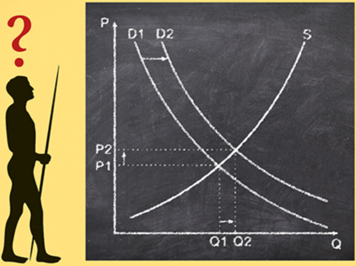
David Leiser and Yhonatan Shemesh



How We MISUNDERSTAND Economics and Why It Matters

The Psychology of Bias, Distortion and Conspiracy

ROUTLEDGE

"This engagingly written book takes us above and beyond traditional judgment and decision-making studies and the heuristics and biases of behavioral economics to explore how people develop explanatory models and concepts in the domain of economics. It contains many fascinating insights into the challenges laypeople have in understanding seemingly simple but deeply complex phenomena and economic entities (e.g. money), as well as offering a bold new direction for research into a topic where greater lay understanding has enormous social policy consequences."

Frank Keil, Yale University, USA

"For decades economists have tidily cultivated their own scientific gardens and forgotten that complex socio-economic issues may be effectively tackled with better knowledge of human beings on top of sophisticated equations. A plea for a multidisciplinary approach, this book is a much-needed attempt to foster dialogue and bridge the cognitive segmentation of social sciences."

Elsa Fornero, University of Turin, Italy

"In recent years, many economists have used psychology to understand the economy better. In their enlightening new book, Leiser and Shemesh use psychology to explain why most people understand economics so poorly. Economics insights often butt against deep-rooted ways of thinking about the world. And even when the lessons of economics are intuitive, economists' rhetoric is not. *How We Misunderstand Economics and Why It Matters* is a great book for anyone who wants to understand the economy – or explain it to others."

Bryan Caplan, George Mason University, USA

HOW WE MISUNDERSTAND ECONOMICS AND WHY IT MATTERS

This is the first book to explain why people usually misunderstand economic phenomena. From the cognitive short-cuts we use to make sense of complex information, to the metaphors we rely on and their effect on our thinking, this important book lays bare not only the psychological traits that distort our ability to understand such a vital topic, but also what this means for policy makers, and civil society more widely.

Accessibly written, the book explores the range of cognitive strategies laypeople employ when thinking about money, finance, and the wider economy. From the intentionality fallacy, whereby all economic phenomena are assumed to have been caused deliberately rather than to have come about by the interplay of different factors, to the role of ideologies in framing how economic thinking is expressed, the book discusses how we interpret important issues such as unemployment, inflation, and how we conceive of money itself.

Exposing the underlying biases and assumptions that fatally undermine financial literacy, and concluding with recommendations for how policies and ideas should be framed to enable a clearer understanding, this will be essential reading not only for students and researchers across psychology and economics, but also anyone interested in progressive public policy.

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The Psychology of Bias, Distortion and Conspiracy

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CONTENTS

PREFACE

This book is the first to explore how the general public understands economics, or rather, how it systematically misunderstands it. Economics has developed such advanced and unintuitive ways of thinking that ordinary people without proper training simply cannot grasp it. Yet they are expected, by others and by themselves, to do so. We marshal a wide range of principles and insights, coming from cognitive, social, and political psychology, to identify the tools laypeople can bring to bear to achieve a semblance of comprehension.

This preface will remain brief, but there are two comments that we wish to make. In discussing the specificities of lay understanding of economics, we use neo-classic economic theory as a reference, and hope this will not annoy proponents of alternative currents. Convenience and familiarity guided our choice, and as humble psychologists we are in no position to endorse a particular school. More importantly, we submit that, had this book been written by a Libertarian or a Marxist, most of our points would have been unaffected, or only slightly amended. Additional kindred points can no doubt be formulated and explored, and if this book serves to encourage such investigations, we would be delighted.

The second comment is that our perspective owes much to the work of Jean Piaget. Laypeople don't understand much of what economists are talking about, while economists don't get what there is to understand, and are frustrated at the public's failure to see the obvious. In the body of the text, we avoided making reference to the Piagetian framework, because it is foreign to most of our expected readers, but here, we would observe that the mismatch and mutual incomprehension between laypeople and economists is analogous to that between one Piagetian stage to the next. Another helpful framework is to consider that gap as that between two Kuhnian paradigms. The two are closely related: Thomas Kuhn made a point of acknowledging how Piaget's work had influenced his own, and when I went to meet him in the course of a sabbatical at MIT, he presented me with a book, and stated that the paper on Piaget it includes (Kuhn, 1977) was "the best thing I ever wrote."

Piaget and Kuhn were united in their view that describing deficient knowledge only as a failure to attain the normative form is insufficient. A proper account must strive to analyze how the incomplete knowledge is structured in its own terms. We too attempt to describe *how* people think, as opposed to measuring the extent to which laypeople fail, or documenting points of disagreement between the general public and trained professionals. It is gratifying to acknowledge this filiation to the work of my erstwhile "*patron*."

