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The Journal of Socio-Economics

NORTH-HOLLAND

Journal of Socio-Economics 32 (2003) 411–427

www.elsevier.com/locate/econbase

Normative behavioral economics

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Accepted 25 April 2003

Abstract

This paper addresses the question of why, in spite of its recent success, behavioral economics does not influence most discussions about how economic policy ought to be made. Failing to penetrate into contemporary discourse on leading policy issues is a serious problem, because behavioral techniques often point to policy prescriptions that are at odds with the prescriptions which follow from models using more standard behavioral assumptions. By comparing how the universe of possible policy implications changes when different methodological approaches are used, this paper demonstrates a systematic link between methodology and the range of policy prescriptions that can be socially desirable. Because of this link, the methodological multiplicity of behavioral economics, and the ideological pluralism which it supports, favor the use of normative behavioral economics. This follows from the basic economic principle of diversification: a policy prescription that reflects averaging over a number of distinct kinds of errors (one for each methodology) is less likely to wander far off target than one generated by a single method.

JEL classification: B4; B5; B0; A1

Keywords: Methodology; Normative; Behavioral

1. Introduction

Many economists may have doubts about the ultimate value of research in the subfield of economics known as “behavioral economics,” but few would disagree that a “behavioral revolution” has taken place over the last 15 years. Although this “revolution” does not carry all the markings of a full-fledged shift of paradigm in the sense of Kuhn (1970), there is

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doi:10.1016/S1053-5357(03)00049-0

abundant evidence that the normal science currently practiced by neoclassical economists incorporates behavioral techniques that would have stood out as unusual just a decade ago.[1] Most convincing on this point is the fact that a number of major themes in behavioral economics, e.g. examining the empirical validity of behavioral assumptions, modeling non-maximizing behavior by firms and consumers, and borrowing from psychology, sociology and cognitive science, now comfortably fit into most major journals in economics.[2]

This newly won attention, although it reflects a substantive achievement for those who advocate the use of behavioral techniques in economic research, has yet to see the insights of behavioral economics coalesce into a normative framework for analyzing economic policy (Knetsch, 1995).[3] Reaching the imagination of policy makers and influencing popular debate about leading issues in public policy is, admittedly, not the only measure of an intellectual movement's success. Still, it is puzzling, at least on the face of it, why the recent ascent of leading behavioralists into the limelight has not been accompanied by a new normative framework for analyzing policy.[4]

In fact, some of the most well-known behavioral economists explicitly warn their readers not to draw normative inferences from their work. Thaler (1991, p. 138), for instance, makes the following assertion about his own work on the empirical validity of rational choice axioms: "A demonstration that human choices often violate the axioms of rationality does not necessarily imply any criticism of the axioms of rational choice as a normative idea. Rather,

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[1] Schwartz's (1998) book, *Rationality Gone Awry*, provides a general survey of behavioral economics with citations of a number of major journal articles using behavioral techniques as well as older edited volumes intended to represent the practice of "behavioral economics." Schwartz's work provides abundant evidence, including citation frequency statistics and accounts of behavioral economics in newspapers and popular non-academic journals, backing the claim that behavioral economics has recently captured a greater share of attention relative to other subfields within economics.

[2] One might contend that the mainstream economics literature has long included within it a debate about the meaning of "rationality" and the appropriateness of maximization as a model of how consumers and firms behave, citing the paradoxes of Allais (1953), Ellsberg (1961), or the provocative work of earlier authors such as Veblen (1899), Keynes (1936), Hayek (1945), Duesenberry (1949), or Galbraith (1958). Of course, in a more detailed historical account of the emergence of behavioral economics, the work of Richard Cyert and Herbert Simon in the 1950s and 1960s would be featured prominently in the story of behavioralists who made a "big impact." The claim being made here is simply that a recent accumulation of empirical work on anomalous price patterns in financial markets (Thaler, 1993), and heightened interest in the experimental results of authors such as Tversky (see Laibson and Zeckhauser, 1998), Smith (2000), and Camerer (1997), have led to an unprecedented level of attention being devoted to the themes of behavioral economics.

[3] Important exceptions to this include policy-oriented discussions of *x*-efficiency such as Leibenstein (1979), Schwartz (1969), and Altman (1996); Katona's (1980) work on policy-related macroeconomic forecasting using attitude survey questions; Frank's (1985) models of optimal income re-distribution with other-regarding preferences; Maital (1986) on the possibility that imperfect credit markets may impose welfare-improving constraints; Schelling's (1984) enumeration of policy problems relating to "self-command"; Tomer's (1986) work on organizational capital; Akerlof and Dickens (1993) on cognitive dissonance and forced retirement savings programs; Frantz's (1992, 1997) application of *x*-efficiency to the problem of regulating a natural monopoly; Scitovsky's (1998) description of how recent political events interconnect with the trend toward irrationally engaging in too little self-cultivation; Altman's (1999a) analysis of welfare-enhancing policy changes ruled out by neoclassical assumptions; Altman (2000) on labor policy; and George's (2001) normative analysis of advertising and meta-preferences.

[4] In a note to the author, Hugh Schwartz confirmed the apparent reluctance of behavioralists to apply their work to solving policy problems. As evidence, he cited a recent phone call from a reporter at *Business Week* trying, without much luck, to get a "behavioral perspective" on specific policy issues from leading behavioral economists.