

AN INTRODUCTION



Scan this QR code to see just how irrational we can be!

Optical illusions are just one way our brains are fooled, and vision is something we have evolved to rely on for millennia.

Imagine what would happen if we asked our brains to do something more complex and unfamiliar at the same time as it is bombarded with other information and requests.



Behavioural economics crosses psychology and economics to study situations where economic agents might be **predictably irrational.**

Irrational means when people make choices and decisions that go against the assumption of rational utility-maximising behaviour.

Traditional Economics assumes:

- Economic agents have well defined preferences
- They are super-smart
- They act solely to maximise their self-interest
- They can handle vast amounts of information
- They can and do use this information to make unbiased decisions
- Rational decisions can be wrong, but they are not systematically wrong.

Some economists call these super-beings "Econs".

Traditional Economics assumes:

- Economic agents have limits to their cognitive ability
- They are flawed and are social animals, influenced by people around them and circumstances
- They are not driven purely by the need to maximise their welfare
- They lack self-control in certain situations such as overeating, overspending or even over-working
- Their decisions can be biased

Some economists call these irrational economic agents "Humans".

For more detail on the links between behavioural and neoclassical economics, use this QR code:



REAL WORLD EXAMPLES OF IRRATIONALITY

Consider these two scenarios

How rational are you?

Take 30 seconds to decide your answer to the question on the right.

A

A massive flood somewhere in North America next year, in which more than 1,000 people drown

B

An earthquake in California sometime next year, causing a flood in which more than 1,000 people drown

Which is the more likely?

The answer is A. Most people choose B because we are drawn to information that is familiar – earthquakes in California. But look again at A and you will see that there is a much smaller list of criteria than B.

People are particularly irrational when they are dealing with:

- Large amounts of information or too little information or unreliable information
- Complex information or where the consequences are complex
- Information economic agents are unfamiliar with
- Decisions taken infrequently
- Limited time

Real world examples where people are likely to be predictably irrational are:

Climate Change

- Large amounts of complex information
- Complex consequences

Financial decisions such as pensions

- Large amounts of complex information
- Decisions taken infrequently

Food choices – Obesity

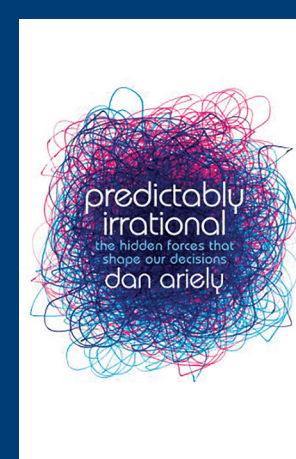
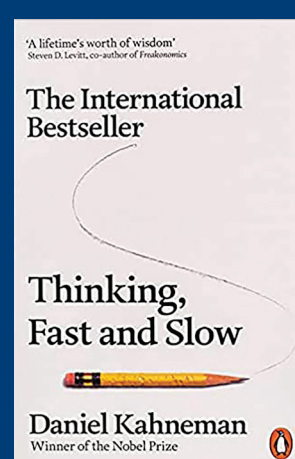
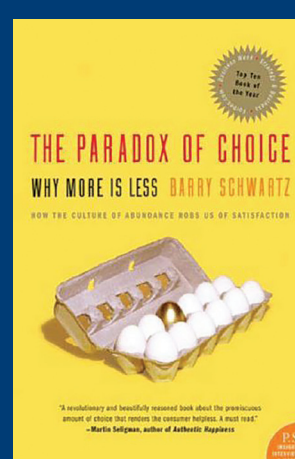
- Some information is contradictory
- Bounded self-control

COVID Pandemic

- Large amounts of information of varying reliability
- Complex consequences
- Decisions taken infrequently

Bounded self-control occurs when economic agents may be aware it is irrational for them to consume or continue consuming something, but they are unable to stop.

Some good books to read on this topic include:



BOUNDED RATIONALITY AND HEURISTICS



When economic agents experience more information than they have the cognitive ability to deal with, they will experience **bounded rationality**.

