Publisher's Note

Principles of Business: Economics is the latest title in Salem's *Principles of Business* series. The first five volumes, *Finance*, *Marketing*, *Entrepreneurship*, *Management* and *Accounting* have been recently published. This series is intended to introduce students and researchers to the fundamentals of important and far-reaching business topics using easy-to-understand language.

The field of economics is vital in the world we live in today, and relevant in any type of business. This work includes topics such as "Behavioral Economics," "E-Commerce," "Financial Globalization" and "Securities Regulations."

The entries in this volume are arranged in an A to Z order, from "Aggregate Demand" to "Transfer Pricing," making it easy to find the topic of interest. Each entry includes the following:
- *Abstract* giving a brief introduction to the topic;
- *Overview* that presents key terms and concepts;
- Clear, concise *presentation of the topic*, including a discussion of applications and issues;
- *Further reading*.

Added features include numerous illustrations and helpful diagrams of relevant topics. The back matter in *Principles of Business: Economics* contains a thorough and valuable glossary of terms as well as an index.

Salem Press thanks the contributors, whose names are listed with each essay. Their diverse backgrounds include graduate degrees in economics, years of business experience, and non-business experience that offers information in language that is often more accessible than that of business specialists, whose explanations may be narrowly focused. A list of contributor's names and affiliations follows the Introduction.

The essays in this volume are written for a varied audience. Our goals include attention to clarity and avoidance of unnecessary jargon. For those readers who desire more specific information on any one topic, each essay includes a list of further reading.

Principles of Business: Economics is, as are all titles in this series, available in print and as an e-book.

Introduction

Understanding the principles of economics is vital for all businesses and governments entities, as well as for individuals. Economics is a field of study that has a long history dating back several centuries. Many brilliant minds have proposed various theories, tested them, discarded some and found others capable of standing the test of time. Looking back at the evolution of economic thought, one cannot help but marvel at how concepts we consider patently obvious, like supply and demand, weren't always so. It took economic scholars such as Smith, Ricardo, Cournot, Jevons, Menger, Walras, Marshall, and Keynes to explain such theories in a manner easily understood by the masses. Looking to the future, though, the true import of their and other innovative economists' work lies in the synthesis of ideas, new and old, confirmatory or contradictory, into a coherent understanding of economic forces that, when applied, will bring us and future generations good rather than ill fortune.

Stages of Thought

Production and trade, investment and profits, poverty and wealth all, of course, predate the rise of capitalism by many, many centuries. Yet the intelligentsia of the ancient world paid scant attention to commercial consideration, instead preferring to debate ethical issues associated with their economies. While profitable commerce benefited the state, making it more powerful in the world, philosophers of the time often condemned those who sought wealth for its own sake. For them, wealth was only a means to an end – the desire to lead a self-reliant and contemplative life.

With the movement away from the land and toward towns, business people gained political influence. The state became increasingly important in protecting their business interests, thus the need for powerful armies and navies developed. Nations began levying taxes and tariffs to pay for their military defenses. However, it was not until later that Adam Smith recognized that the competitive marketplace was the preeminent engine of economic growth. He realized that while self-interest was the predominant force driving human behavior, an economic order must emerge to guide these forces. Smith was the first to recognize that a nation's wealth was based on the goods and services produced by its people. Smith further believed that the role of government in the economy was a limited one and that the market economy should remain open and free.

Smith forever changed the line of inquiry future economic theorists would take. It would, however, be left to David Ricardo to formalize some of his seminal ideas about income distribution, free trade and economic growth. His ingenious argument in support of free trade between nations, the theory of comparative advantage, is Ricardo's most enduring contribution to economic thought. He considered the cost differential between producing countries far less important than the differential within countries. In purely economic terms, importing goods from a more efficient foreign producer, he reasoned, is preferable to purchasing them from a less efficient domestic one.

