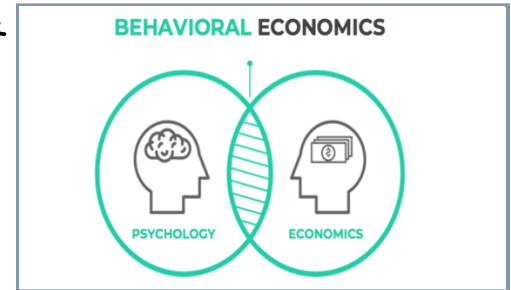




Behavioral Economics Power Point

As you read and listen to the power point define and give examples of the following terms:

Behavioural economics - A subdiscipline of economics that relies on elements of cognitive psychology to better understand agents ^{decision-making of economic}. It challenges the assumption that economic agents (consumers or firms) will always make rational choices with the aim of maximizing the results in some objective.



System One - judgements made in system one are immediate, gut reactions that do not involve contemplative thought. This system is impulsive and instantly makes decision based on information presented.

System Two - involves slow, meditative thought. Unlike system 1 the thinking happens consciously. System 2 is used to make choices between various options and is associated with concentration.

Consumer Rationality - people have consistent, stable preferences and they behave in a manner that seeks to max utility and minimize costs. Thus, the decisions people make are based on a mental cost/benefit calculus.

Utility Maximization - people always seek to maximize their utility (or marginal benefit). Every decision made is geared towards utility maximization.

Perfect Information -- decisions people make are based upon perfect information of all other available options and the subsequent benefits and costs of those options.

Bounded Rationality - Ability to make rational decisions is limited by the environment in which we live and the information that we have. There are also limits on capabilities of human processing that tend to limit our ability to maximize benefits and minimize costs.

We may also lack the time to fully create a mental cost/benefit analysis. In addition, there may be social pressures that prevent us from making the rational decision.

In essence, we are satisficers, who choose to make the best decision we can, given the environment that we find ourselves in and the information that we have.

Bounded Self-Control - Simply put, there are limitations to the degree of Self-control that people can exhibit. In economics people consume a good until the marginal benefit is less than the marginal cost. However, think about overeating...people overconsume to the point where the $MC > MB$. A lack of self-control can prevent rational decision making.



Bounded Selfishness - People may not always act in their own Self-interest when making decisions. People generally care about others and are altruistic. They may also be easily influenced by their social group and behave according to peer pressure, as opposed to their true desires. In this way, Self-interest is not the only requirement for making decisions. People may not always utility maximize if they are thinking about others and the perception that others have of them.

Imperfect Information - Lack of knowledge about the decision you are about to make (about the product itself or about the alternatives available) prevents a rational, utility maximizing choice.

Heuristic (rule of thumb) - biases are often referred to as “heuristics”, or Cognitive shortcuts. These shortcuts mean that people are not taking the necessary time, nor using the required mental energy, to make choices.

In everyday language we say a “rule of thumb” for making a decision involves such and such a shortcut.

Availability Bias - People make decisions based on what information is most available, or what most easily comes to your mind.

For example, you remember that your economics teacher doesn't like Android phones because they are not “user friendly”. This easily accessible information that you perceive to be true (“if he didn't like his phone than I may not either”) may prevent you from making the proper decision on which smartphone to choose.

Confirmation Bias - Once we have formed a view, we embrace information that confirms that view while ignoring, or rejecting, information that doubts it. Confirmation bias suggests that we don't perceive circumstances objectively. We pick out those bits of data that make us feel good because they confirm our prejudices. In making economic decisions we often choose information that confirms our pre-existing notions in order to rationalize this decision. The decision made may not be the rational one.

Anchoring Bias - Individuals make decisions based on the info in front of them. The first piece of information provided to a consumer/decision maker often acts as an “anchor” that will influence subsequent behavior.

Framing Bias - the way information is framed to the consumer or decision maker will influence their decision and possibly prevent an informed decision from being made. For example, services may be presented as a

monthly fee rather than a yearly amount. In the picture below, each product is identical but people will be biased towards the 80% fat free version based on how the information is presented.

Choice Architecture - Decisions are not made independently of the context they are provided. People may make decisions based upon how the information provided to them is “framed”. Below, the \$6.50 medium popcorn is there to make you believe that the \$7.00 popcorn is a much better deal than the \$3.00. The \$6.50 price has manipulated you into believing that \$7.00 for a large is good value.

Default Choices - The theory of Default Choices says that people will opt for the Status quo and choose the familiar (default) option. For example, on your Starbucks Mobile App it saves your preferred (or default) option and will automatically suggest this order again. This implies that people are not maximizing utility when making consumption choices as they just be falling back on the familiar status quo.

Mandated Choices - The theory of Mandated Choice involves people having to make an important decision well in advance. For example, in many US states you have to decide when you get your driver’s license whether or not you want to donate your organs in case of death. Once again, people are not likely to take the time to opt out after they have opted in.

Nudge Theory - Nudge Theory – Nudges aim to change people’s behavior without eliminating their Consumer Choice or undermining their Civil liberties. According to Economist Richard Thaler “To count as a mere nudge, the intervention must be easy and cheap to avoid. Nudges are not mandates. Putting the fruit at eye level counts as a nudge. Banning junk food does not.”

Nudges can be used to change behavior (for example to reduce negative consumption externalities) without use of heavy-handed regulation or taxation.



Behavioural Economics Activity Set

Activity 1: Applying Behavioural Economics



Review The Simpsons comic above.

In the space below, identify and explain the behavioural economics theories being shown in the comic.

Choice architecture and nudge theory
to influence decision without undermining
civil liberty or removing choice.

Activity 2: Advertising and Bias

Advertising makes excellent use of biases that influence consumers' way of thinking. Find a TV or YouTube commercial. Identify the message being conveyed to the consumer and the biases it uses to convince the consumer to buy the product. Write your answer in the space below.

Activity 3: Rational Choice and IB Economics

Was your decision to study IB economics a rational choice? Identify the conditions that would have to be satisfied for this choice to be a rational one. If it was not rational, identify some biases that may have affected your choice.

Activity 4: IB Economics – Paper 1

A. Read the "Assessment Advice" on page 25 and on pages 522-524 of your course companion regarding Paper 1 Essay questions in economics. In the space below, summarize what you need to do for **part (a)** of the essay question:

- Define key terms
- Fully explain relevant theories
- Illustrate theory with diagrams
- Explain the diagrams

B. Read the "Assessment Advice" on page 65 and on pages 524-525 of your course companion regarding Paper 1 Essay questions in economics. In the space below, summarize what you need to do for **part (b)** of the essay question.

- Do everything from pt A
- Evaluate / synthesize - Consider topic / issue and reach conclusion
- Identify & develop a real-world example

Activity 5: Behavioural Economics Essay Question

Complete the following Paper 1 essay question.

Write your answers by hand. When you have finished use a cellphone or the schools' printers to turn your work into a PDF or JPEG.

Upload your work to this Google Form dropbox: <https://forms.gle/58iugd4Lffq8HrKv7>

You may

Paper 1, full question – HL Only

- Describe two cognitive biases that influence consumers when making consumption choices. [10 marks]
- Using real-world examples, evaluate the effectiveness of nudge theory in helping consumers to make better choices. [15 marks]