Introduction to the course

New Thinking in Economics

London, 9.9.2015

„Get ready to change the way you think about economics”

Richard H. Thaler, President of the American Economic Association 2015

Misbehaving – The making of Behavioral Economics, New York / London 2015

So what`s this course about? I would say this course simply has to do with what people want and how they decide in order to get what they want. And there is a radical change of thinking about it at the moment in economics. We are going to be talking about in some organized way I hope.

So we are very interested in the basic ideas of old thinking in economics the so called neoclassical theory first. Then we are going to be studying the new thinking in economics the so called behavioral economics on the one hand and happiness research on the other hand.

Once we understand the nature of neoclassical theory we can then go on to the subject of the new way of thinking in economics.

So let`s go through in more detail:

Neoclassical theory is simply based on the assumption that human behavior could be modeled on the basis of the so called homo oeconomicus assumption. Following this assumption people act rationally, selfishly and time consistent, which means they don`t change their preferences. A further central assumption here is that more material goods/ money is always better then less. And the tricky thing is that economic textbooks in the past normally didn`t mention that all of the theory which was shown in the textbook wass based on the homo oeconomius assumption. So students especially economics and business administration were were indoctrinated by this slowly and wrong imprints were coin about the behavior of others which also influenced the behavior of those students towards others concretely spoken they got more selfish.

The rethinking of economics has two new directions that lie at different levels.

- Behavioural economics deals with the question of how people really decide. It moves away from the a priori assumption of homo oeconomicus on the basis of neurobiological and psychological insights of the dual action system, which consists of our neocortex and our limbic system in our brain.

Extensive research has shown that our ability and our willingness to act rationally according our neocortex which means to act often against our emotions and views of the world in our limbic system is very limited. Or to put it differently: In our dual actions system the limbic system normally wins. This means our decisions are very often influenced by biases, heuristics, faming effects, loss aversion and so on.

Research has also shown that most of the people - 80 % or more - are not selfish. Rather than they are driven by an innate feeling of fairness, more then 10 % are even altruistic. This has something to do with our history and evolution. Crucial for the survival of the tribe of humans (homo sapiens sapiens) was our capability to cooperate. But the prerequisite for cooperation was and is fairness. Without fairness there is no cooperation.

Finally our plans and decisions are also often not time consistent. One reason for it is that we have cold and hot states. In a cold state we think about something in the future theoretically in a calm atmosphere (f.e. we should save more for our retirement) – here is the neocortex active. In the hot state we are in a concrete situation f. e. in a shop. In such a situation our limbic system which only knows the needs and wants of the moment urges us to buy what we want in this moment without thinking about our situation in future (too less money when we get retired). Mostly the limbic system wins. This has something to do with the fact that our limbic system is much stronger as our neocortex. The limbic system is millions of years old. Its task was simply to do all for surviving in the moment. Our neocortex is relatively young, only some hundered thousend years.

Insights of Behavioral Economics are more and more used in politics. On a micro economic level to help to make better decisions i.e. to take the status quo biases into consideration. On a macro economic level to calm markets because we know especially financial markets are less rational but more fluctuating driven by herd behaviour between panic and mania.

- Interdisciplinary happiness research examines the question of what people really want. It is based on the fundamental economic question of how to use resources efficiently. It’s about how people use the ultimate scarce resources. The ultimate resources are our lifetime. So the economics is about do make use of our time in order too be happy and satisfied in life as the final goal. And here research shows that the influence of material things are very limited. Because as soon as the material needs are satisfied more money/ income doesn`t lead to more satisfaction with live – we are getting accustomed to the new situation easily and increase our expectations. So the a priori assumption of "more material things are better than less" does not hold in the light of the results of the interdisciplinary happiness research. But this has clear consequences for the policy of the government: Rather then focusing on economic growth it is central to directly on those factors which are decisive for improving happiness (for more details see OECD Better life index).

From a business perspective this is by far not an theoretical discussion.

It is important to be aware of these findings, because most of today's executives were more or less indoctrinated with the neoclassical assumptions in economics. Neoclassical theory was dominating economics the last three decades or so unfortunately. For example generations of students were indoctrinated with the “believe” that humans normally are selfish or even greedy which has had consequences for dealing with others especially in business.

So unsustainable assumptions of neoclassical economics that lead to certain imprints cause faulty management decisions and bad leadership. Dealing with these assumptions is compulsory to create room for overcoming old imprints and be ready to deal with new thing in economics without prejudice.

These imprints must be identified and invalidated as “mere” settlements before we are ready to deal with new thinking in economics and especially with the findings of the interdisciplinary happiness research. Then this can fall on a fertile ground and really find the way into everyday actions.

