BEHAVIORAL ECONOMICS, ECONOMIC THEORY
AND PUBLIC POLICY

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Abstract: Behavioral economics is discussed in detail, focusing on its varied impact on economic theory, economic analysis, and public policy. Recent contributions related to the work of Kahneman and Tversky’s heuristics and biases paradigm are critically assessed in the context of the broader behavioral line of research that specifies that the realism of one’s simplifying assumptions matter for the construction rigorous economic theory. Such assumptions are not only psychological in nature, but also biological, sociological, and institutional. Moreover, behavioral economics is much more than consumer behavior and behavior on financial markets, a preeminent focus of contemporary behavioral economics. It is also very much concerned with theories of production, theories of the firm, household behavior, and institutions. Findings of behavioral economists tend to refute the notion that individuals behave neoclassically, giving rise to a literature and debate as to which heuristics and sociological and institutional priors are rational, which yield optimal economic results, and which tend to improve socioeconomic welfare. Although many contemporary behavioral economists argue that individuals are fundamentally irrational because they do not behave neoclassically, a forceful narrative remains that considers non-neoclassical behavior rational, yielding optimal economic results under particular conditions. A common thread running through behavioral economics is that modeling assumptions matter and that conventional theory is seriously wanting in this front with significant implication for economic analysis, theory and public policy.

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