It is with great pleasure that we acknowledge the help and encouragements of many: Carmela Aprea, Meir Bing, Ivo Bischoff, Bryan Caplan, Eyal Carmel, Nofar Duani, Elsa Fornero, Zeev Kril, David Laibson, Shabnam Musavi, Tobias Rötheli, Michael Sarel, Robert Shiller, Avia Spivak, Nicolas Weill, and Eyal Winter. Amongst "those without whose" (Booth, 1974), I am especially grateful to Bill Congdon, whose many insightful comments were particularly helpful and set my mind thinking about policy implications. I also wish to thank Rector HaCohen and Ben-Gurion University for granting me an extended sabbatical, and to Sacha Bourgeois-Gironde and the Department of Economics at Paris II (Panthéon-Assas) for inviting me to work on this book in a pleasant and stimulating environment.

David Leiser

1

INTRODUCTION

Folk-economic beliefs

> If I were to pick the field of economics I am most anxious to see adopt behaviorally realistic approaches, it would, alas, be the field where behavioral approaches have had the least impact so far: macro-economics.
>
> *(Richard Thaler, 2015, p. 349)*

Economists, especially those who formulate public policy, often express dismay at the failure of the general public to understand economics. This is not a matter of ignorance as in the way non-specialists cannot say much about the workings of, say, the spleen. No one expects us to possess extensive knowledge about this fine organ. We are not exposed to any information about it nor do we engage in any conscious interaction with it. Just the reverse holds for economics. People do hold beliefs and entertain hunches about economics, but much of them are systematically misguided. This book will document lay beliefs about economics and try to expose their sources.

Why is this important? Because people's economic views have practical consequences. Whereas what you think about your spleen doesn't affect it in any way, economic beliefs guide people's behavior (think of inflation expectations) and figure in economic models. Further, the general public's beliefs also affect public policy, especially in democratic regimes. The authorities ignore the views of the public at their peril, and if the policy measures they put forward are misunderstood or disliked, they may be difficult or impossible to implement. It is therefore extremely important to map the public's understanding of economics, and to consider what it implies for public policy. A recent poll (IGM Forum, 2017) asked two panels of respected economists in the US and in Europe whether "Insights from psychology about individual behavior – examples of which include limited rationality, low self-control, or a taste for fairness – predict several important types of observed market outcomes that fully-rational economic models do not." All the US experts and 88% of the European ones agreed that this is the case. George Stigler (1970, p. 61), who was awarded the Nobel Prize (inter alia) for highlighting the importance of information, turned his attention to economic knowledge:

> Why should people be economically literate, rather than musically literate, or historically literate? … The citizen of a democracy is called upon to judge public policy in a thousand directions – military, educational, medical, economic, and recreational, for example – and he will make better decisions if he is well-informed.

Understanding by the public is of particular importance for Central Banks, who rely on transparency to convince the public that they will control inflation and are committed to their targets, and to that end routinely make all relevant information and considerations public. Ben Bernanke, then Chairman of the Federal Reserve's Board of Governors, was well aware of this:

> The Federal Reserve's mission of conducting monetary policy and maintaining a stable financial system depends upon the participation and support of an educated public. As the Fed pursues the monetary policy objectives … it is essential that the public understand our objectives and our actions. Educating the public about the reasoning behind our decisions helps build confidence in our economic system.
>
> *(Bernanke, 2006)*

This is not just a matter of knowledge or ignorance: misunderstanding exerts its toll. Alan Blinder, an economist with major experience in both the Federal Reserve System and the US administration, discussed how the simplistic views of the general public raise difficulties for running delicate policies:

> There is apparently something in the American character that rejects any remedy too complex to be emblazoned on a T-shirt. … this leads to simplistic solutions. Sometimes those are from the left, sometimes those are from the right. … Too many American kids are brought up without any basic literacy in economics. I don't mean knowledge of fancy economic theory, I mean fairly elementary things like "demand curves usually slope down" … if you are in the political arena, you can't ignore T-shirt attitudes as easily as you can when you are in an apolitical arena.
>
> *(Blinder, interviewed in Erickson, 1994)*

Psychology and economics have been fruitfully engaging for decades. Extensive work has taken place in Behavioral Economics, mostly concerning decision making by individuals. We will refrain from recapitulating the most important insights of behavioral economics, and refer the reader to existing surveys (Ariely & Jones, 2008;

Camerer, Loewenstein, & Rabin, 2011; Kahneman, 2011). Countless studies document the type of mistakes people make, both errors of omission and of commission. These findings have inspired research into helping people avoid mistakes. Best known are the attempts to "nudge" individuals to take a recommended course of action without downright imposing it (Sunstein & Thaler, 2008; Thaler, 2015). The newfound insights are widely being used in the attempt to develop "behavioral public finance." This embryonic field holds promise to expand the set of available policy instruments by relying on realistic psychological foundations, but also opens up the possibility of *evaluating* welfare with respect to a psychologically realistic model of decision making and so provide a sounder foundation for public policy (Congdon, Kling, & Mullainathan, 2011; OECD, 2017). Richard Thaler, the 2017 Nobel Laureate who ranks amongst the most prominent behavioral economists, wishes macroeconomics too were psychologically informed, and laments this isn't taking place to any great extent.