"Why do we keep ourselves busy with happiness and satisfaction? … The reason is quite simple: Investigations in the fields of neurobiology, psychology as well as in the field economics make the link between happy and satisfied employees and better business results completely clear. … . "

Harvard Business Review, January / February 2012 p 77

We explained in our book entitled "Healthy Leadership with findings/perceptions of happiness research" (http://shop.haufe.de/gesundes-fuehren-mit-erkenntnissen-der-gluecksforschung) the meaning of "baseless assumptions " as well as the state of the current findings of the interdisciplinary research in economics in order to derive recommendations for management and personnel. Or to illustrate it with the words of the Chancellor Angela Merkel which she used as opening remarks at the conference of the Nobel Prize winners in economics in August 2014 in Lindau; “It is about distinguishing research in a "vacuum" from the "reality" ”.

Which important role happiness research plays in economics demonstrates the quotation of Ben Bernanke, the former chairman of the US central bank from the year 2012.

"The ultimate goal of Economics is, of course, to understand what constitutes well-being and how it can be increased / improved."

Ben Bernanke, head of the US-Central Bank (until end of January 2014), August 2012

However, the Nobel Prize winner in literature of the year 1925, George Bernard Shaw, said a long time ago: "Economics is the art of making the most of our lives."

The findings of happiness research have serious consequences for politics and companies. The implementation of happiness research findings in politics and enterprises is already in progress. F. e. in two weeks the biggest summit of leaders will meet in New York in an UN summit to fix the Sustainable Development Goals for 2015 – 2030. There are 17 goals. The third goal is health which is one the one hand measured with healthy life expectancy and one the other hand with statisfaction with life, which is worldwide used to measure happiness. And there is a strong connection between happiness and health. We know that happiness leads to a better health and a longer life experience.

1. **What is happiness (subjective well-being)?**

Happiness research addresses happiness in the sense of happiness, i.e. with the subjective well-being and not with being "lucky", thus random luck (e.g. the probability of winning a lottery prize).

**There are two characteristics of the subjective Well-Being:**

1. **Emotional Well-Being:** is the emotional state at the moment. It is based mainly on the relationship between positive and negative emotions on a daily average. This is about the Well-being that people experience as they live their lives.
2. **Cognitive Well-Being:** is the degree of "satisfaction" with life (Evaluation). A trade-off takes place between what one wants (objectives, expectations, desires) and what one has. It is about the judgment that people make when they evaluate their lives. Goal setting is important here, as the decision is made based on whether the goals that are set by the people themselves have been met.

A happy person often enjoys positive emotions and rarely experiences negative feelings in the “Here” and “Now”. He sees a meaning in his life; therefore pursue meaningful and realistic (life-) goals.

**2. What are the sources of subjective Well-being (so-called "Happiness Factors")?**

The interdisciplinary research on happiness deals intensively with the question of what important factors contribute to our subjective Well-being? In this context it’s the so-called happiness factors, they are source of subjective Well-being (benefits). The following factors were identified by the happiness research:

* Successful/ affectionate social relationships (partnership, family, friends, neighbours, colleagues ...)
* Physical and mental health
* Commitment and successful employment and / or Non-acquisition work
* Personal freedom
* Attitude (in terms of gratitude, optimism, social comparison, emotion management, ...) and life philosophy (spirituality, that is a personal search for meaning of life and religiosity)
* Means of satisfying the material (basic) needs and financial security

Social contact is an important factor of happiness, but also work plays an important role as well.

We need work because we want to do something useful with our time and generate income. Work creates opportunities for intellectual development. Work conveys the feeling of being needed, strengthens our confidence, creates identity and provides social contact.

**3. Why is it worth to be happy / satisfied?**

The person who is working on becoming happy and satisfied, will not only feel subjectively better, but also will have more energy, a better creativity, strengthen the immune system, have stronger relationships, work productively and increase his life expectancy.

**4. The relationship between happiness/satisfaction and economic growth in western industrialized countries over the last decades**

The worldwide large-scale survey on satisfaction practiced since the 1960’s showed that in western industrialized countries there is barely any connection between the increase in gross domestic product per capita and life satisfaction ("Cognitive well-being").

On the one hand, expectations adapt to the actual development. That is, as income increase expectations also increases, therefore, no greater satisfaction/happiness arises (So-called hedonic treadmill). On the other hand – if the basic material needs are satisfied - less absolute income, but rather more relative income - i.e. one's income in comparison to other is decisive. A general increase in income for everybody: results in an increase of social norms, therefore the level of satisfaction does not increase, as everyone receive more. With income changes: The sum of ranking positions in a national economy is fixed – when one rises, another one must scale down - a zero sum game.