Economics - Psychology's Neglected Branch

By Sam Vaknin

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"It is impossible to describe any human action if one does not refer to the meaning the actor sees in the stimulus as well as in the end his response is aiming at." Ludwig von Mises

Economics - to the great dismay of economists - is merely a branch of psychology. It deals with individual behaviour and with mass behaviour. Many of its practitioners sought to disguise its nature as a social science by applying complex mathematics where common sense and direct experimentation would have yielded far better results.

The outcome has been an embarrassing divorce between economic theory and its subjects.

The economic actor is assumed to be constantly engaged in the rational pursuit of self interest. This is not a realistic model - merely a useful approximation. According to this latter day - rational - version of the dismal science, people refrain from repeating their mistakes systematically. They seek to optimize their preferences. Altruism can be such a preference, as well.

Still, many people are non-rational or only nearly rational in certain situations. And the definition of "self-interest" as the pursuit of the fulfillment of preferences is a tautology.

The theory fails to predict important phenomena such as "strong reciprocity" - the propensity to "irrationally" sacrifice resources to reward forthcoming collaborators and punish free-riders. It even fails to account for simpler forms of apparent selflessness, such as reciprocal altruism (motivated by hopes of reciprocal benevolent treatment in the future).

Even the authoritative and mainstream 1995 "Handbook of Experimental Economics", by John Hagel and Alvin Roth (eds.) admits that people do not behave in accordance with the predictions of basic economic theories, such as the standard theory of utility and the theory of general equilibrium. Irritatingly for economists, people change their preferences mysteriously and irrationally. This is called "preference reversals".

Moreover, people's preferences, as evidenced by their choices and decisions in carefully controlled experiments, are inconsistent. They tend to lose control of their actions or procrastinate because they place greater importance (i.e., greater "weight")

on the present and the near future than on the far future. This makes most people both irrational and unpredictable.

Either one cannot design an experiment to rigorously and validly test theorems and conjectures in economics - or something is very flawed with the intellectual pillars and models of this field.

Neo-classical economics has failed on several fronts simultaneously. This multiple failure led to despair and the re-examination of basic precepts and tenets.

Consider this sample of outstanding issues:

Unlike other economic actors and agents, governments are accorded a special status and receive special treatment in economic theory. Government is alternately cast as a saint, seeking to selflessly maximize social welfare - or as the villain, seeking to perpetuate and increase its power ruthlessly, as per public choice theories.

Both views are caricatures of reality. Governments indeed seek to perpetuate their clout and increase it - but they do so mostly in order to redistribute income and rarely for self-enrichment.

Economics also failed until recently to account for the role of innovation in growth and development. The discipline often ignored the specific nature of knowledge industries (where returns increase rather than diminish and network effects prevail). Thus, current economic thinking is woefully inadequate to deal with information monopolies (such as Microsoft), path dependence, and pervasive externalities.

Classic cost/benefit analyses fail to tackle very long term investment horizons (i.e., periods). Their underlying assumption - the opportunity cost of delayed consumption - fails when applied beyond the investor's useful economic life expectancy. People care less about their grandchildren's future than about their own. This is because predictions concerned with the far future are highly uncertain and investors refuse to base current decisions on fuzzy "what ifs".

This is a problem because many current investments, such as the fight against global warming, are likely to yield results only decades hence. There is no effective method of cost/benefit analysis applicable to such time horizons.

How are consumer choices influenced by advertising and by pricing? No one seems to have a clear answer. Advertising is concerned with the dissemination of information. Yet it is also a signal sent to consumers that a certain product is useful and qualitative and that the advertiser's stability, longevity, and profitability are secure. Advertising communicates a long term commitment to a winning product by a firm with deep pockets. This is why patrons react to the level of visual exposure to advertising - regardless of its content.

Humans may be too multi-dimensional and hyper-complex to be usefully captured by econometric models. These either lack predictive powers or lapse into logical fallacies, such as the "omitted variable bias" or "reverse causality". The former is concerned with

important variables unaccounted for - the latter with reciprocal causation, when every cause is also caused by its own effect.

