

BEHAVIORAL ECONOMICS: A FRAMEWORK FOR REALIZING DREAM OF NEW INDIA



Dr. S K Gupta
M.Com, FCS, FCMA, Ph.D



Durva Shetye
Student – Gokhale Institute of
Politics and Economics

The Perspective

In an ideal world, people would always make optimal decisions that provide them with the greatest benefit and satisfaction. In economics, rational choice theory states that when humans are presented with various options under the conditions of scarcity, they would choose the option that maximizes their individual satisfaction. This theory assumes that people, given their preferences and constraints, are capable of making rational decisions by effectively weighing the costs and benefits of each option available to them. The final decision made will be the best choice for the individual. The rational person has self-control and is unmoved by emotions and external factors and, hence, knows what is best for himself. Alas behavioral economics explains that humans are not rational and are incapable of making good decisions.

Behavioral economics draws on psychology and economics to explore why people sometimes make irrational decisions, and why and how their behavior does not follow the predictions of economic models. Decisions such as how much to pay for a cup of coffee, whether to go to graduate school, whether to pursue a healthy lifestyle, how much to contribute towards retirement, etc. are the sorts of decisions that most people make at some point in their lives. Behavioral economics seeks to explain why an individual decided to go for choice A, instead of choice B. Because humans are emotional and easily distracted beings, they make decisions that are not in their self-interest.

What Is Behavioral Economics?

Behavioral economics is a rather recent field of mainstream economics. The field of study known as behavioral economics initially began as a purely academic attempt at modeling irrational consumer choices, thereby challenging the notion of the rational consumer of traditional economics. However, recent events have launched behavioral economics from a purely academic pursuit to the forefront of public policy.

Our minds are far less independent than we would like to believe. Through Behavioral Science we aim to generate legitimate, objective conclusions on human behavior and understand the effect that our individual contexts have on our decisions. Behavioral Economics is an analytical approach that uses contextual research to explain how people make decisions. While we may feel we have clear intentions, our actions do not always reflect that. Establishing motivation & intent is a critical first step and studying habits, goals and identity is crucial to a real understanding of the reasons behind the choices we make. These learnings can help us understand, predict, and act on the inconsistencies in our preferences and actions.

Behavioral economics differs from standard economics in that it uses a more realistic (and more complicated) model for people; it differs from psychology in that it maintains the focus on institutions and the contexts in which decisions are made. Behavioral economists study how the context of decisions interacts with our expanding understanding

of human psychology. By combining the insights from these two very different perspectives, behavioral economists have been able to reveal new depths in ourselves. The foundational principle of behavioral economics lies in the understanding of the power of context; specifically, the idea that the context around which decisions and actions are made and taken has huge effects on outcomes

Behavioral economics considers the ways that people are more social, more impulsive, less adept at using information, and more susceptible to psychological biases than the standard economic models assume. Behavioral economics is the study of how psychological, social, and emotional factors often conflict with and override economic incentives when people make decisions. When applied to management, behavioral economics can help us uncover ways to limit the organizational impact of biases and cognitive limitations—or ethically exploit them to help drive enterprise value.



Behavioral economics is a discipline examining how emotional, social and other factors affect human decision-making, which is not always rational. As users do not always have stable preferences or act in their best interest. Behavioral economists assume a contrarian stance that individuals—no matter their age or intelligence—are rather myopic with respect to what is best for them. Behavioral economics assumes irrationality in decision making. As such, individuals are susceptible to temptations and tend to make poor and rash decisions, even though it is clear there are better options that will improve long-term outcomes. Behavioral Economics is the study of psychology as it relates to the economic decision-making processes of individuals and institutions.

