Behavioural Economics Perspectives: Implications for Policy and Financial Literacy

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Abstract

This paper summarizes and highlights different approaches to behavioural economics. It includes a discussion of the differences between the "old" behavioural economics school, led by scholars like Herbert Simon, and the "new" behavioural economics, which builds on the work of Daniel Kahneman and Amos Tversky and is best exemplified by Richard Thaler and Cass Sunstein's recent book, Nudge. These important currents in behavioural economics are also contrasted with the conventional economic wisdom. The focus of this comparative analysis is to examine the implications of these different approaches in behavioural economics for financial literacy.

The Simon approach argues that intelligent people can make decisions that appear irrational from the perspective of conventional economic wisdom. However, these decisions are typically the right ones for the individuals making them and are often based on how the brain is wired as well as on the decision-making environment these individuals face. Errors in decision making can be made if rationality is bounded—that is, if the quality of information used is poor or the information is framed in a misleading fashion. Also, the decision-making environment might be such that individuals don't have the right incentives to make ideal choices. Finally, individuals may not have the knowledge base to make ideal choices in finance-related matters. Therefore, financial decision making can be improved by providing decision makers with better quality information presented in a non-complex fashion, an institutional environment conducive to good decisions, and financial education that will facilitate making the best use of the information at hand within a specific decision-making environment.

The Kahneman-Tversky approach is more focused on nudging or even legislating rules that drive choice in desired directions as defined by experts, as opposed to educating the decision maker. This perspective, often referred to as libertarian paternalism or light paternalism, holds that decisions may be inconsistent with conventional economic wisdom norms for rational decision-making because they are based on how the brain is hard-wired. Because it is difficult to alter hard-wired behaviour, decisions are often error-prone, biased, and irrational. Financial education plays a much smaller role in improving choice behaviour in this approach than in Simon's or the bounded rationality approach to behavioural economics.

However, by recognizing the importance of the quality of information and how it is presented or framed for a decision maker, behavioural economics in general opens the door for public policy to improve the overall decision-making environment. It helps us understand why it is critically important to improve financial literacy. This is particularly the case with the Simon approach and its focus on the quality of the decision-making environment married with a strong dose of financial education. This approach holds that improved financial education allows decision makers to take advantage of an improved incentive and information decision-making environment. Little attention is paid to nudging or manipulating choice in a particular manner. Individual choice is largely respected, as in traditional economics, unless choices are deemed to cause social harm.

Keywords: financial literacy, behavioral economics, labels, errors and biases, rational inefficiency, bounded rationality, nudging, paternalism, capabilities

JEL Classification: A1, A2, D1, D6, G2, H3, I2, K2, K4, L5, Z1

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