These are symptoms of an all-pervasive malaise. Economists are simply not sure what precisely constitutes their subject matter. Is economics about the construction and testing of models in accordance with certain basic assumptions? Or should it revolve around the mining of data for emerging patterns, rules, and "laws"?

On the one hand, patterns based on limited - or, worse, non-recurrent - sets of data form a questionable foundation for any kind of "science". On the other hand, models based on assumptions are also in doubt because they are bound to be replaced by new models with new, hopefully improved, assumptions.

One way around this apparent quagmire is to put human cognition (i.e., psychology) at the heart of economics. Assuming that being human is an immutable and knowable constant - it should be amenable to scientific treatment. "Prospect theory", "bounded rationality theories", and the study of "hindsight bias" as well as other cognitive deficiencies are the outcomes of this approach.

To qualify as science, economic theory must satisfy the following cumulative conditions:

All-inclusiveness (anamnetic) – It must encompass, integrate, and incorporate all the facts known about economic behaviour.

Coherence – It must be chronological, structured and causal. It must explain, for instance, why a certain economic policy leads to specific economic outcomes - and why.

Consistency – It must be self-consistent. Its sub-"units" cannot contradict one another or go against the grain of the main "theory". It must also be consistent with the observed phenomena, both those related to economics and those pertaining to non-economic human behaviour. It must adequately cope with irrationality and cognitive deficits.

Logical compatibility – It must not violate the laws of its internal logic and the rules of logic "out there", in the real world.

Insightfulness – It must cast the familiar in a new light, mine patterns and rules from big bodies of data ("data mining"). Its insights must be the inevitable conclusion of the logic, the language, and the evolution of the theory.

Aesthetic – Economic theory must be both plausible and "right", beautiful (aesthetic), not cumbersome, not awkward, not discontinuous, smooth, and so on.

Parsimony – The theory must employ a minimum number of assumptions and entities to explain the maximum number of observed economic behaviours.

Explanatory Powers – It must explain the behaviour of economic actors, their decisions, and why economic events develop the way they do.

Predictive (prognostic) Powers – Economic theory must be able to predict future economic events and trends as well as the future behaviour of economic actors.

Prescriptive Powers – The theory must yield policy prescriptions, much like physics yields technology. Economists must develop "economic technology" - a set of tools, blueprints, rules of thumb, and mechanisms with the power to change the " economic world".

Imposing – It must be regarded by society as the preferable and guiding organizing principle in the economic sphere of human behaviour.

Elasticity – Economic theory must possess the intrinsic abilities to self organize, reorganize, give room to emerging order, accommodate new data comfortably, and avoid rigid reactions to attacks from within and from without.

Many current economic theories do not meet these cumulative criteria and are, thus, merely glorified narratives.

But meeting the above conditions is not enough. Scientific theories must also pass the crucial hurdles of testability, verifiability, refutability, falsifiability, and repeatability. Yet, many economists go as far as to argue that no experiments can be designed to test the statements of economic theories.

It is difficult - perhaps impossible - to test hypotheses in economics for four reasons.

Ethical – Experiments would have to involve human subjects, ignorant of the reasons for the experiments and their aims. Sometimes even the very existence of an experiment will have to remain a secret (as with double blind experiments). Some experiments may involve unpleasant experiences. This is ethically unacceptable.

Design Problems - The design of experiments in economics is awkward and difficult. Mistakes are often inevitable, however careful and meticulous the designer of the experiment is.

The Psychological Uncertainty Principle – The current mental state of a human subject can be (theoretically) fully known. But the passage of time and, sometimes, the experiment itself, influence the subject and alter his or her mental state - a problem known in economic literature as "time inconsistencies". The very processes of measurement and observation influence the subject and change it.

Uniqueness – Experiments in economics, therefore, tend to be unique. They cannot be repeated even when the SAME subjects are involved, simply because no human subject remains the same for long. Repeating the experiments with other subjects casts in doubt the scientific value of the results.

