Rationality versus Irrationality

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Any introductory textbook on economics always starts with the fundamental assumption of rationality. The rationality axiom guarantees that given scarce resources, a consumer always tries to maximize utility. The maximization of utility however is a function of manifold environments. The certainty or the uncertainty issue often brings the decision making process fuzzy as pointed out by Friedrich von Hayek. He asserts that the achievements or a decision is often poorly understood when configured by a different perspective on the role of socioeconomic institutions, behavioral and cultural norms encapsulated in the "knowledge, the idiosyncratic, dispersed bits of understanding of "circumstances of time and place." This deviation in the decision making process due to uncertainty has changed the landscape of the conventional economics and given birth to new frontier of behavioral economics or empirical economics. When you look into the behavioral finance, you will observe a set of paradoxes and thus need to goad to ascertain the delicacy in the paradoxes and get a solution that satisfies the irrationality in this decision making process. The most important paradoxes are "St. Petersburg Paradox. Mean - Variance Paradox in the selection of portfolio of assets and Maurice Allais Paradox. Now the financial economics has two branches; Classical and Behavioral. Behavioral finance is more related to situation that deals with human psychology and thus often lukewarm in relation to its first cousin, classical counterpart.

Friedrich von Hayek was the Nobel Prize Winner in Economics in 1974. His erudition to understand the fallacy in the propensity of imitation of the rule of physical sciences in a social context often guided by subjectivity "may lead to outright error.' "And while in the physical sciences the investigator will be able to measure what, on the basis of a *prima facie* theory, he thinks important, in the social sciences often that is treated as important which happens to be accessible to measurement. This is sometimes carried to the point where it is demanded that our theories must be formulated in such terms that they refer only to measurable magnitudes."

Unfortunately, there are attempts to measure the utility both by subjectivity and by devices such as "hedonimeter" that would measure the utility; each individual could gain from different possessions. It was indeed a peculiar idea by Francis Edgeworth who proposed this device, though the behavioral economics gained prominence when Daniel Kahneman and Vernon L. Smith shared Nobel Prize in Economics for their contribution in experimental economics. A psychologist from Princeton University, Daniel Kahneman and Vernon L. Smith, the George L. Argyros School of Business and Economics explore the immense possibilities of research based on data generated from laboratory experiments in contrast to data obtained from observations of real economics. The idea of experimental economics later developed by Kahneman and Tversky in the Prospect Theory that provides a working formula to calculate subjective utility based on a value and weighting function. The behavioral economics possesses genuine reasoning in explaining the investment behavior based on rationality but are based on alternatives with

different probabilities that reflects the state of mind. It can explain the investment decision related to Capital asset Pricing Model [CAPM], APT and owns a separate version of the CAPM. The behavioral finance is helpful to explain certain episodes such as the creation of bubbles in asset or the financial crisis of 2007-2009. It refutes the Efficient Market Hypothesis [EMH] because EMH is arbitrage free but that does not indicate transactions in the market are without any profit. You may trade in market based on beliefs, time preference and risk aversion. Thus rationality is not purely objective by nature but it is also difficult to refute that irrationality is purely subjective. It depends on framing of mind and the context you allude in the decision making process. It is quite different to assert that a gift of $1 billion to Bill Gates with total wealth of over $ 50 billion is the same to a person whose total wealth is $ 50,000.

Often irrationality cannot be ascertained by the behavior of a person. Take the case of Bob Dylan who finally accepted the Nobel Prize for Literature. Was it his consciences that how the Nobel committee can select a person; a song writer for the coveted price of Literature? Is it because the volume of his contribution was paltry, he does not deserve a big gathering rather a secret meeting would be befitting for him? Another Nobel Laureate, Robert Lucas who was the fifth University of Chicago economist to win Nobel Prize in Economics in 1995 shared the prize with his wife Rita Lucas who wrote a clause in the divorce settlement letter that if Robert Lucas received a Nobel prize in the next seven years, she would be eligible to get 50 percent of the prize. " Robert Lucas won the Nobel Prize for his theory called " rational expectations" " But it looks as if Rita Lucas though not trained as an economist, had some pretty good rational expectations of her own when she got her lawyer, Charlotte Adelman, to draw up paragraph six of the divorce property settlement dated Jan 23, 1989." However, the bonanza would have been worthless for her if the Nobel committee declared the prize just after 21 days later.

How do we justify our living in a world of rationality! To quote Friedrich von Hayek, "The Pretense of Knowledge," a reminder that economists and policy-makers should remember that we all know far too little to presume to know enough to successfully plan and regulate the world through any political authority."

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