



Remembering Daniel Kahneman: The architect of behavioral economics

Maj Gen GG Dwivedi

April 10, 2024, 14:34:59 IST

An iconic figure, whose pathbreaking work integrated psychological research with economic theory, Kahneman has left an incredible footprint



(File) 2002 Nobel Economics Laureate Daniel Kahneman. Reuters

Professor Daniel Kahneman who died recently on 27 March, 2024 at the age of 90 was a psychologist by training but emerged as the founding father of behavioral economics. Through his lifetime experiential work on the mechanism of human thinking, Kahneman highlighted the brilliance and limitations of the human mind. In the process he showed that the decisions people make in real life are

hardly rational, thus challenging the mainstream theories of microeconomics.

Kahneman was awarded the Noble Prize in 2002 for his pioneering work on decision-making and uncertainty undertaken in collaboration with Amos Tversky. They introduced the ‘Prospect Theory’, based on psychological research which indicated that people are neither consistently risk-seeking nor risk-averse. The coherence comes mostly from the way an individual’s mind works.

As per Kahneman, the human brain is highly evolved to perform many functions with great efficiency but ill-suited to accurately carry out other mental tasks; thinking being riddled with behavioral fallacies. Further, people react quickly based on incomplete information, often with unfortunate results. Kahneman went on to expose that human biases hugely affect decision-making, His ‘peak-end rule’ theory highlighted that people tend to focus on the most intense aspect and end point of an experience while ignoring everything else.

It was during the course on ‘Leadership Decision Making’ at Harvard Kennedy School which the author attended that Daniel Kahneman theories were discussed in depth. Interestingly, the concepts enunciated by Kahneman have been commonly practiced

in the armed forces, though unconsciously. On the battlefield or amidst a crisis, when situations happen to be extremely critical and ambiguous, intuitive decision-making stands out as the most practiced process.

Kahneman's popular book *Thinking Fast and Slow* published in 2011 explains how the human brain processes information and combines two modes of thought which he described as System 1 and System 2 while both coexist. To illustrate, when commuting to work, you take the set route without having to consciously think about it. However, in case of exploring an alternate way will require some thinking and deliberation.

The Fast-Thinking System 1 is almost an instantaneous process that operates effortlessly and instinctively. It relies on intuition and experience. It is an error-prone process, used for common routine decisions, termed heuristics. In judging distance, for example, the mind frequently relies on heuristics which equates clarity with proximity. The clearer an object, the closer we tend to judge while fuzzier ones appear farther. Simple mental shortcuts help to make a continuous stream of judgements to navigate the environment. Incidentally, moods affect the operation of System 1. When unhappy, people tend to lose touch with their sense of intuition. On the other hand, while in a good mood human beings become creative, with increased reliance on System 1.

Slow Thinking which is System 2 is reflective, deliberate and logical requires greater cognitive effort. It is well well-reasoned and reliable process, employed for complex decisions. The operations of this system are often associated with subjective experiences and choices. Whatever is easier for System 2 is more likely to be believed as it arises from repetition and clarity of ideas. It so happens that restatement of falsehood can lead to people accepting it despite knowing it to be false because such information becomes familiar and cognitively easy to process.

As per Kahneman, before making big decisions, individuals or organizations ought to be well aware of cognitive biases as these can distort reasoning. Confirmation bias for instance leads people to ignore the evidence that contradicts their preconceived notions. Anchoring trap leads to giving disproportionate weightage to the first information received. Status quo bias results in the maintenance of the current situation even when better alternatives exist. The sunk-cost bias inclines people to perpetuate past mistakes. Framing bias occurs when the problem is misstated, undermining the entire decision-making process. While overconfidence bias results in hyperbolization, prudence trap leads to overcautiousness.

The biases invariably creep into organisational reasoning and distort thinking with serious consequences. Hence, it is pertinent for the

decision-makers to conduct a pragmatic review of not only the recommendations but also the process followed in formulating the recommendations. The best way to avoid biases is awareness, as the saying goes- ‘forewarned is forearmed’. The McKinsey study of more than 1000 business investments showed that when companies worked to reduce the effects of biases, returns on investment rose by seven percentage points.

Kahneman came up with the “Peak-End Rule” which advocated that in any event, it is the beginning and end which matters the most, duration being of lesser consequence. More importantly how it ended. For example, if one had a bad conversation towards the end of the day, it felt as if the whole day was bad. Again, eating the preferred piece of food last during a meal improves the reflective experience. Hence, it is pertinent to create a strong peak and finish on a high note.

Kahneman contended that happiness and satisfaction are distinct. He described happiness to be a momentary experience that arises spontaneously. Satisfaction on the other hand is a long-term feeling built over a period of time, based on achievement of objectives and goals. It amounts to leading a life that one truly admires. In a foundational work published in 2010, Kahneman and Deaton found

that day-to-day happiness rose as annual income increased, but above \$75,000 it levelled off, tending to plateau.

In his last exclusive conversation with N Mahalaxmi of *Moneycontrol*, when asked what he would like his legacy to be, Kahneman true to himself candidly admitted that he hadn't thought about it as he did not take himself very seriously. An iconic figure, whose pathbreaking work integrated psychological research with economic theory, Kahneman has left an incredible footprint. Given, 'Decisions shape Destiny' his legacy is set to inspire the posterity for generations to come.

The author is a War Veteran, former Assistant Chief; currently Professor Strategic-IR, Management Studies. Views expressed in the above piece are personal and solely that of the author. They do not necessarily reflect Firstpost's views.