The undergeneration of testable hypotheses – Economic theories do not generate a sufficient number of hypotheses, which can be subjected to scientific testing. This has to do with the fabulous (i.e., storytelling) nature of the discipline.

In a way, economics has an affinity with some private languages. It is a form of art and, as such, it is self-sufficient and self-contained. If certain structural, internal constraints and requirements are met – a statement in economics is deemed to be true even if it does not satisfy external (scientific) requirements. Thus, the standard theory of utility is considered valid in economics despite overwhelming empirical evidence to the contrary - simply because it is aesthetic and mathematically convenient.

So, what are economic "theories" good for?

Economic "theories" and narratives offer an organizing principle, a sense of order, predictability, and justice. They postulate an inexorable drive toward greater welfare and utility (i.e., the idea of progress). They render our chaotic world meaningful and make us feel part of a larger whole. Economics strives to answer the "why's" and "how's" of our daily life. It is dialogic and prescriptive (i.e., provides behavioural prescriptions). In certain ways, it is akin to religion.

In its catechism, the believer (let's say, a politician) asks: "Why... (and here follows an economic problem or behaviour)".

The economist answers:

"The situation is like this not because the world is whimsically cruel, irrational, and arbitrary - but because ... (and here follows a causal explanation based on an economic model). If you were to do this or that the situation is bound to improve".

The believer feels reassured by this explanation and by the explicit affirmation that there is hope providing he follows the prescriptions. His belief in the existence of linear order and justice administered by some supreme, transcendental principle is restored.

This sense of "law and order" is further enhanced when the theory yields predictions which come true, either because they are self-fulfilling or because some real "law", or pattern, has emerged. Alas, this happens rarely. As "The Economist" notes gloomily, economists have the most disheartening record of failed predictions - and prescriptions.

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The Didjeridu
by: **Susanna Elisabet Duffy**

In Northern Australia the Didjeridu is seen as a phallic symbol and therefore a male instrument. Women are prohibited from playing.

Stories of the Didjeridu vary from place to place among the different language-speaking groups in this large continent.

In the beginning, in the North of Australia, a giant captured two young girls to be his wives. One day they escaped and made their way back to their tribal people.

The tribal elders knew the giant would ccme looking for his brides so they dug a huge pit along the path leading to their home camp as a trap. They waited behind an anthill.

In his anger and haste, the giant came running and fell into the pit. The tribal hunters threw their spears, mortally wounding him. The giant curled into a ball in his death throes. As he curled into himself he began to blow on his penis, making an eerie droning sound. He rolled and roared, thrashing around in the pit, the deep drone of his penis thrummed through the earth and caused the birds to fly high into the heavens.

The men wanted to recapture such a sound of power, so they searched for and found a large hollow log with the centre eaten out by termites. By blowing on one end of this hollow log, they were able to create the sound made by the giant in his death throes.

And from that time, the didjeridu is a sacred instrument to men, for it holds the power of the giant.

In another story from the South-East of Australia, three men were camped in the bush on a cold night in the middle of winter. One of the men, watching the fire, picked up another log to feed the flame which was getting low. As he picked up the log he found it was hollow but thought no more about it until he turned to drop it into the fire and noticed the entire length was covered with termites.

He didn't know what to do for the termites were his totem ! He couldn't throw the branch into the fire, because it would kill the termites but the fire had to be kept burning on such a night.

He carefully removed all the termites from the outside of the log by scooping them into his hand and gently placing them inside the branch. Then he raised the branch to his lips and blew the termites into the air.

And the termites blown into the air became the stars and the first didjeridu was made.

The didjeridu is the world's oldest known musical instrument. Traditionally, it's made from a branch in which white ants eat their way up through the centre towards the sunlight. The outer shell of the branch remains solid and protects the ants. Eventually the branch dies and falls to the ground. After shaping the ends and marking it with personal designs, this becomes the didjeridu.

Many Aboriginal people believe that there is a man's spirit inside the didjeridu - so women may not play it.

And if you listen now to the didjeridu it will go into your ears, open your heart and lift your spirit.

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