Human Behavior and Austrian Economics

Leef H. Dierks

In virtually every aspect of human life, decision-making features emotional components. Put simply, decisions are never based on strictly rational behavior alone. And still, an overwhelming number of economic models are based on this very assumption. Even contemporary models still understand the influence market participants' (unconscious) emotions exert on behavior to be moderate, at best. While classical investment theories assume that investment decisions are always based on a strictly rational process—and that an investor can forecast future developments in an undistorted manner, behavioral finance assumes that investors frequently

It was in Ancona, Italy, in December 2015 that I bumped into one of this Festschrift's fellow authors. For reasons which even several years later still remain unknown to us, the conference we attended, strongly resembled the Annual General Meeting of the John Maynard Keynes Society.

Over dinner (done in style, at least) my fellow author and I discussed the efforts related to organizing an academic conference (needless to say, on

L. H. Dierks (✉)
Lübeck University of Applied Sciences, Lübeck, Germany
e-mail: leef.dierks@th-luebeck.de

D. Howden, P. Bagus (eds.), *The Emergence of a Tradition: Essays in Honor of Jesús Huerta de Soto, Volume I*,
https://doi.org/10.1007/978-3-031-17414-8_9

act irrationally. This makes their behavior subject to considerable biases with regard to perception and evaluation. However, if market participants understand this phenomenon, inevitable consequences could a priori be accounted for (Dierks & Tiggelbeck, 2019).

A Potential Overlap of Behavioral and Austrian Economics

Behavioral economics present challenges to the neoclassical theory of individual behavior, which is based on individuals seeking to maximize their expected utility. However, behavioral economics has illustrated that, indeed, it is common for individuals to systematically deviate from this axiom. To a certain extent, Austrian economics is based on axiomatic theories of utility maximization, too, but the underlying assumptions are considerably weaker. In consequence, Austrian economics benefits from a (more realistic) behavioral foundation, which makes it less vulnerable to challenges by experimental and empirical approaches. Put differently, Austrian economics appears to be better suited for policy analyses. And yet, Austrian economics has often been criticized for its alleged inability to incorporate more modern economic paradigms. Particularly principles such as the *homo oeconomicus*, who strictly abides the concept of rationality, have been questioned. Critics claim that such approaches fail to adequately reflect reality—but instead are of mostly theoretical relevance. The concept of the *homo oeconomicus* is unrealistic; it can only be held upright in an environment of certainty or risk but not uncertainty (or ignorance).

Austrian Economics). It was not until we had drinks later that night that the scales fell from our eyes: Why not try and bring the conference to Madrid, i.e., to the "new Vienna" as my dear colleague appropriately referred to it.

It fell upon me to reach out to him who is honoured by this Festschrift. Reply was swift, reply was positive—and no later than autumn 2017 the inaugural Madrid Conference on Austrian Economics was held on the Vicálvaro campus of Universidad Rey Juan Carlos. That was when I first met Jesús Huerta de Soto.

Of course, I had heard the anecdotes long before we finally met. He would inevitably reach to his pocket, people claimed, seize a golden coin—and toss it to the ground, delightedly bathing in his audience's reaction, the amazement, and the emotions.

Still, in order to develop economic models, it is indispensable to make simplifying assumptions regarding decision-making. In extremis, the *homo oeconomicus* neither is subject to emotions, nor is his consciousness subject to limited absorption capacities. As models can merely depict an excerpt from reality it is inevitable to reduce complexity. However, more realistically (but contradicting the concept of the *homo oeconomicus*), market participants spontaneously adjust their preferences to environmental conditions. This ought to be taken into consideration. Whereas traditional models thus assume that market participants operate independently of any personal reference points, behavioral economics could show that decision-makers repeatedly behaved in contrast to the neoclassical axiom of rationality (Dierks & Tiggelbeck, 2021).

Limitations to Human Decision-Making

Behavioral economics refers to actual human decision-making through extending the neoclassical concept outlined above by methodological diversity, inter alia emphasizing the limitations of human thinking (Taffler, 2018). More recent research indicates that intuition and mental abbreviations (heuristics) can indeed be efficient tools for reaching a judgment. In an environment of uncertainty, they are not necessarily the origin of systematic errors in reasoning or of cognitive distortions.

