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Economics

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BEHAVIOURAL ECONOMICS

KEY TERMS GLOSSARY

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Key Term

Explanation

Altruism

The phenomenon in behavioural science for humans to behave with more kindness and fairness than would be the case if they behaved rationally.

The **ultimatum game** is a good example of the principle. Imagine a situation in which two people are paired up; one participant is given £20 and asked to split it between the two of them in any way that they like. The rational decision (i.e. optimising) is to split it 19:1 but this rarely happens, with the split usually being closer to 10:10.

Altruism is often linked to the concept of **inequity aversion** i.e. humans do not like unequal outcomes. Whilst this is usually seen as positive, it can also result in a negative outcome e.g. a person being willing to forego a gain / reward if it means that someone else won't gain an even better reward.

Anchoring

The use of (usually) irrelevant information as a reference point for helping to make an estimate of an unknown piece of information. In other words, people use an "anchor point" of an event or a value that they know in order to make a decision or estimate.

Behavioural scientists describe this as a **cognitive bias**.

Bounded rationality

The idea that the cognitive, decision-making capacity of humans cannot be fully rational because of a number of limits that we face. These limits include:

- Information failure – there may be not enough information, or it may be unreliable, or maybe not all possibilities or consequences have been considered
- The amount of time that we have to make our decisions
- The limits of the human brain to process every piece of information and consider every possibility
- The impact of emotions on decision making

The result is that we usually end up making **satisficing** decisions, rather than **optimising** decisions. To make decision, we end up using "rules of thumb" or **heuristics**. Sometimes we rely on **automatized routine** too.

The impact of bounded rationality is that contracts cannot be fully complete in order to cover all possibilities, and this suggests that markets rarely work perfectly.

Behavioural economists generally point out that bounded rationality is not the same as irrationality, because decision-makers are still attempting to make as rational a decision as possible.

Bounded self-control

This concept is closely linked to that of bounded rationality. Rationally, and according to neoclassical economic theory, consumers know when the price of a good/service exceeds the marginal utility they gain from consuming that good/service – in this rational world of homo economicus, consumers stop consuming. In reality, though, there is plenty of evidence to suggest that consumers often do not stop consuming even when it makes sense to stop – think about over-eating, excessive investment in a particular stock or share and so on.

Many behavioural scientists link bounded self-control to the concept of **hyperbolic discounting** i.e. valuing the present much more than the future, and making decisions that their "future self" would not like. This can help to explain, for example, people's inability to save effectively for retirement.

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Choice architecture

This refers to a scenario in which the environment in which someone must make a decision / choice has been carefully designed in order to try and influence that decision.

There is a variety of ways in which the “environment” can be designed. For example:

- Altering the “default” option – studies show that most consumers stick with the “default” option, so producers should think about which option they would most like consumers to used
- Providing “immediate feedback” on choices that are made in order to make consumers reconsider their decision
- Altering the number of options available or changing the wording in order to subconsciously manipulate decisions

This term was developed by Thaler and Sunstein in 2008.

In short, the framing of a choice in order to manipulate the outcome of someone’s decision.

Choice overload

A situation in which someone is faced with too many choices or options. The outcome is likely to be one of the following:

- Greater application of heuristics, resulting in a less-than-optimal outcome
- Greater unhappiness / stress in the decision-maker
- Greater chance of going with the default option
- Greater chance of choice deferral i.e. being so overwhelmed that no decision is made at all
- Greater chance of bounded self control as decision fatigue kicks in.

Cognitive bias

This exists when someone thinks in a way that can be regarded as irrational or that goes against good judgement. Cognitive biases are usually a result of either mental shortcuts or heuristics (i.e. techniques that we use to help us make decisions more quickly) or ‘motivational’ explanations.