While Smith and Ricardo brought new and enduring theories to the field of economics, the most far-reaching theorist in modern economics was John Maynard Keynes. Macroeconomics — the study of how national economies function — effectively began with Keynes. And his central thesis, that aggregate demand in turn is a function of consumer spending and business investment, has figured prominently in debates over both monetary and fiscal policy ever since.

The bottom line is that economics is an observational, not an experimental science. The proof of a theory here thus rests in how well it empirically withstands the counter-arguments hurled at it: That, and the test of time.

Economic Systems

There are three basic economic systems in the world today: traditional, free market and command. Each system addresses the fundamental problem of how to allocate scarce resources in a different way. Kinship, custom and religion enter into these decisions in a traditional economy. In a free-market economy, self interest alone matters; buyers and sellers bid freely and openly on goods and services, and the price of purchases directly affects supply and demand. Unlike both traditional and free market systems, orthodox command economies ban all forms of private ownership; the state employs everyone and resources are allocated by central planners.

Economic systems are complex, multidimensional entities where decisions about what is produced, how to produce and for whose benefit have a moral and political context. An economy and the society it serves are inseparable. What differentiates one from the other is the nature of the basic problem being addressed. Social cohesion and regeneration are society's most pressing perennial concerns. Capital formation, productive capacity and full employment are necessary for a healthy economy. Traditional, free-market and command economies approach each of these situations differently. In this work we will examine how successful each system is in today's global economy.

The field of economics has a lengthy history because of its importance in everyone's daily lives on many levels. It is important for members of our society to understand the basic concepts of economics, as well as how these concepts impact our daily lives through our interactions with our government, businesses and with each other. While new situations will require ever-changing methods to deal with these issues, many of the basic premises surrounding economics are here to stay.

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B

Behavioral Economics

ABSTRACT

Behavioral economics draws upon the fields of economics and psychology to study how people make choices. Behavioral economists believe that the choices individuals make may be neither statistically predictable nor always rational. This article explores concepts of behavioral economics; cites relevant findings; and summarizes some of the contemporary research in the field. The article concludes with a glossary of relevant terms.

OVERVIEW

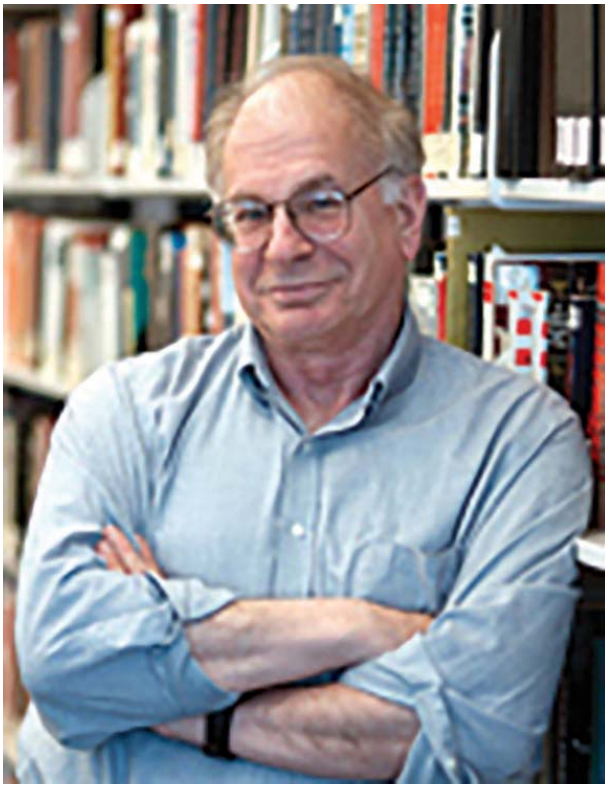
Behavioral economics draws upon the fields of both economics and psychology to study how people make choices (Lambert, 2006, p. 50). According to Merriam-Webster's Collegiate Dictionary:

Economics is a social science that describes and analyzes the production, distribution, and consumption of goods and services (2000, p. 365) [while] psychology is the study of mind and behavior (2000, p. 940).