The Influence of Emotions

In contrast to reasoning, emotions are an instinctive or intuitive feeling, which usually arises outside an individual's consciousness. It therefore cannot be directly influenced (Taffler, 2014, p. 2). However, a cognitive basis is a prerequisite for an emotion. Decisions made on the basis of emotions are usually not based on rational evaluations (i.e., maximizing expected utility in accordance with available fundamentals), but on the feelings which humans perceive in certain situations (Kahneman, 2011, p. 175).

Combining Behavioral and Austrian Economics

Austrian economics relies on praxeology (rather than empirical studies). Based on the action axiom, objective and universal conclusions about human behavior can be drawn, for example, the notion that investors engage in acts of choice implies that they have preferences. This must be true for anyone who exhibits intentional behavior. Austrian economics further suggests that individualism is non-existent in an environment in which subjectivism generates a spontaneous order by interacting with other investors. Notwithstanding unpredictable future developments, there will always be particular behavioral patterns repeatedly occurring.

Behavioral economics, in contrast, is primarily concerned with investors' bounded rationality—and seeks to explain how decisions are made, the explanatory power of any economic principle could ceteris paribus be greatly enhanced by combining these paradigms.

Parallels? Or Contradictions?

Behavioral economics appears to contradict Austrian economics with regard to influencing individuals' behavior in an attempt to arrive at a socially optimal outcome and to maximize economic welfare. Yet, among the essential characteristics of Austrian economics is its view of market competition in terms of processes and rationality—as opposed to merely an optimal equilibrium. This comes as Austrian economics' focus is on understanding the coordination of (eventually incompatible) plans among agents with limited knowledge, that is, in individual learning, effectively. This, in turn, is assessed in terms of the capacity to allow market participants to discover new solutions to market problems and to realize and correct individual mistakes (Muramatsu & Barbieri, 2017).

Behavioral economics, which typically benefits from a sound microeconomic foundation, attempts to answer the question to what extent unconscious processes influence individual investment decisions, that is, what significance emotions have for investment decisions and the perception of risk. From an Austrian perspective, however, behavioral economics could benefit from relaxing its restrictive and axiomatic definition of rationality—in an attempt to treat humans as *active* rather than passive recipients of (environmental and cognitive) influences (Whitman, 2021). It remains unclear to what extent this argument indeed is valid as behavioral economics being an interdisciplinary subdiscipline of economics, neurosciences, sociology, and psychology is inter alia based on a renunciation of the traditional concept of rationality in the sense of the *homo oeconomicus*. From the perspective of behavioral economics, in contrast, Austrian economics could benefit from better understanding the fundamental question of how individuals arrive at choices and to analyze how such choices interact with the agents' respective environment (Whitman, 2021).

Conclusion

Behavioral economics and Austrian economics feature considerable conceptual differences, which makes their relationship complex and multifaceted (Rizzo & Whitman, 2009). But as both behavioral economics and Austrian economics scrutinize the axiom of human rationality, a combination of the paradigms' essential features will undoubtedly create considerable academic value-added. A combination of Austrian economics and behavioral economics would considerably enhance the understanding of humans' sometimes erratic decision-making under uncertainty. This comes as economic models are but an axiomatic simplification of reality, whereas (a supposedly objective) reality ultimately is but a phenomenon of an individual's subjective perception.[1]

References

Dierks, L. H., & Tiggelbeck, S. (2019). (Ir-)Rationality of Investor Herding. *Procesos de Mercado: Revista Europea de Economía Política*, *16*(2), 253–270.

Dierks, L. H., & Tiggelbeck, S. (2021). Emotional Finance—Zum Einfluss von Emotionen auf Investmententscheidungen. *Der Betriebswirt, 62*(2).

Kahneman, D. (2011). *Thinking, Fast and Slow*. Penguin.

Muramatsu, R., & Barbieri, F. (2017). Behavioral Economics and Austrian Economics: Lessons for Policy and the Prospects of Nudges. *Journal of Behavioral Economics for Policy, 1*(1), 73–78.

Rizzo, M. J., & Whitman, D. G. (2009). The Knowledge Problem of New Paternalism. *BYU Law Review, 2009*(4).

Taffler, R. (2014), *Emotional Finance: Theory and Application*.

Taffler, R. (2018). Emotional Finance: Investment and the Unconscious. *The European Journal of Finance, 24*(7–8), 630–653.

Whitman, G. (2021). Austrian Behavioral Economics. *Journal of Institutional Economics*, 1–18.

[1] Oh, and before I forget: After all, the coin he did toss. What did you think?