Economic agents are still attempting to be rational but there are limits or “boundaries” to how successful they can be. Rationality will be more or less bounded depending on the circumstances – it can vary. It isn’t only people who experience bounded rationality but businesses and governments.

Economic agents will reduce the cognitive load by adopting “heuristics” or simple rules of thumb. These are mental short cuts.

Inertia and habitual choices

Making the same choice as before. This is closely linked to loss-aversion, where economic agents value losses more than the equivalent gain.

Availability bias

Using easily recalled information to inform a decision e.g. earthquakes in California or assessing the probability of a plane crash based on stories in the news.

Anchoring

The use of (sometimes irrelevant) information as a reference point for an estimate e.g. seeing an “original price” for a good that is now “on sale” and thinking you have a good deal.

Economic agents who experience bounded rationality and use heuristics are adopting utility satisficing behaviour rather than utility maximising.

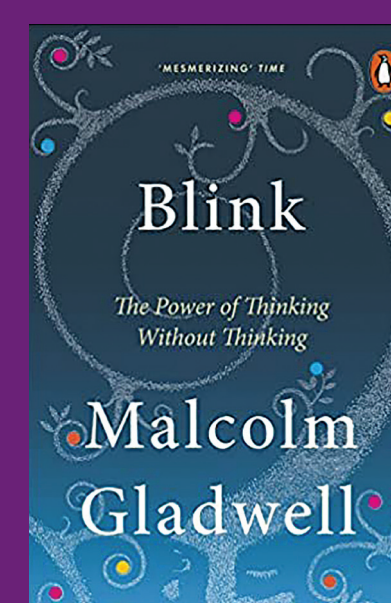
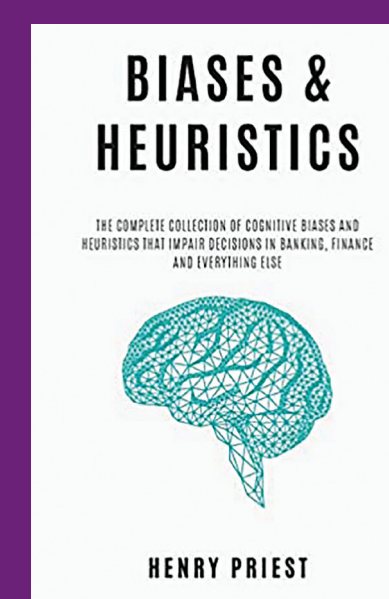
To experience some of these effects for yourself, try these experiments:



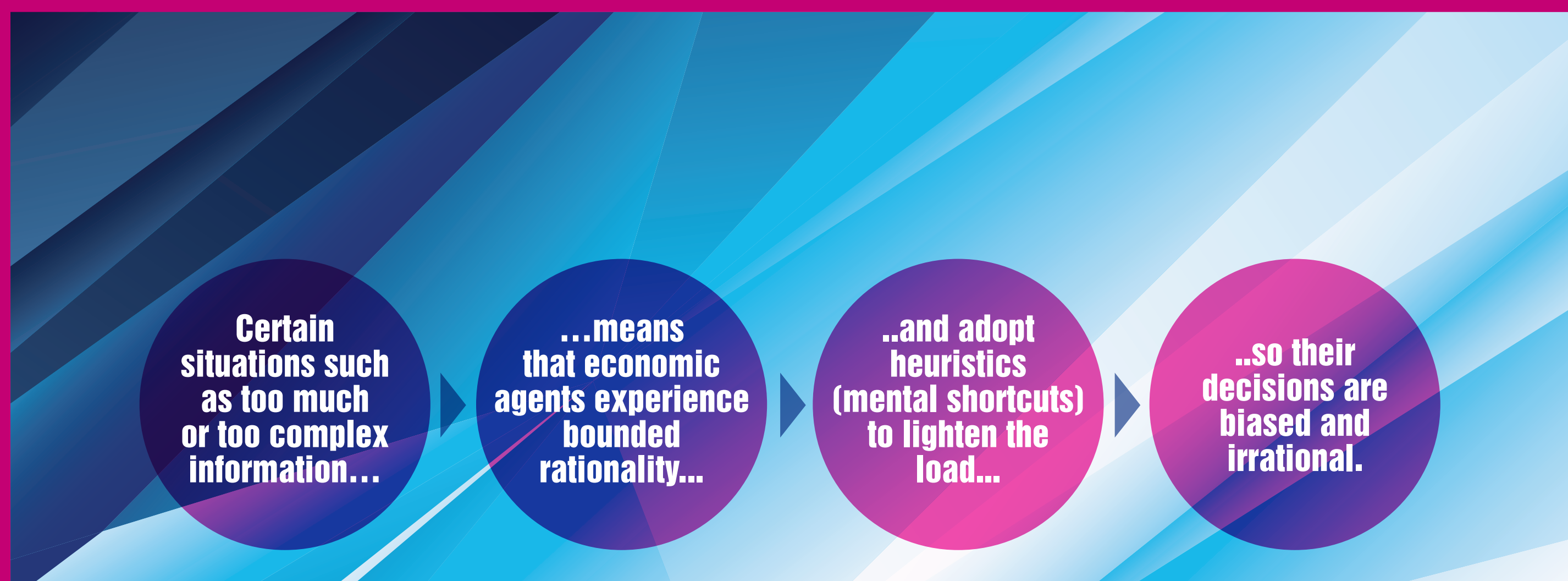
You can find out more about heuristics by following this QR code:



Some good books to read on this topic include:



BEHAVIOURAL BIASES



Behavioural biases exist when economic agents make decisions that are deviating from rational choices in a systematic way. Importantly for economists, biases are often predictable, so we can still model behaviour and outcomes.

Default bias (status quo bias)

This is where consumers avoid making an active choice. For example, they accept the default choice that is offered e.g. if premium delivery on online shopping is the default then consumers will not “un-choose” it. This is closely linked to loss aversion.

Optimism bias

This exists when economic agents believe they are less likely (perhaps than others) to experience a negative event. This can be closely linked to the availability heuristic e.g. recalling a person living to 100 who smoked heavily.

Recency bias

This is where most recent data is weighted more heavily than older data e.g. speculators might think recent trends will continue and especially combined with herd mentality (the belief that something must be right if others are doing it).

Outcome bias

This exists where a decision is based solely on the outcome e.g. winning the lottery does not mean that gambling is a wise decision.

Salience

This is the tendency to focus on the most easily recognisable features of a concept or event rather than the whole thing.

Confirmation bias

This exists where greater weight is given to information that fits with our existing beliefs e.g. our choice of media sources to find news that reflects our already-held beliefs.

Stereotyping

This is where certain groups or people are expected or assumed to be associated with certain characteristics.

Survivor bias

This exists where errors in judgement are made by focussing only on survivors or successes e.g. trying to replicate features of successful companies.

Ostrich effect

This is where economic agents ignore negative information. Research suggests investors check the value of their assets less frequently during bad markets.

Try watching these tutor2u videos on biases to get more detail:

Availability bias



Scarcity bias



Default bias



General overview



BEHAVIOURAL NUDGES



A nudge is a policy or a strategy used to influence economic agents who are behaving irrationally. A nudge would not usually affect the decisions of a purely rational economic agent. Both businesses and governments adopt nudges.

Framing

Framing relates to how information is presented. Economic agents are much more likely to respond to information presented positively or to avoid a loss e.g. act now to avoid a penalty for late payment of tax.

Choice architecture

Choice architecture is a wider concept (but includes framing) and refers to changing the whole context in which people make decisions e.g. positioning healthy food at the front of a cafeteria, default choices, decoy options.

Smoking - These images on cigarette packets aim to provide a strong image to create an availability bias against smoking.



Pensions - Employees are required to opt out of employer provided pension schemes. This has a powerful effect on numbers in the scheme. The default choice is to remain. Similar approaches have been used for organ donation.

Food Labels - Behavioural economics suggests that the key to influencing irrational behaviour such as over-eating unhealthy foods is providing information in a simple, consistent, easily understood format.

