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Title: Anchoring in Economics: On Frey & Gallus on the Aggregation of Behavioural Anomalies

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Recommendation: Accept as is

Comments: The paper, I gather, is a comment on a contribution to a special issue of *Economics E-Journal* devoted to psychology and choice theory. I have not read the Frey & Gallus paper upon which Professor Earl comments, but Earl's nicely written note makes a useful point and therefore merits publication. Although the piece is publishable more or less as it stands, I offer a few comments that Professor Earl might want to take into account in preparing a final draft.

Starting from the now hardly controversial observation that economic actors do not always behave in accordance with the standard conception of economic rationality, Frey & Gallus argue that economists need to find ways to assess how far such deviations from 'rationality' affect real-world economic outcomes. The idea is that a highly developed market system offers mechanisms and resources upon which economic actors may draw when making decisions, and these resources and mechanisms are likely to have a bearing on the soundness of the decision-making process outside the artificial environment in which economists nowadays often conduct their studies of choice behavior. Earl's concern is that the possibility of improving decision-making by drawing upon market-provided expertise opens the way for orthodox economists to treat micro-level deviations from economic rationality as anomalies that market forces will by-and-large correct at the macroeconomic level:

By emphasizing that outside the research laboratory, decision-makers may have incentives to overcome their psychological shortcomings, as well as having resources to enable them to do so, Frey and Gallus have provided a means for rational choice theorists to try to continue applying 'as if' justifications for adhering to the traditional approach.
(p. 5)

Earl's preemptive argument against such efforts to shore up the rational choice approach is that decision-making isn't grounded in given well-defined preference sets: economic actors are continually revising their decision criteria in reaction to unfolding events. That is to say, the starting premise of the rational choice framework—the idea that there are such things as preference functions that can, in principle, be optimized—is a profoundly wrong-headed way of thinking about how people make choices.

I agree with this, of course. But I suspect that an orthodox economist would view the argument as just so much quibbling. An 'as if' justification could as easily be applied to the preference function hypothesis as to the rationality hypothesis. Frey & Gallus might respond to Earl by saying, "Well, let's just get on with the empirical work, and see what that tells us. Only then will we be able to decide which 'as if' hypotheses are serviceable and which ought to be discarded." I'm sure Earl doesn't mean to suggest that the empirical projects Frey & Gallus want to encourage can't tell us anything useful. Yet I detect in his comment a hint—perhaps unintended—that such studies will be misleading or otherwise problematic in so far as they are

grounded in the rational choice outlook. Perhaps I have misunderstood. But if the Frey & Gallus paper mainly wants to make a case for empirical work, Earl may want to say a bit more about why he is taking issue with their rational choice anchoring. That's the default position of the vast majority of economists, after all, and there is nothing unusual in the fact that Frey & Gallus take it as their starting point. Their hypothesis about the ameliorative impact of aggregate market activity on dysfunctional choice behavior will no doubt appeal to mainstream economists as a way of sweeping such behavior under the theory-land carpet. That too is to be expected. But in the end, if Earl's objections to rational choice theory are sound, won't the empirical studies advocated by Frey & Gallus tend only to expose additional defects in the mainstream approach? So precisely what is Earl's target in this comment?

I'm a little skeptical about the suggestion on p. 10 that the laws of probability may enable incompetent or predatory firms to survive over the long run; the costs and inconveniences associated with poor quality eventually lead customers to superior suppliers, even if once in a while bad luck matches a particular buyer with a dodgy seller. True, firms can muddle through by providing middling service; but such firms cannot thrive if the goods and services their competitors provide are of considerably higher quality. And in the absence of empirical evidence to the contrary, I doubt that truly incompetent firms can last very long. They either get better or struggle until they must close their doors. Capitalism is brutal in this regard. I imagine also that the market is somewhat more effective at chasing predatory suppliers out of the game than it is at weeding out mediocrity: cheats get no repeat business.* I mention this because Professor Earl treats incompetence and predation as interchangeable supply-side defects; he might want to note that they are different and have different consequences for survivability.

Also on this matter of the survival of firms who provide goods & services of poor quality, I do agree with Earl that bad practices can persist. *But they do so mainly when they are universally adopted by big players in monopolistic or oligopolistic markets.* Examples are easy to come by. The deterioration of service in the airline industry is a case in point. If every carrier on almost every route is charging fees for checked luggage and headphones, eliminating in-flight meals, reducing legroom, cutting the number of direct flights etc., customers cannot vote with their feet. Similar indignities have been inflicted on retail banking customers. These practices, which rightly deserve the label "poor service", persist, as do the firms that adopt them. But none of this has anything to do with the incompetence of suppliers or the irrationality of buyers: the suppliers are deliberately adopting policies that inflict inconvenience and costs on their customers, and the customers have no recourse but to accept the deterioration of quality. In a sense, such phenomena turn the Frey & Gallus hypothesis on its head: rational behavior at the microeconomic level exacerbates non-optimality at the macroeconomic level.

Finally, I wonder if, at p. 16, Professor Earl can find examples of dysfunctional choices that are less exotic. People who choose not to immunize their children or who are phobic about flying are a microscopic subset of the population in developed countries. If Earl's aim here is to show the *general practical relevance* of his argument about preference formation, examples of a more routine character might better serve his purpose.

* I acknowledge that predatory sellers may endure. But generally they can do so only in fringe activities such as the selling of illegal drugs or sexual services. This is not what professor Earl has in mind.