Because behavioral economics is concerned with how individuals make their choices rather than how statistical data or calculated notions predict what their choices should be, behavioral economic concepts are differentiated from two well-known economic theories. These theories are: the Bayesian theory, which relies upon statistics to draw conclusions about the future occurrence of a given parameter of a statistical distribution by calculating from prior data on its frequency of occurrence ("Bayesian theory," 2007), and the rational choice theory, which assumes that an individual, using reason, will choose the option that yields maximum advantage or gain and minimizes disadvantage or loss ("Rational choice theory," 2009). In fact, behavioral economists believe that the choices individuals make may be neither statistically predictable nor always rational. Rather, decisions are heavily influenced by other factors; it is these patterns of irrational choice that form the basis of study for behavioral economists (Fillion, 2008).

Psychology Melds with Economics

In 1982, Daniel Kahneman and Amos Tversky met psychologist Eric Wanner, who wanted to integrate the fields of psychology and economics. Under his presidency of the Russell Sage Foundation, Wanner awarded a grant to economist Richard Thaler to spend the 1984–85 academic year with Kahneman and explore the integration. During that year, psychologists Kahneman and Tversky, and economists Thaler and Jack Knetsch, conducted a series of research experiments that studied the nature and rules of fairness for a variety of transactions (Kahneman, 2002). In 1986, Richard Thaler, Daniel Kahneman, and Jack Knetsch published "Fairness as a Constraint on Profit Seeking: Entitlements in the Market," in the *American Economic Review.* The article described their analysis of a telephone survey that was conducted during the 1984–85 academic year. Among the findings, the survey respondents indicated that they thought it was fair for firms to raise prices or lower wages when profits are suffering, but that it was unfair for firms to raise prices or lower wages for the purpose of exploiting market demand, such as when quantities of an item are temporarily limited, or when unemployment is high (Kahneman, Knetsch, & Thaler, 1986, p. 728). This research on the nature and perception of fairness among individuals provided psychological insight into economic factors in the marketplace: The public applies fairness concepts to their transactions with merchants, landlords, and employers. If the rules of fairness (what individuals have deemed acceptable or unacceptable according to their fairness reference points) are violated, the public will retaliate (Kahneman, 2002). For example, the retaliation may take the form of withholding



Daniel Kahneman shared the 2002 Nobel Memorial Prize in Economic Sciences with Vernon L. Smith for his work on the psychology of judgment and decision-making. (Courtesy of Wikimedia Commons)

business from a merchant who is considered unfair, or by paying more to transact with a merchant because he is deemed to be fair.

In 2002, Daniel Kahneman won half of the Sveriges Riksbank Prize in Economic Sciences—the Nobel Memorial Prize in Economic Sciences—"for having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty" ("The Sveriges Riksbank Prize," 2002). (The "other half" of the prize was won by Vernon L. Smith, an experimental economist.) This prize brought the field of behavioral economics to the forefront as a legitimate and important area of study.

FURTHER INSIGHTS

Concepts & Prospect Theory

Based upon the preliminary research and analysis mentioned above, as well as subsequent research and study, five prominent concepts within the field of behavioral economics have been identified:

- judgment under uncertainty
- heuristics
- illusion of validity
- intuitive prediction
- prospect theory

Judgment under Uncertainty

Judgment under uncertainty refers to an individual's process for assessing probabilities and predicting values (Tversky & Kahneman, 1974, p. 1124) when choosing an option. As Sleeth-Keppler noted, judgment under uncertainty is not a rigid process, and individuals will often rely upon heuristic strategies to aid their judgment (2007, p. 768).

Heuristics

Heuristics is a method for problem-solving or decision-making that arrives at solutions through exploratory means such as experimentation, trial and error, or evaluation ("Heuristics," 2007).

In 1974, Daniel Kahneman and his long-time collaborator Amos Tversky published an influential paper in *Science*, "Judgment under Uncertainty: Heuristics and Biases." The paper defined three heuristic methods that encompass multiple biases that individuals rely upon to assess the probability of an uncertain event or the value of an uncertain quantity (Tversky & Kahneman, 1974).

