Journal of Behavioral Economics for Policy, Vol. 3, No. 1, pp. 46-47, 2019

BOOK REVIEW: David Leiser & Yhonatan Shemesh on How We Misunderstand Economics and Why It Matters

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Bibliographic Information
David Leiser and Yhonatan Shemesh, *How We Misunderstand Economics and Why It Matters: the psychology of bias, distortion and conspiracy*. Published by Routledge, 2018.
ISBN 978-1-138938922 (hardback)
ISBN 978-1-138938939 (paperback)
ISBN 978-1-315675343 (eBook)

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Laypeople – in their majority – do not realize the subtleties of physics or biology, or come along with ready-made judgements about medicine or chemistry. This sequence could be continued and economics would not be an exception – yet it is. And way too many common judgments on economic issues turn out to be wrong. Examples abound: laypeople do not realize the impact of a drop in demand on market price changes, object to a tax rise even if it certainly leads to the overall improvement of future public welfare, fail to see the connection between real estate prices and interest rates, neglect the adverse consequences of price regulation, get lost in unemployment-inflation trade-off (the Phillips curve), and neglect opportunity costs when making their own decisions. Why is it so, and what is much more important – why *should* we bother about it? David Leiser and Yhonatan Shemesh provide an elegant and striking analysis of the behavioural origins of public misperceptions of the logic and development of modern economics, and of their implications for public policy.

The short answer to the question ”Why?” lies in the consequences of the economics way of thinking. The law of gravity exists regardless of personal preferences: whether someone despises it or adheres to it - gravitation will reveal its mechanism as soon as one gives it a trial. However, in economics such beliefs, stereotypes and penchants are not easily put into scrutiny – yet they are spread over each individual and household. The failure of the public to understand the principles of economics undermines the efficiency of public policies. As the authors concisely put it at the very beginning, “this is not just a matter of knowledge or ignorance: misunderstanding exerts its toll” (Leiser and Shemesh, p.2).

And now the second factor – which might be even more significant – comes into play: complexity or complications in human decisions. Not only is knowledge of economics not popular but the very essence of this knowledge is too sophisticated for laypeople. At the heart of that discrepancy lies the argument that ≪economics is misunderstood by the public because of the mismatch between central features of economic theory, and the human cognitive endowment.≫ (ibid, p.17). Specifically, the authors attribute this inability to deficiencies of working memory (WM), which is short in range of items it can process and thus myopic, and long-term memory (LTM), which possesses extensive information that is often difficult to retrieve and combine in the right order. (Akin to this, one may also think of a distinction between fine (analytical and deep, but limited in scope) and geometric (broad but not very deep) ways of thinking introduced by Blaise Pascal.) The two notions are connected to System 1 and System 2 thinking (Kahneman, 2011): LTM contains and suggests ready-made solutions which may not be sufficiently accurate, while WM processes information analytically, but lacks scope to make the right decision.

In this context, Leiser and Shemesh distinguish two types of actors (that can remotely resemble Thaler’s concept of “*Econs*” and “*Humans*” (Thaler Sunstein, 2009)): economists (specialists) and laypeople (“people without specialized training”). Economic questions typically require analytical decisions of WM and System 2, while natural, laypeople thinking is bounded by a narrow scope, involving LTM and System 1. As a result, common people do not perceive the multi-factorial nature of economic processes. They exaggerate at the same time the actual importance of direct effects. They underestimate indirect and feedback effects. They have a predilection to personalised judgments in terms of ethical questions, such as, for instance, what should be one’s attitude to profit-making motive, to taxation systems, to different conceptions of fairness etc. And of course, decisions of ordinary people are prone to all kinds of biases, such as overconfidence in own knowledge (the Dunning-Krueger effect), the halo effect of neglecting risks when facing a very profitable asset, or priming effect of past experience in experimental games. Much of the book is devoted to these and many more examples drawn from academic literature, not least by the authors of the present work.

The economic way of thinking stands far away from all that. Unlike laypeople, economists forbid to themselves the luxury of metaphorical thinking. Statements such as "the economy is like a machine" or "a financial crisis is like a tsunami" are misleading not only because they are imprecise, but more importantly, because the mechanical analogues they imply are simply wrong for multi-dimensional, multi-faced economic issues. Similar colloquial visions result in many misdirected apologies and critiques of capitalism, or emotional attitudes to the "golden weal" (money).

Final, and probably the most essential and practical query of the authors is that of implications for public policy (to which the last chapter is fully devoted). Economics is misunderstood and that is not accidental – yet this is a "natural state of affairs, in view of the mismatch between cognitive tendencies and the particular type of analyses and concepts that economic science has developed". Regarding this phenomenon, Leiser and Shemesh suggest a taxonomy of mismatches: all economic knowledge obtained over the centuries should be divided into two categories. On the one hand, some of these can be shared with the general public, while others cannot ("not because it is secret but because it is inaccessible"). On the other hand, it is possible to distinguish between two different parts of the same economic knowledge based on personal finance and political economics. Examples of truth that can be explained include the need to save for one's pensions, or the need to vote at the elections. Examples of the opposite include herding behaviour in financial markets, or failure to understand long chains of consequences – for instance, a simple basic fact that prices are affected not only by the (mostly bad) will of the sellers, but also by consumer demand. Meanwhile, the boundary between the issues which can be explained and those that cannot is not an obvious one and that is why the authors call for further research into that question as well as in people's views of economics.

In view of these mismatches, much of the critique of economic way of thinking as being 'not realistic enough', can and ought to be turned upside down. Instead of calling for "more realistic" models that would bring economics closer to *real life*, the authors suggest, one should strive to eliminate, or at least to minimise mis-perceptions and irrational reactions of laypeople to simple economic truths.

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