Compared to that extensive body of work, strikingly little is known about how people *think* in the economics domain, as opposed to how they *decide*. This neglect of lay economic understanding is a serious lacuna. As humanity expands its environment, it becomes increasingly important to investigate how our existing cognitive and psychological endowment is deployed in understanding this broader environment.

Psychology traditionally wasn't interested in the question. Cognitive psychologists mostly concentrate on the processing of limited quantities of information, such as can be encompassed in very few sentences at most, whereas the study of how entire domains are comprehended is relatively undeveloped (Friedkin, Proskurnikov, Tempo, & Parsegov, 2016). There are research traditions, originating with the work of Carey (1985) and Keil (1989, 1992), who study the development of understanding in fundamental domains such as the natural (fire, liquids, weather), biological (health and disease, organisms), physical (material objects, forces), and psychological/interpersonal realms of life, all domains where cognitive preparedness developed to benefit our forebears (Pinker, 2003; Shtulman, 2015). But, as Pinker notes, economics as it developed over the last centuries never benefited from such preparedness, and perhaps for this reason, the psychology of economic understanding wasn't considered an interesting psychological question. Recently Boyer and Petersen (in press) upended this insight to great benefit. These authors take domain-specific systems identified by evolutionary psychology (such as cheater detection, ownership intuitions, or coalitional psychology) and that evolved to the benefit of our evolutionary ancestors to enable coordination between them, and then trace how those play out in our current environment, leading to biases in folk-economics. We take a complementary perspective, and relate misunderstanding to the limited cognitive resources available to individuals who struggle to make sense of the modern economic environment. Much of this book involves relating the cognitive and psychological features of humans to characteristics of economic thinking, in an attempt to account for how ordinary people cope with it.

And the fact is, they cope very poorly. Economists, frustrated by the failure of the public to grasp what they see as obvious economic realities, sometimes try to speak to the public and to explain what they are doing and why, only to be met with incomprehension or suspicion.

They typically do not realize the magnitude of the obstacle. Blinder also remarked: "I think the economists, with some exceptions, don't help a lot in that they spend precious little time talking – and I guess that means through the media – to ordinary people in ways that ordinary people can understand" (Blinder, interviewed in Erickson, 1994). Apparently, he believed that if only economists were to take the trouble to explain matters to the public, things would go much more smoothly. That naïve hope was shared by Valery Giscard d'Estaing. On February 10, 1972, while France's Finance Minister, he invited himself onto a talk show[1] because, as he put it: "I am responsible for the French tax system. I would like everyone to understand our tax system, and to a certain extent, approve it." Whereupon he stepped up to a flip board and explained the arcane principles of the now defunct "*l'avoir fiscal*" concept (tax credits linked to dividends paid to shareholders of French companies subject to corporate tax).[2]

A little fireside chat with the public will accomplish nothing, because members of the public understand economic matters very differently than economists do, and the mismatch is deeply rooted in our cognitive abilities. The coming chapters discuss this mismatch in detail, and show why numerous specific tensions arise.

But this covers only half our purpose. Failing to understand economic concepts and reasoning does not paralyze the public. On the contrary, a conspicuous feature of lay discourse about economics (the proverbial bloke in the pub) is that people speak confidently of policies and economic events. How can this be? Later chapters will discuss several means that enable them to be both confident and uninformed.

Economics is not a theoretical discipline that concerns academics only. There are social pressures on individuals to have economic views. Because the issues affect people so much, they are often debated in social settings, and everyone who is anyone *should* have a view. For the same reason, economic issues are frequently discussed in the media. News pieces on the current state of the economy, the consequences of policy changes or the goals pursued by those who formulate them, are routinely addressed to the general public, implicitly conveying to its members that they are expected to grasp them. Newscasts and the written press will discuss whether the present time is a good time to buy a house and why, the reasoning behind the latest decisions by the central bank governor and their likely consequences, or the economic significance of "Brexit" (UK withdrawal from the European Union). This state of affairs is unlike that observed in other domains: news programs do not invite civil engineers to talk about the precise technical mishap that caused a bridge to collapse, as no one expects laypeople to be able to follow the explanation. But in the economic domain, the corresponding information *is* conveyed to the public. Here is a curtailed example at random, taken from the *Orange County News*, entitled "What a Fed rate increase could mean for you" (www.nerdwallet.com/blog/finance/what-a-fed-rate-increase-could-mean-for-you/)