

Behavioral Economics

Behavioral Economics

- In this lecture note, we compare and contrast behavioral economics with expected utility.
- Israeli psychologists Kahneman and Tversky invented behavioral economics; they are also famous for their seminal work in “Big Data” and evidence-based medicine studies.
- In 2002, Kahneman was awarded the Nobel Prize in Economics for integrating psychological insights into decision-making under uncertainty.

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- Kahneman and Tversky have shown that people often miscalculate probabilities when confronted with simple financial choices.
- Kahneman and Tversky find that the *manner* in which alternatives are presented (framed) may cause this to happen.

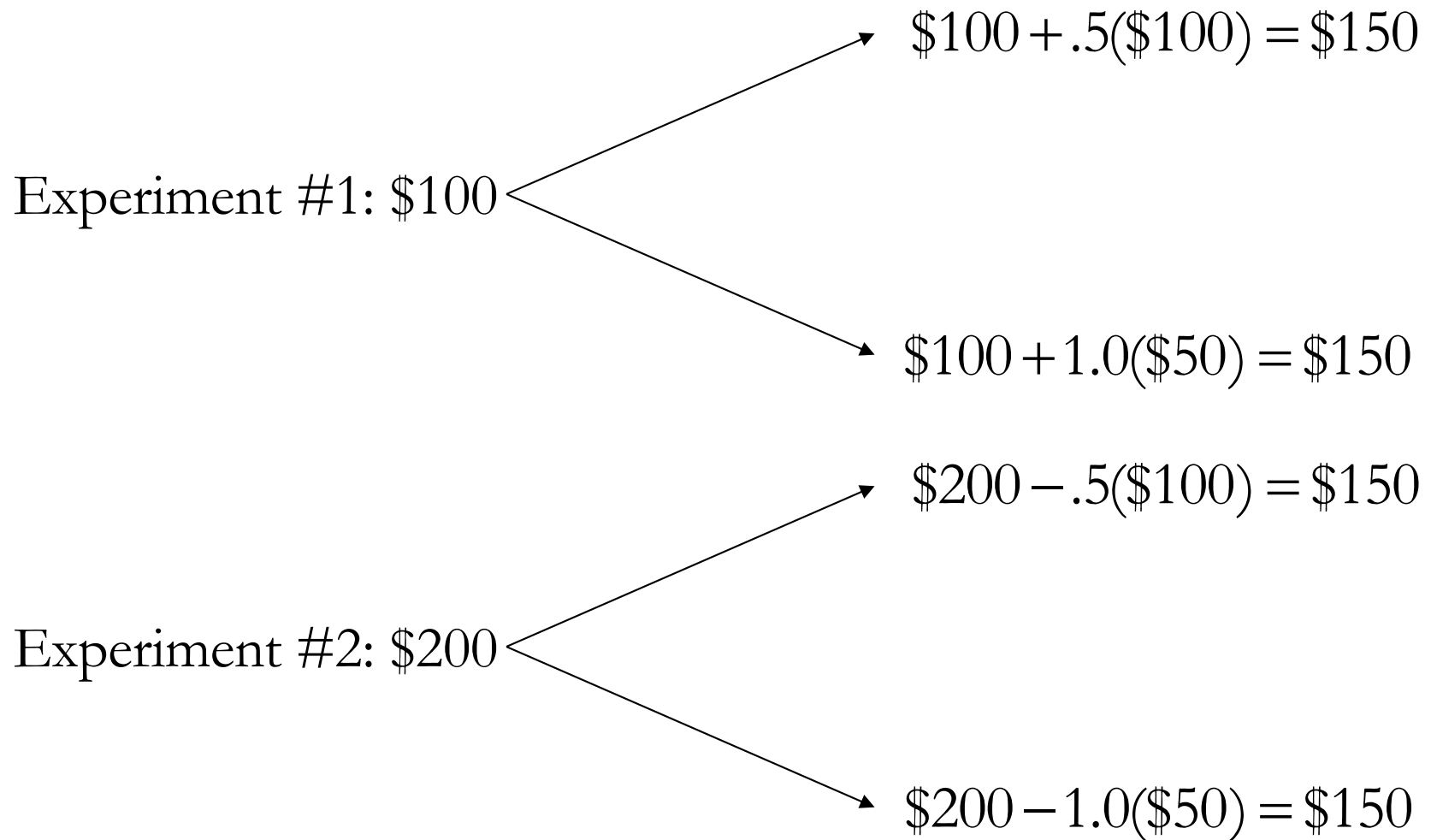
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- Experiment #1: Kahneman and Tversky gave each of their subjects \$100. Then subjects were offered a choice between either a) a 50 per cent chance of winning an additional \$100 or b) a 100 per cent chance of winning an additional \$50.

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- Experiment #2: In this experiment, the same subjects receive an additional \$100, and are given another choice: between either c) a 50 per cent chance of losing \$100 or d) a 100 per cent chance of losing \$50.

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Other Cognitive “Traps”

- *Availability bias* refers to the tendency for people to rely on information that comes readily to mind when making decisions.
- *Hindsight bias* refers to the tendency for people to attach higher probabilities to events *after* they have occurred (*ex post*) compared with *before* they occurred (*ex ante*).

Other Cognitive “Traps”

- *The fallacy of conjunction* (or disjunction): People tend to overestimate the probability that six of seven events of 90 per cent probability will occur, while underestimating the probability that one of seven events of 10 per cent probability will occur.

Other Cognitive “Traps”

- *Confirmation bias* is the tendency to search for, interpret, favor, and recall information in a way that confirms or supports one's prior beliefs or values.
- *Overconfidence in calibration* is the tendency to conflate the ‘best case’ scenario with the ‘most probable’).

Other Departures from Rational Choice

- People often deviate from “rational choice”, particularly when decisions have *important moral contexts*.
 - Examples: making anonymous gifts to charity, returning lost wallets to strangers, choosing to work for modest pay at socially worthwhile jobs.
- People often overestimate (frequency and severity of) external risks which they cannot control (e.g., natural disasters) and underestimate internal risks which they can control (e.g., drinking and smoking).