Are we rational after all?

Every thinker so far assumed that people weigh costs and gains. Two psychologists tested it in 1979; an economist used what they found to help people save; a political scientist showed how villages run what they share.

1 The question

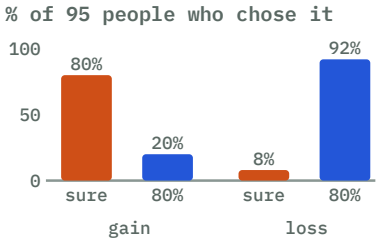
calculator or person?

- Do people weigh costs and gains like a calculator (Smith, Friedman, Hayek: Lessons 1, 6, 7)? · **expected value** = the average result of a bet if you could repeat it many times · `80% of $4,000 = 0.8 × 4,000 = $3,200` · **behavioral economics** = economics that tests how people really choose

2 Two bets

what people chose, 1979

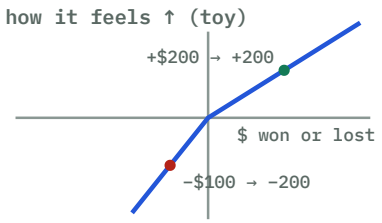
- **Gain:** sure **$3,000** or 80% of $4,000 (average **$3,200**) → calculator gambles · **80%** of 95 people took the sure gain · Econometrica, 1979 (Israeli pounds)
- **Loss:** sure loss of $3,000 or 80% of losing $4,000 (average −$3,200) → calculator takes the sure loss · **92%** gambled → people: the opposite, twice · a pattern, not a slip
- Practice: sure $500 or a coin flip for $1,200 → `0.5 × 1,200 = $600` → calculator flips · as losses → it takes the sure −$500



3 Kahneman, Tversky

prospect theory

- **Daniel Kahneman** · Israeli-American psychologist · `1934–2024` · Nobel **2002** · with **Amos Tversky** · Israeli · `1937–1996` · "Prospect Theory", **1979**
- **Prospect theory** = a result is judged as a gain or a loss from where you stand, not by the final total
- **Loss aversion** = a loss feels bigger than an equal gain, about **×2** · −$100 feels like −200 → needs +$200 to balance · sure gain → keep it · sure loss → gamble to escape it · "losses loom larger (= look bigger) than gains"
- Practice: losing $150 feels −300 → even only at a win of **$300** · win $200: average `(200 − 150) ÷ 2 = +$25`, still refused (−300 > +200)



4 The mugs

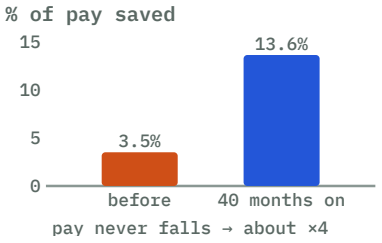
owning raises value

- Kahneman, economist Jack Knetsch, Thaler · Journal of Political Economy (journal), **1990** · mugs given **by chance** → owners asked about **twice** what buyers offered · Coralia: **$6** vs **$3** · **Endowment effect** = people value a thing more once they own it: giving it up feels like a loss · a saver keeps a fallen share · free returns: people keep what they would not buy

5 Thaler, the nudge

save out of raises

- **Richard Thaler** · American economist, Chicago · born `1945` · Nobel **2017** · **Save More Tomorrow** (with economist Shlomo Benartzi, **2004**) → agree now, each increase taken from a future raise → pay never falls, no loss to feel · first company: **3.5% → 13.6%** of pay in **40 months** (a little over 3 years) · `3.5 × 4 = 14` → about ×4 · joining = each saver's choice
- **Nudge** = a change in how a choice is presented that steers people without forbidding anything (Nudge, 2008, Thaler + law professor Cass Sunstein)
- Practice, Mia: $1,000, saves 5% = $50, home $950 → raise to $1,100, saves 10% = **$110**, home **$990** (+$40) · 10% today → home $900 (−$50: a loss)
- FOR helps people do what they say they want, every option open · AGAINST who sets the **default** (= the option if you do nothing)? should states steer? · **argued**



6 Ostrom, so what

the commons, the verdict

- **Elinor Ostrom** · American political scientist, Indiana · `1933–2012` · Governing the Commons, **1990** · Nobel **2009** (with Oliver Williamson), the first woman · **commons** = a resource many use and none owns alone (meadow, fishery; Games 6)
- Neither state nor market: villages kept meadows, forests, irrigation (water channels) for generations · **Törbel** (Swiss Alps): cows on the shared meadow ≤ cows a household can feed through the winter · users make and police the rules · conditions → clear limits, watchers, fines that start small · works only when they hold
- **So what** → rational = an **approximation**: often close, off in known ways · design matters (the default, the wording) · **not**: people are foolish, a planner chooses better (planners are people too, Lesson 8) · **survived** → loss aversion, endowment effect, defaults, Ostrom's conditions · **argued** → do lab results carry to markets? how far to nudge?
- **Timeline of ideas** · 1776 · Smith · prices coordinate strangers → 1798–1817 · Malthus, Ricardo · land is limited → 1867 · Marx · profit from unpaid work (he said) → 1871–90 · Jevons, Menger, Walras, Marshall · the last unit → 1936 · Keynes · spending decides output → 1945 · Hayek · prices carry knowledge → 1963–1968 · Friedman · more money, higher prices, in the long run → 1957–86 · Downs, Olson, Buchanan · governments are people too → **1979–2009 · Kahneman, Thaler, Ostrom · people are predictably not rational; groups can govern themselves**

Watch out: "not always rational" ≠ "foolish" · a calculator gambles on the **gain**, takes the sure **loss** (people: the opposite) · a nudge forbids nothing: a ban or a tax is not a nudge · a commons survives only when the conditions hold