

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

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)

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