Appendix H: Behavioral Economics

History of Behavioral Finance

• During the “classical period” economics and psychology were closely linked
• For example, Adam Smith combined the two in The Theory of Moral Sentiments.

Themes of Behavioral Finance

• The three main themes in behavioral finance/economics are: heuristics, framing, and market inefficiencies.

Heuristics

• The idea that decisions are based on “rules of thumb” not rationality


Behavioral Economics and Consumer Demand

• Behavioral economics has potential to explain the dynamics of consumer demand.


Market Inefficiencies

• Failures of the market system like mispricing, irrationality, and “return anomalies” create outcomes that are irrational.
• For instance, mispricing could put supply way above demand and harm the market if demand is not accurately measured.


Behavioral Economics

• A reaction to the deficiencies of conventional economics.
• To incorporate more realistic notions of human nature into economics.

Behavioral Economics

- Behavioral Economics deduces principles of economic behavior from features of human nature assumed to be valid at all times and in all cultures.


Criticism against the Behavioral Approach

- Criticism from the left: The behavioral model of communication research does not explore the relationship between communication and the social and economic structure.


Behavioral Audience Research

- Main Methods:
  - Survey
  - experiment
  - mental measurement

Behavioral Economics: Altruism

- Preferences depart from pure self-interest
  - Subjects contribute to public goods more than can be explained by pure self-interest

- People put positive value on the well-being of others

Behavioral Economics: Time Preferences
- People discount streams of utility over time exponentially.
- Immediate gratification is preferred to long term rewards.
- Preferences are not time consistent.
- We may not behave as we would wish to behave.


Behavioral Economics: Rationality
- Nobelist Akerlof denies that individuals are always fully rational.


Behavioral Economics: Reciprocity
- Preferences of people’s consumption depend on the behavior of other people.


Behavioral Economics: Cognitive Bias Reaffirmation
- People have some control over their beliefs, and hence can manipulate their beliefs by selecting information consistent with their beliefs.

• Therefore, beliefs ("heuristics") remain stable over time, despite other information to the contrary.


Judgment Under Uncertainty
– People usually do not detect the biases in their judgments of probability.


Value Measurement
• Value measurement has been heavily experimented on.
• One interesting finding is the disparity between willingness to pay (WTP) and lowest amount one is willing to accept (WTA).

The WTA/ETP Disparity

- This difference is usually very large and that WTA is higher than WTP.
- This large (and unexpected) disparity has generated lots of research.


The WTA/WTP Disparity - The Theory Behind it

- The theory behind it is two pronged: psychology and economics.
- The psychology is the idea of loss aversion which is the idea that people perform actions to avoid loss rather than incur gains.


The WTA/WTP Disparity

- This disparity exists for “common market goods” (ex: food) and it is even larger for “nonmarket goods” (ex: health)


The WTA/WTP Disparity - The Theory Behind it

- The economic theory is that experiments held income effects constant, but not substitution effects.
- Hanemann (1991) postulates that controlling for the substitution effect will eliminate the disparity in experiments.

On the Psychology of Prediction
• In making predictions and judgments under uncertainty, people do not appear to follow the calculus of chance or the statistical theory of prediction.

Intuition about Regression
• People do not acquire a proper notion of regression
  – They do not expect regression in many situations where it is bound to occur
  – A proper notion of regression is extremely difficult to acquire.
  – When people observe regression, they typically invent spurious dynamic explanations for it.

On the Psychology of Prediction
• Intuitive predictions are dominated by representativeness and are relatively insensitive to prior probabilities.

Behavioral Base Rates, Prediction, and Attribution
• People are simply not very good at dealing with probabilistic data.
Conservatism in Human Information Processing

- A major cause of conservatism is human misaggregation of the data.


- People perceive each data point accurately and can handle its individual diagnostic meaning, then have a hard time to combine its diagnostic meaning with the diagnostic meaning of other data, especially if it conflicts with a prior opinion.