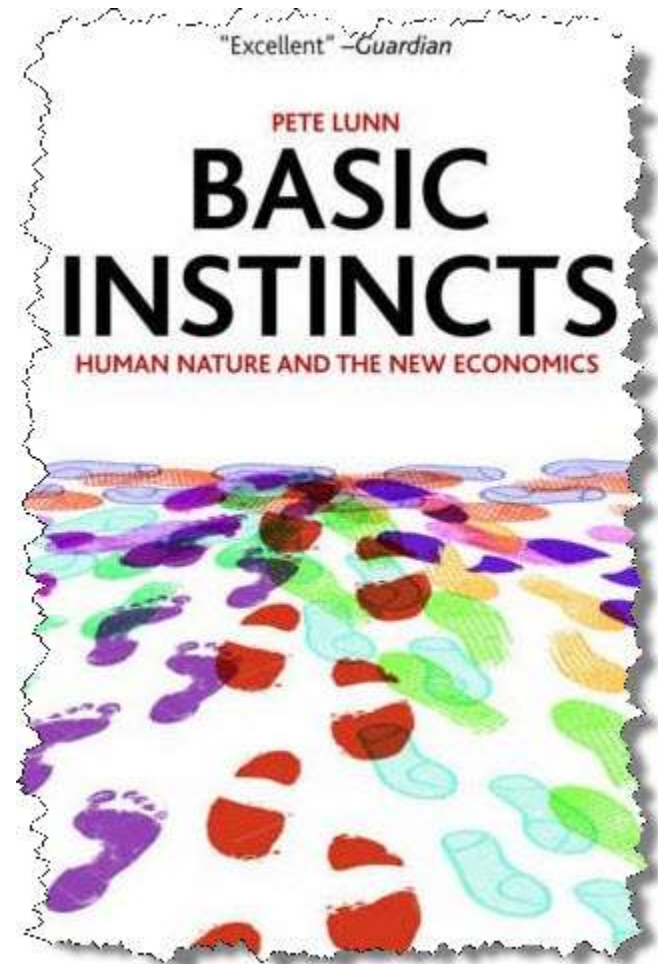
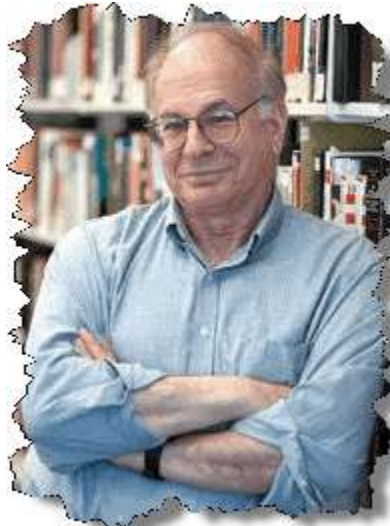
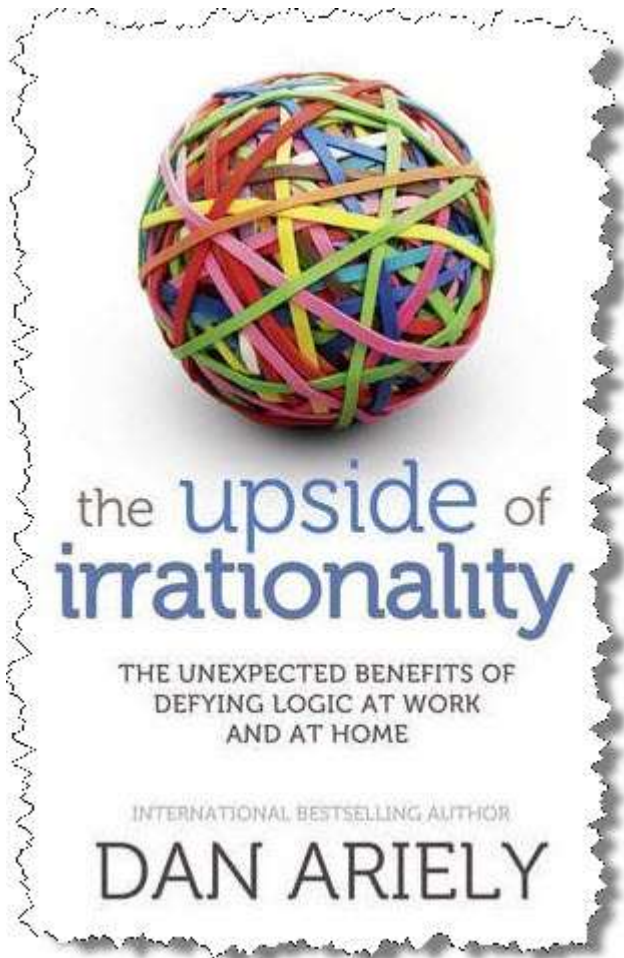


# Introduction to Behavioural Economics



# Some behavioural concepts

- Altruism
- Anchoring
- Status Quo Bias
- Expert Bias
- Rules of Thumb
- Framing problem
- Default behaviour
- The Winners' Curse
- Libertarian paternalism
- Neuro-economics
- Bounded rationality
- Endowment effect
- Familiarity bias
- Money illusion
- Herd behaviour
- Sunk cost fallacy
- Hyperbolic discounting
- Social capital

# Behavioural economics

- Behavioural economics studies things like what people think "fairness" means, how much they are driven by greed, how they respond to cheats and so on.
- Traditionally, economists have assumed people to be coolly rational calculators of their own self-interest. Over the past few years, however, evidence from psychology and brain scans has persuaded many economists that reason does not always hold sway.
  - *Acknowledged Source: New Scientist, March 2009*

# Some warm up exercises

- A town is served by two hospitals. In the larger hospital, about 45 babies are born each day, and 15 in the smaller hospital. You know that roughly 50% of babies born are boys, though may be higher or lower on a particular day. Over one year each hospital recorded the days on which more than 60% of babies born were boys.
- Which hospital recorded more such days?
  - **LARGE** or
  - **SMALLER**

# Balls

- A baseball and bat together cost \$11. The bat costs \$10 more than the ball. How much does the ball cost?
- Write down your answer.

# Balls

- A baseball and bat together cost \$11. The bat costs \$10 more than the ball. How much does the ball cost?
- Write down your answer.
- Half of Harvard students said \$1, which is the intuitive answer but wrong!
- Correct answer is 50 cents:  $\$10.50 - \$0.50 = \$10.00$
- People tend to use “intuitive thinking” or rules of thumb when answering these questions!

# Personality Disorder?

- Geoff is shy and withdrawn, invariably helpful, but with little interest in people. He is meek and tidy, and has a need for order and structure, and a passion for detail.
- Geoff is most likely to be?
  - 1. A Sheep Farmer
  - 2. A Salesman
  - 3. An Airline Pilot
  - 4. A Librarian
  - 5. A Novelist

# Personality Disorder?

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- Geoff is most likely to be?
  1. A Sheep Farmer
  2. **A Salesman**
  3. An Airline pilot
  4. A Librarian
  5. A Novelist

# Names for Children

- Mary's Father has 5 daughters.
- The first four are called:
- Sante
- Senti
- Sinto
- Sontu
- What do you think the fifth one is called?

# Names for Children

- Mary's Father has 5 daughters.
- The first four are called:
- Sante
- Senti
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- Sontu
- What do you think the fifth one is called?
- **Mary**

# Daytime

- If today is Friday, what is the day that follows the day that comes after the day that precedes the day before yesterday?

# Daytime

- If today is Friday, what is the day that follows the day that comes after the day that precedes the day before yesterday?
- **Thursday**

# Hotel Economics

- You are the caretaker of a new hotel
- The owner has asked you to buy numbers to fix to the doors of the rooms
- There are **100 rooms** in the hotel numbered 1-100
- How many number 9s do you need for the doors?

# Hotel Economics

- You are the caretaker of a new hotel
- The owner has asked you to buy numbers to fix to the doors of the rooms
- There are 100 rooms in the hotel numbered 1-100
- How many number 9s do you need for the doors?
- **20**

# Hotel Economics

- You are the caretaker of a new hotel
- The owner has asked you to buy numbers to fix to the doors of the rooms
- There are 100 rooms in the hotel numbered 1-100
- How many number 9s do you need for the doors?
- **20**
- 9,19,29,39,49,59,69,79,89,99
- 90,91,92,93,94,95,96,97,98

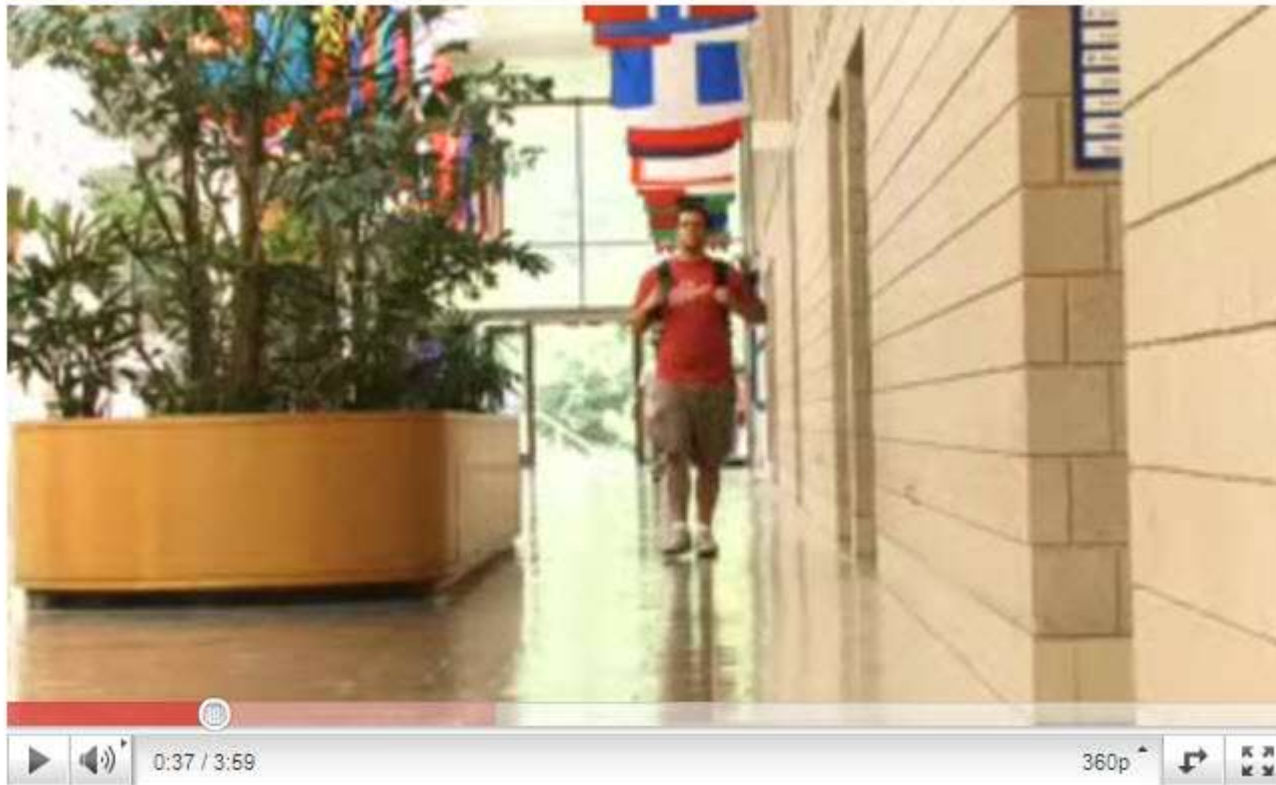
# Behavioural traits - procrastination

I'll Stop Procrastinating... Tomorrow.

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# What is behavioural economics?

- Economics meets psychology
- Explores alternatives to perfect rationality
- Seeks to provide micro-foundations for our choices

# Self-raised economists

- “The first company to manufacture a bread-making machine offered one model, priced at \$275. Virtually no one bought it.”



- “The first company to manufacture a bread-making machine offered one model, priced at \$275. Virtually no one bought it.”
- “The company then added another, larger model, priced at \$400. Overnight, the sales of the \$275 model took off.”
- *Source: Dan Ariely*



# Econs v Humans

- ECONS

- HUMANS

# Econs v Humans

- ECONS
  - Super-smart
  - Rational
  - Well defined preferences
  - Self-interested / selfish
  - Utility maximizers
- HUMANS

# Econs v Humans

- ECONS
  - Super-smart
  - Rational
  - Well defined preferences
  - Self-interested / selfish
  - Utility maximizers
- HUMANS
  - Flawed
  - Biases in behaviour
  - Social animals
  - Not driven purely by the need to maximise their welfare

# We will look at

- Known biases in behaviour
- Default behaviours
- Importance of social norms
- Significance of emotion and affected states when making choices

# Some behavioural (cognitive) biases

- Loss aversion and the endowment effect
- Fear of change / status quo bias
- Herd behaviour
- Framing effects
- Availability heuristic
- Anchoring effects
- The zero price bias
- Confirmation bias

# Loss aversion

- There are **emotional and perceptual asymmetries** between losses and gains.
  - A loss is more painful than a commensurate gain is pleasurable: losing a £10 note can be more irritating than finding one is joyful
  - People will go out of their way to avoid losses, while at the same they would not bother to go out of their way to gain something
- This is linked to **the endowment effect**
  - People try to keep something that they consider is ‘theirs’, even when it is quite arbitrarily given

# Fear of change

- People are often uncomfortable with uncertainty and therefore fear change
- We tend to prefer things the way they've always been, and invest additional amounts in past strategies which we have pursued
- Examples?

# Social (herd) behaviour

- **Social learning**

- We often look to others to see how to behave e.g. in crises



- **Expert bias**

- We are open to influence from people in authority or people we like e.g. Milgram pain experiment

## People 'still willing to torture'

Decades after a notorious experiment, scientists have found test subjects are still willing to inflict pain on others - if told to by an authority figure.

US researchers repeated the famous "Milgram test", with volunteers told to deliver electrical shocks to another volunteer - played by an actor.



Subjects were apparently given electric shocks

Even after faked screams of pain, 70% were prepared to increase the voltage, the American Psychologist study found.

Both may help explain why apparently ordinary people can commit atrocities.

# A Young Monk asks.....

**Can I  
smoke  
while I'm  
praying?**



**Can I  
pray  
when I'm  
smoking?**

# Ask a new question to change behaviour



**How can you get people to use the stairs rather than the escalator?**

# Encouraging re-cycling



# Framing and anchoring



- How a decision is **framed** affects your choices
- Most people are poor when it comes to
  - Assigning probabilities
  - Dealing with a little added complexity when making decisions
  - Too many choices may cause paralysis by analysis, reducing sales

# Framing: Home Insulation



- House insulation reduces electricity bills by £200 per year. Two advertising campaigns:
- Campaign A: “If you insulate, you will save £200 per year”
- Campaign B: “if you do not insulate, you will lose £200 per year”
- Which campaign will be more effective?

# Availability heuristic

- Which has more?
  - Words that begin with the letter "R" or "K"
  - Words that have the letter "R" or "K" in the third position

# Availability heuristic

- Which has more?
  - Words that begin with the letter "R" or "K"
  - Words that have the letter "R" or "K" in the third position
- **Answer**
  - **Words that have the letter "R" or "K" in the third position are more common.**
  - **There are three times as many words that have the letter "K" in the third position**

# Availability heuristic

- Availability heuristic, which means that people assess probabilities by asking whether examples easily come to mind



# Hyperbolic discounting

- Which would you rather have?
- 50% off a new £20 shirt if you pay in cash
- 1.3% off a new £750 sofa
- £10 off the price of a £80 air ticket if you book online

# The zero price bias

- People would rather receive a free \$10 gift certificate (a \$10 gain) than pay \$7 for a \$20 one (\$13 gain).

# Price anchoring (1)

- Imagine that you are on a beach on a sweltering day and that a friend offers to go back to your hotel to buy a bottle of your favourite beer - one for you and one for your friend. How much would you be willing to pay?



- Your answer is

\_\_\_\_\_

# Price anchoring (2)

- Imagine that you are on a beach on a sweltering day and that a friend offers to go to the nearest supermarket to buy a bottle of your favourite beer - one for you and one for your friend. How much would you be willing to pay?
- Your answer is \_\_\_\_\_



# Default behaviour

- Default
  - Sometimes known as **status-quo bias**
  - Which aspects of your life are default?
  - Default settings can become **sticky**
    - Computers and screensavers / sleep mode
    - TV schedules – watching one programme after another
    - Choices made in the supermarket

# Some behavioural economics issues

- Why people spend more when they swipe a credit card?
- Why do so many people fail to save for the future?
- How can we get people to reduce their own carbon footprint?
- Why do students find it hard to complete assignments on time?
- Does our emotional state affect our spending decisions?
- Should we move in the UK to a system of presumed consent for organ donations?

# Bounded behaviour

- Bounded **behaviour**

- People have limited time and capacity to weigh all relevant benefits and costs of a decision.
- Added complexity can distort choice

- Bounded **will-power**

- We tend to have more self-control “in the future” than now

- Bounded **self-interest**

- We are often keen to engage in co-operative behaviour for the common interest and the common good

# Social and private norms

## The Cost of Social Norms

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# Price anchoring

## Paying the Price

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# Affected states: Influence of arousal

## The Influence of Arousal

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