Essential Behavioral Economics Principles

- **The Overconfidence Effect** ; While humans lack objectivity on many matters, they may be most biased in assessing themselves. Numerous studies have demonstrated a tendency for participants to overrate their own performance on a range of tasks.
- **Temporal Discounting** : In traditional economics, cost-benefit calculations are the means consumers use to make decisions. But what if timing could radically alter these assessments? In a variety of contexts, humans respond far more to immediate rewards than those that require a wait. This “temporal discounting” contributes to our preference for immediate gratification
- **Loss Aversion** : The well-documented phenomenon of loss aversion refers to our tendency to place greater emphasis on the potential absence of something we already have than the acquisition of something we don’t currently possess.
- **Anchoring and Framing** ; refers to our habit of relying too heavily on the first piece of information we receive. In an ongoing string of interactions, this initial impression sets the tone for how subsequent data are interpreted.
- **Social Norms** : We’re all obliquely aware of social influence – none of us is completely immune to peer pressure or certain social imperatives, such as expectations about personal hygiene or politeness. But the urge to align ourselves with social norms is more powerful than most of us imagine. At a psychological level, we’re instinctively inclined to conformity.
- **Optimization** : People try to optimize their choices and preferences by choosing the best and feasible option available to them but often are observed to be making mistakes. One of the important factors is experience; people with experience tend to make better choices as oppose to people with lesser experience.

How Behavioral Economics Differs from Traditional Economics

Prior to behavioral economics, economic predictions were based on an assumed capacity in the average consumer for making rational choices. The model of rational choice assumed the decisions of consumers were rational, planned and made for their own wellbeing. This model hinged on the created concept of homo economicus : humans motivated by self-interest, choosing amongst options in situations of scarcity. The earliest revelations of behavioral economics revealed entirely different trends in consumer behavior, showing how flawed the assumptions of rational choice models were. Consumers are often uncertain of what they want, for example, and make choices that are not to their long-term benefit. Frequently, consumers don't know themselves what they will want in the future.

The standard economic model of human behavior includes three unrealistic traits—unbounded rationality, unbounded willpower, and unbounded selfishness—all of which behavioral economics modifies. Traditionally, economics uses sophisticated mathematical and econometric methods, but relies on relatively simplistic assumptions about human nature. Meanwhile, by contrast, research in neighboring social sciences generally uses less sophisticated analytical methods while entertaining a richer description of man.

BE has recently become the fastest growing field in economics—and one of the most exciting. It examines a wealth of evidence, often experimental, identifying empirical phenomena that are not adequately explained by traditional economic analysis. BE develops new models that incorporate emotions, fairness, reciprocity, social norms, bounded rationality and myopia, among others. The research often builds on game theory, which provides more flexible tools for this purpose than classical price theory or general equilibrium theory

Behavioral economics attempts to integrate insights from psychology, neuroscience, and sociology in order to better predict individual outcomes and

develop more effective public and commercial policies. Behavioral economics studies how individuals behave, and how thinking and emotions affect individual decision-making. By adding insights from psychology, behavioral economics tries to modify the conventional economic approach, and to analyze how “flesh-and-blood” people act in social contexts

Behavioral economics incorporates the study of psychology into the analysis of the decision-making behind an economic outcome, such as the factors leading up to a consumer buying one product instead of another. Unlike the field of classical economics, in which decision-making is entirely based on cold-headed logic, behavioral economics allows for irrational behavior and attempts to understand why this may be the case. The concept can be applied in miniature to individual situations, or more broadly to encompass the wider actions of a society or trends in financial markets. Brexit is one example of how behavioral economics can be useful. Thaler has suggested that the theory can help explain how the narrow vote to leave the EU was influenced by gut choices, as opposed to rational decision-making. Fundamental to behavioral economics is that two thought systems are at work in people—one operates with intuitive, experience-based and relatively unconscious processes; the other involves controlled analytical processes and depends on a person's cognitive ability, in-the-moment bias and influence from society.

Of late, however, Behavioral Economics has shown that our decision processes are far from rational. Recent findings indicate that we have a strong inherent bias towards negative information—we are hardwired to pay attention to negative information and less so to positive information. This focus on biases is unhelpful in several ways. It fails to acknowledge that biases are broad tendencies, rather than fixed traits, and it oversimplifies the complexity of human behavior into an incoherent list of flaws. This leads to misguided applications of behavioral science that have little or no effect, or which can backfire spectacularly. We need to appreciate better the role biases play on the wider behavioral-economics stage.

The Mind, Behavior, and Development Unit (eMBeD), the World Bank's behavioral sciences team, works closely with project teams, governments, and other partners to diagnose, design, and evaluate behaviorally informed interventions. By collaborating with a worldwide network of scientists and practitioners, the eMBeD team provides answers to important economic and social questions, and contributes to the global effort to eliminate poverty and increase equity

Emergence of Behavioral Economics

The field of Behavioral Economics was pioneered by our own Carnegie Mellon faculty Herbert Simon (a Nobel Prize winner in Economics) and George Lowenstein. While Behavioral Economics started as a small movement in the 1970s, it has made an enormous impact on academic research and research in Behavioral Economics papers regularly appears in the top economics journals. Public policy influences people's choices and preferences in a socially desirable way; hence, application of behavioral economics in public policy becomes relevant. Behavioral Economics research has been used to help governments enact better public policy and operate more efficiently, to help businesses improve their profitability, and to help individuals make better decisions.

Behavioral economics emerged as a subfield of economics. Economists were discovering that people did not quite act and react like the consistently rational, self-interested, utility-maximizing agents in their neoclassical models. The deviations from the standard model had to be captured somehow, and psychology provided a basis for doing so. It is these deviations—or biases—that get the popular attention. That is, at best, a mixed blessing. To a worrying extent, biases have become the defining feature of behavioral economics.

Compared to just a few years ago, the term behavioral economics has gained tremendous currency. To say it is on everyone's lips would be only a minor exaggeration. For the scientists and practitioners in the field, this emergence from relative obscurity should, at first glance at least, be a source of happiness. One

reason for this growing interest is the way behavioral economics has been presented and interpreted. Behavioral economics is, it seems, the field that confronts us with our deeply irrational selves. We are bamboozled by biases, fooled by fallacies, entrapped by errors, hoodwinked by heuristics, deluded by illusions.

Behavioral Economics is not only theory on paper

Business leaders often struggle to understand why their employees and customers behave the way they do. More often than not, the answer simply comes down to human nature, but this is still news to many people. Over the years, classic economic theory has assumed that individuals make decisions based solely on rational thinking. In fact, some have suggested that economic decision making is up to 70% emotional and 30% rational.

Gallup has found that it contains the secret to driving higher levels of growth and profitability. According to our analysis, companies that apply the principles of behavioral economics outperform their peers by 85% in sales growth and more than 25% in gross margin. Gallup analysts have found there is more low-hanging fruit in behavioral economic strategies than in the valuable processes of Six Sigma and lean management.

Companies are increasingly incorporating behavioral economics to increase sales of their products. In 2007, the price of the 8GB iPhone was introduced for \$600 and quickly reduced to \$400. What if the intrinsic value of the phone was \$400 anyway? If Apple introduced the phone for \$400, the initial reaction to the price in the smartphone market might have been negative as the phone might be thought to be too pricey. But by introducing the phone at a higher price and bringing it down to \$400, consumers believed they were getting a pretty good deal and sales surged for Apple. Also, consider a soap manufacturer who produces the same soap but markets them in two different packages to appeal to multiple target groups. One package advertises the soap for all soap users, the other for consumers with sensitive skin. The latter target would not have purchased the product if the

package did not specify that the soap was for sensitive skin. They opt for the soap with the sensitive skin label even though it's the exact same product in the general package.

Building a Brand on Human Truth

These insights from the world of behavioral economics can transform the way any business approaches its challenges. With conclusions rooted in psychological reality, rather than abstract theories, brands can begin to adopt strategies that truly speak to customers. That's the nature of innovation: Clarity produces opportunity, and solutions to complex problems become possible.

Behavioral Economics and Sustainability

Behavioral Economics is a science of psychology that can help to better understand economic decision-making processes by individuals and institutions with respect to sustainability and other issues relevant to humanity today. This discipline combines the principles of psychology, sociology and economics, with the aim of better understanding how we make financial decisions. By using Behavioral Economics, it is possible to incentivize people to buy renewable energy instead of conventional energy (from fossil fuels and the main contributors to carbon emissions). Behavioral Economics can be used to solve some of the great challenges in the fight against climate change,

What Behavioral Economics Is Not

Behavioral economics is not a tool for controlling the behavior of people, it is not an intrinsically political discipline, and it is not founded on the belief that people are irrational. The foundational principle of behavioral economics lies in the understanding of the power of context; specifically, the idea that the context around which decisions and actions are made and taken has huge effects on outcomes

Behavioral Economics for New India

The Economic Survey 2019 has drawn on Nobel Laureate Richard Thaler's Behavioral Economics Theory to lay out what it describes as an "ambitious

agenda" for behavior change that will bring in social change, which in turn, will help India transit to a \$5 trillion economy by 2024-25. Programmes such as Swachh Bharat Mission, Jan Dhan Yojana and Beti Bachao Beti Padhao, provide testimony to the potential for behavioral change in India.

Given India's rich cultural and spiritual heritage, social norms (that play a very important role in shaping the behavior), can be utilized to effect behavioral change. Behavioral economics is, however, not a panacea to policymaking.

How Behavioral Economics can be applied in the Indian context?

- Recently, behavioral economists have discovered the efficacy of a new class of policies called "nudge" policies. Nudge policies gently steer people towards desirable behavior even while preserving their liberty to choose.
- According to Nudge theory: People need reminders and positive reinforcement to sustain socially desirable behavior.
- According to the Organization for Economic Cooperation and Development, there are more than 202 government institutions using behavioral insights around the world.

Examples of nudge policies:

- For increasing tax compliance in India: Citizens can be sent communications through various media on how the amount of taxes they pay makes a difference to public services that in turn will induce citizens to pay taxes.
- For reducing drop out rate in poor families: Parents can be informed about the average income gains from spending one more year in school for children.
- To increase savings rate: People can be offered specially designed savings accounts that locked up funds until a self-specified target was met.

In this scenario, government regulation, taxes and free-market policies should be clubbed with a nudge

effect to increase the efficacy of policymaking. If it is implemented diligently than Indian policymaking will be transformed:

- From BBBP to BADLAV (Beti Aapki Dhan Lakshmi Aur Vijay Lakshmi)
- From Swachh Bharat to Sundar Bharat
- From “Give it up” for the LPG subsidy to “Think about the Subsidy”
- From tax evasion to tax compliance

And the dream of New India 2022 can be realized.

Conclusion

The field of behavioral economics is about analyzing the motivations behind economic decisions and showing the relevance of behavioral economics to our own lives and everyday economic and financial problems. It explores the reasons why we make irrational decisions; how we decide quickly; why we make mistakes in risky situations; our tendency to procrastination and short-termism; and how we are affected by social influences, personality, mood, and emotions. The implications of understanding the rationale for our own financial behavior are huge. Behavioral economics could help policy-makers to understand the people behind their policies, enabling them to design more effective policies

Behavioral economics is a blend of traditional neoclassical microeconomics and empirically motivated assumptions whose goal is a better understanding of economic behavior. It can be divided into behavioral decision theory and behavioral game theory. Each subfield differs from its mainstream counterpart by paying particular attention to the psychological realism of behavioral assumptions and their consistency with empirical evidence. The goal is to identify empirically important deviations from traditional assumptions, use the alternative assumptions the evidence suggests to build tractable formal models, and use the models to reconsider standard microeconomic questions.

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