These three heuristics include the following:

- judgment by representativeness
- judgment by availability
- judgment by adjustment and anchoring

Judgment by Representativeness

Judgment by representativeness is a determination of the probability that object A belongs to class B, or that event A originates from process B, or that the probability that process B will generate event A (Tversky & Kahneman, 1974, p. 1124).

For example, in the "object A belongs to class B" scenario, an individual is provided with a personality description of a man and then asked to guess the man's occupation from a list of possibilities. The individual, relying upon judgment by representation, will guess the man's occupation to be the one that fits his personality most stereotypically (Tversky & Kahneman, 1974, p. 1124). This practice is referred to as stereotyping. Bodenhausen (1990, p. 319) argues that while stereotyping is convenient and common, it is a less likely strategy when individuals are motivated by personal involvement or are at their peak energy levels.

Judgment by Availability

Judgment by availability is an assessment of the frequency of a class or the probability of an event by the ease with which instances or occurrences can be recalled (Tversky & Kahneman, 1974, p. 1127).

For example, a person may suppose that a new pizza restaurant will fail because three other pizza restaurants in the same neighborhood failed.

Judgment by Adjustment and Anchoring

In judgment by adjustment and anchoring, adjustment involves estimating using a base number that is then altered to garner the final value. Anchoring refers to the phenomenon that different starting points will yield different estimates that are biased toward the initial values (Tversky & Kahneman, 1974, p. 1128). When using adjustment and anchoring to estimate an unknown quantity, an individual uses information he already knows (the anchor) and then makes adjustments from that point to arrive at an acceptable answer (the adjustment) (Epley & Gilovich, 2006, p. 311).

For example, groups of research subjects were asked to estimate the percentage of African countries in the United Nations by adjusting their numbers up or down from a number obtained by spinning a wheel of fortune (the anchor or starting point). Despite the relevance, or lack thereof, the arbitrary anchor numbers represented, subject answers varied according to them (the adjustment) (Tversky & Kahneman, 1974, p. 1128).

Illusion of Validity

Illusion of validity refers to a "complete lack of connection between the statistical information and the compelling experience of insight" (Kahneman, 2002).

Intuitive Prediction

Intuitive prediction refers to a "willingness to make extreme predictions about future performance on the basis of a small sample of behavior" (Kahneman, 2002).

The terms "illusion of validity" and "intuitive prediction" were created by Daniel Kahneman when he first began developing his behavioral viewpoints of individual choice as a psychologist in the Israeli army. After comparing the results of an exercise designed to identify which soldiers showed the best potential to be officers, to the actual success of the same soldiers in officer training, Kahneman deduced that the correlation was minimal. The term he created for this disconnect between statistical information and the experience of insight is the "illusion of validity" (Kahneman, 2002). Kahneman also noted that there was an "intuitive prediction" factor to this method of identifying officers: It resulted in making extreme predictions about future performance based on a small sample of behavior (Kahneman, 2002).

Prospect Theory

Prospect theory "attempts to explain why individuals make decisions that deviate from rational decision-making by examining how the expected outcomes of alternative choices are perceived" ("Prospect theory," 2007).

The term "prospect theory" was created by Daniel Kahneman and Amos Tversky. As they were delving into the intricacies of decision-making, they constructed a theory for risky choice, which they called value theory. They eventually renamed it "prospect theory" when they published their article, "Prospect Theory: An Analysis of Decisions under Risk" in *Econometrica* in 1979. The significance of prospect theory was that it established that "objects of choice are mental representations, not objective states of the world." The publication of the article in *Econometrica*—rather than in a psychology journal—positioned prospect theory to be a strong influence in the field of economics (Kahneman, 2002).

Contemporary Research in Behavioral Economics

Behavioral economists are interested in the benefits of behavioral economics to society. Here are some suggestions from two prominent behavioral economists Richard H. Thaler and Dan Ariely.