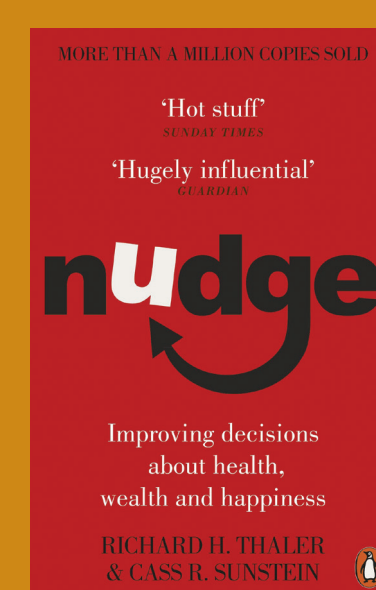
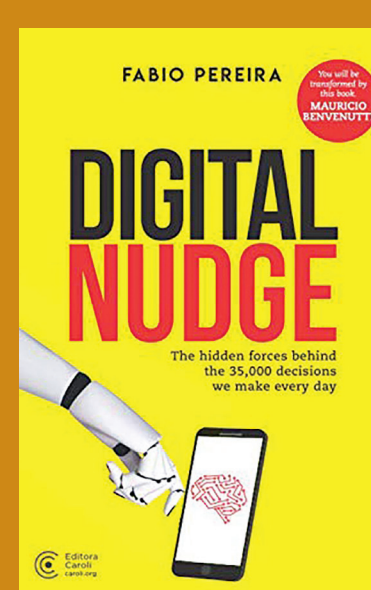
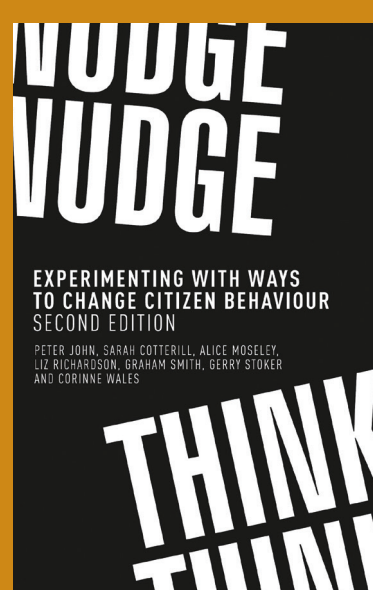
COVID 19 - Clear simple messages on government press conferences and in numerous other locations reduce decision making and appeal to altruism. Altruism is where economic agents act in the interests of others.



To find out more about nudges, head to this tutor2u page



Some good books to read on this topic include:



ALTRUISM



Altruism is where economic agents consider the impact of their actions on others. This, by definition, means that they are irrational. Rational economic agents by assumption act to maximise their own self-interest.

Giving to charity

While it could be argued that people gain utility from helping others, this is none the less an altruistic act. Research shows that the majority of people donate to charity although they tend to give from time to time rather than regularly. Some services such as the RNLI are funded entirely by donations.

Actions to reduce climate change

The atmosphere and the environment are an example of a common pool resource. One characteristic is that the impacts of any one economic agent is infinitesimally small. It is therefore altruistic (irrational in an economic sense) to take action to reduce climate change.

COVID vaccinations

Although there are examples are young people being affected by COVID they are at much lower risk than other groups of the population. This means that part of the reason for getting vaccinated and indeed taking any of the COVID protective measures is altruistic.

Business examples of altruism

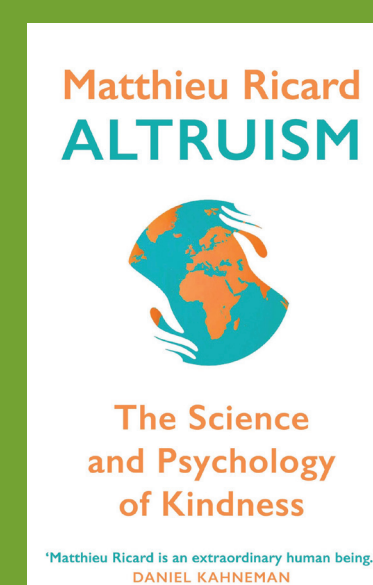
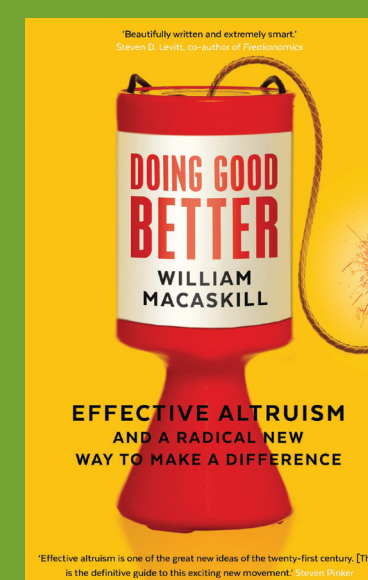
Some companies encourage and enable employees to offer their time to charitable causes.

