical economists for decisions taken under uncertainty. However, the theory also proposes a slightly different interpretation. The results are here interpreted by the individual as positive or negative deviations from a reference point, which has a neutral psychological value. In this case, the term utility is substituted with the one of value (the utility function becomes the value function). Furthermore, the utility of an outcome does not depend on absolute wealth (like in the neoclassical theory), but it is interpreted as a gain or a loss. Further, the behavioural patterns involved in the inter-temporal choice are based on time inconsistency. That is why the economists add a series of discounting parameters in the non-exponential scheme. These parameters are based on the assumption of maximizing a utility function separable in time and on the fact that, opposed to the mainstream view, preferences are not stable in time and can be reversed. Last but not least, in addressing social preferences, behavioural economics adds parameters that increase the concern of decision-makers to also assess their utility function in relation to others.

When science is in crisis, according to Kuhn, a new paradigm can be created. Is this the case of behavioural economics? Even if one would consider this possibility, the main difficulties encountered so far, according to Etzioni (2010, p. 53), are: firstly, there are too many variables established as being

involved in the choice theory*; secondly, there is not a common consensus between the specialists of behavioural economics regarding the variables that should be included; and, finally, many variables that affect the behaviour are not quantitative, but qualitative, and cannot be precisely measured. The findings of behavioural economics are relevant and can help the mainstream theory by providing a more realistically base of study. But in the same time the findings are not yet cursive and integrated into a general design. Moreover, although the goal of Thales's essays was to reveal the anomalies and the paradoxes of the mainstream theory, process which according to Kuhn (1970, p. 52) is an important step towards a paradigm shift, lately this direction has been largely abandoned. This argument has contributed to the development of behavioural economics, because that there are a large number of empirical phenomena that cannot be entirely explained by the mainstream economics. However, the scholars of this emerging field are confident. At the beginning of their essay, for example, Camerer and Loewenstein argue that behavioural economics does not imply the totally exclusion of the neoclassical approach and that most studies in this area try to provide a more realistic base of the standard theory. In the concluding remarks of the same article, the authors stress out their belief that, in time, behavioural economics models will replace the simplified ones, based on unlimited rationality (Camerer și Loewenstein, 2004, pp. 3, 42). In the last period, economists have provided a great importance to the quantitative structures, departing from the human nature. However, behavioural economics can become truly revolutionary only if its scholars will always be receptive and will provide a critical insight to their own theories and perspectives, and especially the ones regarding the aspects that they reproach to the traditional economic theory.

* The neoclassical approach argues that the individual's behaviour on the market is determined only by economic factors. In brief, individual choices and, by this, the demand variation are explained only by the variations in the prices of goods / services and the available personal income. An important discussion in the field of behavioural economics is whether only these factors determine directly the economic behaviour of an individual. The specialists argue that it's possible that some influences which hitherto were considered as indirect (like the sociological and psychological factors) are actually active elements in the process of decision making. This assumption is very important because it can determine the reshaping of the utility functions. For example, as Loewenstein (2000) demonstrates, if we accept the Simon bounded rationality, than the emotions (or visceral factors) influence the individual behaviour on the market and can be considered in the utility functions.

CONCLUSIONS

The purpose of economics is to understand and explain as well as possible the conduct of the market phenomena, as it occurs in reality. In this sense, the research of behavioural economics aims to see how the neoclassical model could be improved, using mainly psychology concepts. Although, there are some specialists who argue that behavioural economics can be an alternative to the neoclassical theory, most of the facts seem to reinforce Rabin's belief that this discipline is rather an extension and an addendum to the theories of mainstream economics.

Most findings, of the studies conducted in this field, modify some of the standard economical assumptions, in order to provide a greater psychological realism. These results are not radical and they complement and expand the neoclassical analysis, rather than to replace it. The additions proposed by behavioural economists simply recognize the human limitations on (mentally) calculations, will and self-interest. These additions underline the individual's bounded rationality, in the words of Herbert Simon. For example, it was demonstrated that people often choose heuristics to solve their problems (which in present have become so complex that sometimes cannot be solved exactly even with the help of modern technique), instead of rationality.

Generally, Kuhn describes how traditional theories develop from a so called pseudo-scientific status to a normal one. In this process, the crisis generates new issues that have the potential to evolve. And even if this will not be the case of behavioural economics, scientists are interested in studying and deepening their knowledge by including new directions in order to improve (or to reinforce) the standard assumptions. In conclusion although the proposed analysis uses some different tools and techniques, behavioural economics is not a revolutionary change of the core of the neoclassical program. It rather seems that the changes proposed by it provide a strong support in the expansion and adjustment of the standard theory. The purpose of economics is to better understand and explain the conduct of the economic activities as they occur in reality. The human being is complex and its behaviour and constitution is studied by all the social sciences. Consequently, multi and interdisciplinary approaches can bring real benefits to the economic science, by providing a more realist foundation. Although, remarkable perspectives have been achieved, behavioural economics is still a rising field.

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