Richard H. Thaler

Richard H. Thaler studies the relationships among behavioral economics, finance, and the psychology of decision-making. He discounts the assumption that the economy is totally based on rational and selfish

Richard H. Thaler, 2017 Nobel Memorial Prize Laureate in Economic Sciences, during Nobel Prize press conference in Stockholm, on December 7, 2017. (Courtesy of Bengt Nyman from Vaxholm, Sweden CC BY 2.0 via Wikimedia Commons)

behavior and explores the possibility that human factors are a strong influence. Much of his work focuses on the role of behavioral economics in finance and financial decision-making (University of Chicago Booth School of Business, 2009).

Thaler believes that it is naïve to think that high school students are prepared to be astute consumers. He suggests that financial institutions should be more transparent up-front and teach individuals to be smart consumers by educating them about the costs of their options without limiting them. Thaler calls this approach to teaching financial literacy "libertarian paternalism" (Thaler & Sundstein, 2008).

Thaler's work on retirement savings was influential in the creation of the 2006 Pension Protection Act. In 2008, Thaler described his findings in *Nudge: Improving Decisions about Health, Wealth, and Happiness,* which compared automatic enrollment in retirement plans with opt-in plans and found that people were likely to accept a default decision made on their behalf. That is, people were unlikely to either opt out of automatic enrollment plans or opt in to freely offered plans (Burstyn, 2011). After moves by the Obama administration to make government data more available to the public, Thaler argued that the response of individuals to such data depended less on actual self-interest than on perceived self-interest, which could be controlled merely by presentation (Thaler & Tucker, 2013).

Dan Ariely

In an article titled, "The Dishonesty of Honest People: A Theory of Self-concept Maintenance," Ariely and two coauthors analyzed the results of six experiments with university students and concluded that they valued honesty and wanted to feel like they were honest. However, they did choose to cheat a little bit if they benefited by it, but did not cheat enough to convince themselves that they were dishonest (Mazar,

Dan Ariely in Camden, Maine, on October 20, 2010. (Courtesy of PopTech CC BY-SA 2.0 via Wikimedia Commons)

Amir, & Ariely, 2008). This has clear implications for behavior theory in general and specifically in determining how people balance their ethical beliefs with their needs.

In 2008, Ariely published his book, *Predictably Irrational*, in which he attempts to describe research findings from behavioral economics and decision-making in non-academic terms so that a broader audience may use the research to improve their lives (Ariely, 2007, p. 5). The book tackles such issues as why a commitment to dieting dissolves when we see a tempting dessert; why we buy items that we don't need; why an expensive aspirin cures a headache better than a cheaper aspirin; and why honor codes reduce dishonesty in the workplace (Ariely, 2007, p. 6).

Homo Economicus vs. Homo Communitatis

H. Joel Jeffrey and Anthony O. Putnam declared in their 2013 article "The Irrationality Illusion: A New Paradigm for Economics and Behavioral Economics" that the old paradigm supported by Kahneman, Ariely, and others of human irrationality in financial decision making—homo economicus—was a mere grafting onto the classical model to explain anomalous decision- making that deviates from utilitarian predictions of human behavior. Jeffrey and Putnam put forward their homo communitatis paradigm, which calls for a framework of principles that asserts that "[b]ehavior choices are made in light of the individual's reasons to engage in one behavior or another" and that "[e]very behavior is an instance of engaging in a social practice of a community" (Jeffrey & Putnam, 2013).

CONCLUSION

Behavioral economics gathers insight from the fields of psychology and economics to try to analyze why people make choices. Behavioral economists do not subscribe to the fact that individual choice always follows rational guidelines or is statistically predictable, but believe that individual choice is heavily influenced by other factors. The importance of behavioral economics as a significant field of study is evidenced by the fact that leading behavioral economist Daniel Kahneman shared the 2002 Nobel Memorial Prize in Economic Sciences "for having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty" ("The Sveriges Riksbank Prize," 2002).

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