Chapter 8	McConnell, Brue and Flynn 20th

Behavioral Economics

Scientific theories are judged by the accuracy of their predictions. As an example, nobody would take physics seriously, if it weren't possible to use the equations taught in college physics classes to predict the best trajectory for putting a satellite into orbit or the best electromagnetic frequency to penetrate buildings and provide good indoor cellular service.

Conventional **neoclassical economics** makes many accurate predictions about human choice behavior, especially when it comes to financial incentives and how consumers and businesses respond to changing prices. On the other hand, a number of neoclassical predictions fail quite dramatically. These include predictions about how people deal with risk and uncertainty, choices requiring willpower or commitment, and decisions involving fairness, reciprocity, or trust.

Behavioral economics attempts to make better predictions about human choice behavior, by combining insights from economics, psychology, and biology. This chapter introduces you to behavioral economics and the areas in which it has most dramatically increased our understanding of economic behavior. Among the highlights is prospect theory, which offered such a large advance in our understanding of how people deal with risk and uncertainty that its inventor, Daniel Kahneman, received the Nobel Prize in economics.