There are many examples of cognitive bias which have been investigated by behavioural scientists. Some common ones are below:

- **Anchoring effect:** relying too heavily on an irrelevant piece of information to help us make a decision
- **Availability heuristic:** overestimating the likelihood of something happening because a similar event has either happened recently or because we feel very emotional about a previous similar event
- **Confirmation bias:** the tendency for humans to only remember information that supports their own views
- **Curse of knowledge:** the difficulty that well-informed people have in understanding how lesser-informed people might think
- **Endowment effect:** the phenomenon in which people often demand a greater amount of compensation/money to give up something that they have than they would be willing to pay for it in the first place
- **Hindsight bias:** the tendency to see events in the past as having been predictable
- **IKEA effect:** a scenario in which people place an overly-high value on an object that they have either fully or partially assembled themselves, regardless of the quality of the outcome

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- **Overconfidence effect:** the phenomenon in which humans are often over-confident in their answers to questions
- **Planning fallacy:** the tendency to (significantly!) underestimate how long it will take to complete a task
- **Zero-risk bias:** the human preference for reducing an already-small risk to zero, rather than reducing a high risk by a large amount

Default Choice

The default choice or default option is the option that a consumer “selects” if he or she does nothing. Studies have shown that consumers rarely change the default settings. So, the nature of the default option strongly affects consumer behaviour. Therefore, if the default option or setting is changed, then consumer behaviour will change.

Dual-system theory

This term stems from the Nobel-prize winning work of Daniel Kahnemann, who is best known for his work *Thinking, Fast and Slow*. System 1 thinking is fast, sub-conscious and automatic. System 2 thinking is slow, controlled and conscious. We tend to use System 2 thinking when the decision is really important, is highly personal to us and when our decision may have a large impact on other people.

Habit

This refers to a rigid pattern of behaviour followed by a person. For example, it could refer to the subconscious purchase of identical items each week, or the pattern followed by someone who always lights up a cigarette, without thinking, when they make a cup of coffee. Habit is often linked with **System 1 thinking** (see **Dual-system theory**). It is also often linked with the idea of the **status quo bias**, when people stick with a previous decision, even if it is no longer the most appropriate decision.

Herding / herd behaviour

A phenomenon in which individuals act collectively as part of a group, often making decisions as a group that they would not make as an individual.

There are 2 generally accepted explanations of herd behaviour. Firstly, the social pressure to conform means that individuals want to be accepted – and this means behaving in the same way as others, even if that behaviour goes against your natural instincts. Secondly, individuals find it hard to believe that a large group could be wrong (“2 heads are better than 1”) and follow the group’s behaviour in the mistaken belief that the group knows something that the individual doesn’t.

We sometimes also see this described as the **bandwagon effect** or **groupthink**.

In short, herd behaviour is about making a decision based on the behaviour of others.

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Heuristics

In general terms, a heuristic is a method or technique that people use to help them make a decision or solve a problem more quickly. We often use the phrase **rule of thumb** to mean the same thing. The outcome from using the heuristic may not be perfect or optimised, but is usually “good enough”.

The term was developed, along with **bounded rationality** and **satisficing**, by the cognitive scientist Herbert Simon.

Mandated choice

A situation or scenario in which people must make a decision in advance with respect to whether they wish to participate in a particular action – they are required by law to make that choice. These decisions are usually “public policy” decisions e.g. deciding whether to donate your organs when you die, deciding whether to make a “living will” etc.

Negative framing

A technique used by choice architects in which someone is persuaded to make a decision based on negative consequences e.g. if you choose to park in that space then there is a chance that your car could be towed.

Partitioning

A technique by which consumption can be reduced by packaging something into smaller amounts. When something (e.g. money, a packet of crisps, sweets) are packaged into separate, smaller packages, then consumers face more **decision points** which can slow the rate of spending or consumption.

Restricted Choice

Because of the existence of **bounded rationality**, consumers can find it really difficult to make effective decisions when the number of choices or options is large; this may result in them failing to make any decision. Therefore, restricting the number of available choices may be more likely to cause consumers to act and actually make a decision, resulting in a more efficient outcome.

Zero price effect

A phenomenon in which the demand curve for a good changes shape dramatically once the price of the good is zero. Standard economics cannot explain the psychological power of a good that is free!