Behavioral Economics

Bhavik J Shah

Economics

- A social science that studies how individuals, governments, firms and nations make choices on allocating scarce resources to satisfy their unlimited wants.
- Economics can generally be broken down into: macroeconomics, which concentrates on the behavior of the aggregate economy; and microeconomics, which focuses on individual consumers.

Behavioral Economics???!

- The study of psychology as it relates to the economic decision making process of individuals and institutions.
- Explained – Behavioral economics explores why people sometimes make irrational decisions, and why and how their behavior does not follow the predictions of economic models .

Study of Behavioral Economics

- Psychological Factors – Theory behind behavioral economics is based on human decision making.
- Bounds of rationality of economic agents.
- “We’re human - we all make mistakes!”

Conventional Vs Behavioral Economics

Conventional Economics Says . . .

- For economic analysis, the assumptions made about people don't have to be realistic.
- People are endowed with the capacity to efficiently and effectively acquire and process all relevant information.
- People can figure out and factor in the future consequences of current decisions.
- People always make smart decisions, ones that they don't regret.
- People always make decisions in an ideal decision-making environment, where they have all the information they need and the time to make the best possible decision.
- Wealth and income maximization are all that matter.
- Relative positioning isn't important. It doesn't matter how much money your neighbour makes; all that matters is how much you make.
- People aren't influenced by anyone or anything else.
- People are narrowly self-interested, and this is the only rational way to be.
- How hard and well people work is assumed to be fixed, usually at some maximum point. Therefore, people don't change how hard they work and productivity can't be affected by the work environment.
- People are pretty much all the same.
- Markets are efficient, even if they appear to be inefficient. Efficiency is everywhere.

Conventional Vs Behavioral Economics

Behavioral Economics Says . . .

- For economic analysis, the assumptions made about people must be realistic.
- People are not endowed with the capacity to efficiently and effectively acquire and process all relevant information. People are referred to as being boundedly rational — they do the best they can, given the constraints they face.
- People aren't always able to figure out the future consequences of current decisions, especially in a world of uncertainty (in other words, the real world).
- People can and often do make decisions they end up regretting.
- People often face decision-making environments that prevent them from making the best possible choices.
- Wealth and income maximization aren't the only things that matter. Being fair, doing the right thing, maintaining a good reputation, and pleasing friends, neighbours, and partners are also important.
- Relative income can be as important to people's happiness as absolute income. People are influenced by their peers, by their past, and by their circumstances.
- Many people are narrowly self-interested, but altruism and ethics also can be important motivators for behaviour.
- People are different, with different tastes and preferences.

Examples?

Fruits Vs Chocolates?

Now Vs Next Week?

Examples?

- Fruits Vs Chocolates
- Now Vs Next Week
- Buy One, Get One Free
- Wall Street Crash
- First On The List
- Parking Fines
- Drugs

Neo-Classical Economic Theory

- Approaches to economics focusing on the determination of prices, outputs, and income distributions in a market through supply and demand.

Von Neumann Morgenstern Theory

- “Rationality” – any entity has a utility function.

What Is Prospect Theory?

- It's about how people make choices between different options or prospects - designed to better describe, explain, and predict the choices that the typical person makes, especially in a world of uncertainty.

1. Certainty
2. Loss Aversion
3. Relative Positioning
4. Small Probabilities

Expected Utility Theory

- The expected utility hypothesis is a theory of utility in which "betting preferences" of people with regard to uncertain outcomes (gambles) are represented by a function of the payouts, the probabilities of occurrence, risk aversion, and the different utility of the same payout to people with different assets or personal preferences.

Game Theory/Interactive Decision Theory

- Game theory is a study of strategic decision making. Game theory is mainly used in economics, political science, and psychology, as well as logic and biology.

- Game theory applies to a wide range of behavioral relations.

Conclusion

- The study of behavioral economics takes into account both psychological aspects such as decision making and cognitive processes, and economical aspects such as the state of the economy.
- It makes Economics more real!