

LECTURE 19: BEHAVIORAL ECONOMICS

- I. Behavioral economics
 - a. The curious case of Israeli day-care.
 - i. Daycares have a problem: if parents come late to pick up a kid, they must pay someone to look after the children, forcing them to stay late.
 - ii. So why not charge for a late fee? Economists implemented a \$3 late fee for parents that came late in ten different daycares in Haifa, Israel.
 - iii. As a result of the fine, the number of late parents went *up*, from eight per week to *twenty*. Why?
 - b. Because people see the world in not just strict economic terms, adding conventional incentives can have unintended consequences.
 - i. *Behavioral economics* is the cross between economics and psychology to explain and predict behavior.
 - c. Before we dive too much in behavior economics, be warned. Much of the theory doesn't undo our economic thought (as some behavioral economics claim) but rather expands the scope of what people care about and the kinds of costs they suffer.
 - i. For example, that people use short-cuts to make decisions doesn't mean they aren't rational. Making the "rational" decision is difficult for the brain to do. When the marginal benefit of making the best decision is small, it makes sense that people will make an "imperfect" decision.
 - ii. This is why people spend more time shopping for a house compared to cereal. That people take short-cuts buying cereal—like relying on advertising or selecting brands closer to eye-level—is really evidence that they don't care that much about making a mistake or the chance of mistake is small. It's not evidence that they're irrational.
- II. Heuristics
 - a. A *heuristic* is a rule of thumb that helps people make decisions. These rules are simplifications to help facilitate decision-making but because they are simplifications, they can lead people down a poor path or reasoning.

- b. One heuristic is the *reference point*: or an amount that an option is compared to.
 - i. When evaluating outcomes that involve uncertainty, people are “reference dependent.” They have some threshold that they consider acceptable and then compare new results with that threshold.
 - ii. Imagine you have a job offer for a sales position. You could make a good amount of money but in order to earn your salary, you have to sell a lot. The product, however, is quite strong.
 - iii. The research suggests that you’ll compare this job to typical job as a reference point, where the salary is fixed and isn’t so strongly linked to job performance. What do you do?
 - iv. There’s evidence to suggest that though it would be easy to make that good salary, people would be so afraid of failure that they’d turn down the job. If you lose when other people win, you feel much worse than if you lose when other people lose.
- III. On loss and gain
 - a. The *endowment effect* describes the tendency for people to value something more just because it’s theirs.
 - i. Imagine you run a company and want to motivate your workers as we discussed last class. You choose between one of the following:
 1. Tell workers if they meet a given production target by week’s end, they will get \$1,000.
 2. Tell workers they’ve received \$1,000 provisionally but if they don’t reach the same production target, they won’t get it.
 - ii. These are technically the same—hit the target and get \$1,000—but in an experiment by economists Tanjim Hossain and John List, the second strategy was more effective.¹
 - b. This effect is interconnected with another idea: *loss aversion*—losses have a heavier weight than gains.
 - i. Imagine you’re applying to lots of jobs and you hear from a potential employer that they want to hire you. How do you feel?
 - ii. Then, an hour later, they call you back to apologize: they made a mix up and meant to hire someone else. They withdraw the offer. Now how do you feel?

¹ <http://www.economist.com/node/15271260>

- iii. If you're like most people, you now feel worse than if they never contacted you in the first place.
 - iv. Empirically, the suffering from a loss is about twice as large as the benefit from a gain.
 - c. Note the connection between this and the reference point. When losses are rare, you fixate on the worst-case scenario. You are terrified of being the one person who lost.
- IV. Social preferences
 - a. People have a deep fondness for how they feel people in a society should act. They are subject to social norms, notions of justice, and other "social preferences."
 - i. Imagine you're waiting in line at the grocery store and someone cuts in line. When you point out they cut, they ignore you.
 - ii. You are likely to feel outraged by their actions and attitudes. But the practical cost to you is tiny—a few minutes more in line. Your rage is largely stemming from how they are acting and how you are being treated. You don't feel respected.
 - b. Most legal disputes are often settled outside of court. But when they do go to court, the parties often *hate* each other. They are going to court—and spending a great deal of money to do so—to seek "justice."
 - c. The "ultimatum game" involves one player splitting a sum of money between that player and someone else. This other player, the decider, accepts or rejects the split. If rejected, both get nothing.
 - i. In theory, the splitter should give herself a large share of the money and the other player a small share because something is better than nothing. Say, 90% and 10%.
 - ii. In practice, the decider will often reject such "unfair" splits.
 - d. Social preferences, like all preferences, are subject to the law of demand. If indulging in these preferences gets more expensive, people will indulge in them less. In the ultimatum game, the decider is more willing to accept unfair splits as the pool of money increases. 10% of \$10 is cheap justice but 10% of \$1,000 is expensive justice!
- V. Sunk cost fallacy
 - a. *Sunk cost*—a cost that cannot be retrieved. Such costs incurred—such as specialized equipment which can't be resold—shouldn't be a factor in decisions.
 - b. This is noteworthy because people often want to consider them when they shouldn't. This is called the *sunk cost fallacy*—continuing a behavior based on incurred costs that can't be retrieved.

- i. A business owner might buy a custom piece of equipment for a business venture. After starting the business, she discovers a related business would be more profitable. But this new venture wouldn't require this piece of equipment.
- ii. Because the equipment costs are gone regardless of what's done, it shouldn't be a factor in her decision. But she's likely to continue on her original plan because she doesn't want to "waste" the money.

VI. Bonus reading.

- a. The concepts for this section were adapted from [this paper on teaching behavioral economics](#). If you'd like to know more about behavioral economics, I suggest you check it out. (It's an easy read.)