Some companies donate to charities and/ or work with start-up companies offering their expertise to increase the chance of success.

Most private schools have out-reach programmes and undertake significant voluntary work.

There are other reasons why businesses might undertake this type of activity such as recruiting staff, branding, and attracting customers and improved access to finance through ethical investment funds.

Some good books to read on this topic include:



THE “NUDGE UNIT”

THE BEHAVIOURAL INSIGHTS TEAM



The UK based Nudge Unit was set up in 2010 to apply the lessons from behavioural economics to public policy. It now advises governments and public bodies around the world on using nudges to persuade people to pay their taxes, make better use of public services and even Columbia's peace process. The Nudge Unit has been closely involved in tackling the spread of COVID.

“Practicalities are the most significant impediment to people getting a COVID vaccine”. Research showed high numbers saying they are willing to receive the vaccine but there is a large intention-action gap. The BIT's EAST framework suggests people put off tasks when they become too effortful.



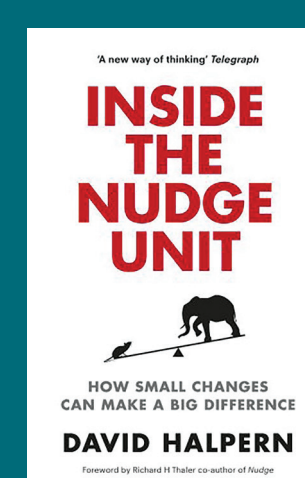
“COVID prevention – too much information”. Policy makers face a delicate balance between sharing enough information with people but not so much that it becomes overwhelming. A randomised control trial in Bangladesh of handwashing found that a step-by-step guide improved recall but adding too many steps obscured the message.



The Nudge Unit (or the Behavioural Insights Team) has worked on prompting people to pay their tax on time, turn up in court, improving organ donation and improving job centre outcomes. Find out more here:



A good book to read on this is:



SOCIAL NORMS AND HERD BEHAVIOUR



Our day-to-day behaviour is influenced strongly by what we understand to be the prevailing social norms or social customs. Social norms become accepted by the majority of a given community of people. Social network effects can amplify different types of behaviour (both good and bad).

Herd behaviour is a type of social norm in which individuals act collectively as part of a group, often making decisions as a group that they would not make as an individual. Herd behaviour occurs because

- Individuals want to be accepted, and this can mean behaving in the same way as others, even if that behaviour goes against your natural instincts.
- 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. This is described as the bandwagon effect or groupthink.

Examples

Observing white lines in car parks	Wearing facemasks even when not legally required	Wearing seatbelts
Queueing behaviour e.g. for shops, for public transport, for entry to events etc	Buying a round of drinks when in a bar or pub with friends	Different ways of greeting people in different cultures / countries
Asset bubbles e.g. houses, shares etc	Making different choices from a menu when with friends rather than alone	Commenting and interacting with social media platforms

Using herd behaviour and social norms to tackle economic problems

Hotel bathroom signs suggesting that the majority of hotel guests reuse their towels rather than requesting fresh ones each day, helping to reduce water usage and environmental impact.

Tax bills from tax authorities indicating the proportion of taxpayers that pay their taxes on time, to encourage citizens to pay their taxes and reduce government borrowing.

Providing information to young people on the number of people using alcohol, drug and nicotine, to correct their over-estimates of usage.

Find out more by taking a look at these tutor2u videos:

