

## Chapter 9

# A Challenge to Homo Economicus: Behavioral Economics

**Hatice Isıl Alkan**

*Ondokuz Mayıs University, Turkey*

### **ABSTRACT**

*Neoclassical economics is the mainstream economic paradigm of the present era and has certain assumptions such as rationality, perfect knowledge and unique equilibrium. In this regard, homo economicus, namely rational economic man is the main agent of mainstream economics. However, this main agent has aspects that are inconsistent with reality. In other words, decision units are likely to be irrational in the real word because individuals are emotional and social beings. Considering that this conception of rationality contradicts with the instability of economies and crises that have happened, it seems that the dominant economic view cannot exactly explain current events. This chapter questions the concept of homo economicus, the compatibility of homo economicus with homo sapiens and attempts to reveal the shortcomings of the dominant view. It substantially tries to explore why behavioral economics is necessary and how behavioral economics can make up for the shortcomings of the mainstream economic paradigm by the help of its branches; experimental economics and neuroeconomics.*

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## **INTRODUCTION**

Economics is a science that, like other sciences, changes and evolves over time. Economic thought has undergone significant evolution since the emergence of mercantilist thought. Following every economic view, new schools have emerged that highlight the shortcomings of the previous one. It should here be noted that a neoclassical view has been the dominant view in economics for many years; thus, neoclassical economics has become the mainstream. However, neoclassical economics has shortcomings and aspects that are inconsistent with reality. In this regard, the term “homo economicus”, which refers to the rational and unemotional individual who pursues his or her self-interest, stands out as one of the basic assumptions of neoclassical economics. It is an economic agent who acts inconsistently with reality and has low explanatory power in terms of economic decisions.

The dominant paradigm suggests that human beings always act rationally. It also ignores irrationality and bounded rationality and by extension the influence of psychological factors in behaviors and decisions. However, human beings are emotional and social; therefore, psychological traits are of importance in decisions. The rationality of individuals seems to be contradictory to the destabilization of economies as a result of the emergence of financial crises, thereby indicating that the current mainstream economics cannot fully explain individual decisions.

Against this background, the first section describes the concept of homo economicus as the main agent of the mainstream. The second section attempts to show how behavioral economics (BE) emerged as a result of the shortcomings of mainstream economics and illustrates the development of BE within the context of old and new BE. It also discusses the pioneers of BE and their significant contributions to economics. The third section focuses on the basic concepts and methodology of BE. It also looks at experimental economics and neuroeconomics, which are the branches of BE. Moreover, the third section asserts the methodological differences between BE and mainstream economics. The conclusion section explains the general implications of the study and discusses why BE is needed in our era.

## **THE MAIN ACTOR OF MAINSTREAM: HOMO ECONOMICUS**

Mainstream economics generally refers to neoclassical economics, which has several assumptions such as rationality, perfect knowledge, unique equilibrium, and diminishing returns. In this respect, rationality is one of the main assumptions

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