

Behavioral Economics

- 4.1 Why we make mistakes
 - 4.2 Salience
 - 4.3 Framing Effects
 - 4.4 If it makes you happy
 - 4.5 Choices under risk and uncertainty
 - 4.6 Time inconsistent preferences
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4.1 Why we make mistakes

- (1) **Bounded rationality:** bounded by the limits of our capacity to obtain info + handle complex issues
 - (2) **Emotional and stressful** to compare complex items
 - (3) **Dual Systems** - Kahneman
 - (a) **Intuition:** quick, easy, autopilot choices (limbic system - emotion, pain, pleasure)
 - (b) **Reasoning:** deliberate and effortful thought (frontal lobe - higher order mental functions)
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4.2 Salience

Salience: how striking or memorable something is

Example: CFB polls weekly AP rankings - win/loss is more salient than margin of victory, home or away, etc

4.3 Framing Effects

Framing effects: how information is presented

- (1) **False beliefs**
 - (a) Marketers will promote misinformation when it yields higher returns
 - (b) Consumers will be more likely to accept misinformation when it makes them happier
 - (c) These beliefs are spread from consumer to consumer
- (2) **Anchoring:** being influenced by irrelevant information
 - Group 1 - How many dates have you been on this month? How happy are you? .66 correlation
 - Group 2 - How happy are you? How many dates have you been on this month? .12 correlation
 - For Group 1 - The happiness question was **anchored** by the dating question

(3) **Default effects:** Tendency to choose the default option

- (a) Helps cope with anxiety
- (b) Some view the default as the recommendation
- (c) May prefer the status quo and due to loss aversion

Example: Organ donor program in 7 European countries

When default is organ donor = 97.4% enrollment

When default is NOT organ donor = 18% enrollment

4.4 Poor decisions we make to make ourselves happy

(1) **Overconfidence:** People tend to be overconfident when assessing their abilities

(2) **Confirmation bias:** People accept info that supports their view, reject info that doesn't

(3) **Cognitive Dissonance:** When actions diverge from beliefs

Must change belief, change behavior, or accept false belief

4.5 Choice under risk and uncertainty

Reference point: Under uncertainty, people make choices relative to a reference point (often the status quo or current choice)

(1) **Reference dependence:** different reference points leads to different choices

A rich person would be willing to pay 100 dollars for high end wine, poor person only willing to pay 5 dollars

(2) **Endowment effects:** people place greater value on what they already own

Status quo: People prone to making decisions consistent with the current state

Loss aversion: people weigh losses heavier than gains

(3) **Signals of quality:** people experience greater pleasure from product if they think its high quality beforehand

4.6 Time-Inconsistent Preferences

(1) **Discounting:** People tend to value benefits more the sooner they are obtained

$$PV(U, t) = D^t U$$

Present value (PV) of utility (U) received in period (t) = utility (U) times the discount rate (D) raised to the number of periods ahead (t)

Notice that the discount function is exponential

Time inconsistency: people tend to be more impatient when comparing today vs tomorrow than when comparing 30 days from now vs 31 days from now

(2) **Neuroeconomics** says there are two interacting brain systems involved in intertemporal choice

- (a) One concerned with immediate outcomes
- (b) One concerned with future outcomes

Discount rates are NOT constant over time.

Implication: Reduce the cost of first purchase. Boost temptation of instant gratification.

(3) **Impulsivity**

Sources: time pressure, high pressure sales pitch, cognitive overload with multiple tasks, sleep deprive, stress

(4) **Addiction and cues:**

Cold state: noncraving state

Hot state: vulnerable to craving

Environmental cues will lead to greater demand for good when exposed to cue

4.7 Economics and Identity

(1) **Groups:** People can experience loss in utility if they take actions that go against the group

(2) **Prestige or snob:** jumping to a "higher" social group

(3) **Mass market:** people who like to associate with a large social group will jump on the bandwagon

(4) **Niche market:** people who like to set themselves apart will associate with a smaller niche market