

Behavioral Economics Principles An Overview

Behavioral economics is the study of the effects of psychology on economic decision making. In other words, how people's emotions and thoughts can affect how they make decisions about money. The context in which people make choices is very important.

The following principles are taken from the web site if ideas42 (www.ideas42.org), an organization focused on applying behavioral economics to design innovative solutions to some of the world's toughest social problems.

1. LIMITED ATTENTION

At any given moment, we have a finite amount of attention at our disposal. When this attention is split – for instance, when we try to focus on driving, listening to the radio and texting all at once – performance can suffer. We often are much less attentive to tasks than we ourselves assume. As a result, we may forget things or miss details that turn out to be important.

Limited attention affects the decisions people make. When attention is stretched, people have a difficult time focusing on both the benefits and consequences of options. Being aware of these attentional limits allows us to make changes that mitigate their negative consequences. Setting default options or forcing choices that require individuals to stop and consider the pros and cons of choosing an alternative can refocus their attention. Reminding people about actions they may have forgotten to take can likewise be remarkably effective at changing how they act.

2. STATUS QUO BIAS

There's no place like home."

This memorable quote from *The Wizard of Oz* sums up how many of us feel about home—it's comfortable and familiar. But beyond the physical place, people consider other things "home" too, sometimes unconsciously: beliefs, previous choices, set routines. These things form an individual's *status quo*, which people tend to prefer to stick to. As a result, people often "choose" pre-set options even when many others are available.

As a result, even arbitrary options that set the *status quo* – for example, default settings – play incredibly important roles in decision-making, and can influence what people choose and what eventually happens. Of course, knowing this also allows us to harness the power of the status quo. For example, changing what happens if people do nothing can make it more likely that it is "chosen". This insight has revolutionized retirement savings in the United States: many more companies now enroll employees into retirement-savings programs by default (giving them the option to leave the program if they so wish), instead of making them fill out and submit a form in order to enroll. This small change has led to many more people saving for retirement than before, accomplishing something years of education, exhortation and matching contributions failed to achieve.

3. MENTAL ACCOUNTING

We often think of different bits of our income as falling into different buckets, each intended for a different purpose: the monthly bills account, entertainment funds, food money, and mortgage down payment fund. This has its uses: it can protect us from self-control issues, for instance by preventing us from spending too much of our paycheck on tempting goodies. But there's a flip side: the practice of viewing money as having specific labels can become generalized and cause us to behave in ways that are not in our best interest.

On the other hand, mental accounting can be turned to our advantage. People are less likely to spend money that has mentally been designated as "saving" than if it is thought of as being general spending money, even if there is nothing preventing them from dipping into the so-called savings. Linking saved money to a particular goal – perhaps an appliance a person wants to buy, or ensuring their daughter can go to college – can make them reluctant to deplete it. Used judiciously, mental accounting can be our friend. In cases where people aren't putting money into such mental accounts, creating them can have beneficial effects.

4. IDENTITY

Many of our choices are partly driven by our perception of our role in society. But we all have multiple identities. The same person can be a wife, lawyer, mother and gardener. Each of these identities may carry different goals and values, and decisions are often made with reference to the objective or ideals of the identity that is most active.

The existence of multiple social identities means that the way a message or option is framed can change the way people think about a problem. For example, making a person's role as a citizen more salient than it would be otherwise can increase the likelihood of convincing her to perform a socially beneficial action like recycling or energy conservation.

5. SOCIAL NORMS

Parents of teenagers have often wheeled out the line, "If everyone else jumped off a bridge, would you do it too?" But high school kids aren't the only ones who care about what everyone else is doing. Knowing what others do provides a reference point against which people can compare options when they are unsure about what to do.

Giving people a clearer picture of what constitutes "normal" behavior for their peers, friends, neighbors, or citizens in general can make them more inclined to do the same. Thus, simple changes to the wording of options to include accurate information about their peers' decisions can overcome their original miscalculations.

6. PLANNING FALLACY

We often underestimate the amount of effort and time it will take them to complete a task. This can make it difficult for us to do relatively small things, like finish college essays or be on time for meetings. But it can also make it hard to do things like signing up for retirement savings or meeting the application deadlines for college scholarships.

If someone has underestimated the amount of *effort* required to complete a task, they may become discouraged and abandon it. If they have underestimated the amount of *time* required they may make rushed decisions, submit an incomplete document or miss deadlines altogether.

Presenting the requirements and steps of the task clearly can increase completion rates. Indeed, simply informing people of the average time it takes a person to complete the task in question can provide a more accurate guide than unguided guesses by enabling them to allot enough time for the task.

7. PRESCRIPTIVE AND DESCRIPTIVE NORMS

People usually have a good sense of what they should and shouldn't do: do offer your seat to a pregnant woman; do wash your hands after you use the restroom; don't double dip potato chips. But we don't always follow these rules.

Much the same is true of the decisions we make. We know what decisions we should be making, but sometimes we do something quite different. Yet often the messages we receive, especially for important decisions like retirement savings and organ donation, tend to focus on reminding us of what we should be doing.

An alternative approach is to simply inform people of descriptive norms— what the majority of people actually do. In a review of twenty-one studies... researchers found that knowing what other people do is a stronger influence on how they eventually behave than knowing what society says they should do.

Messaging around such descriptive norms has been used to push up voting rates, to get people to conserve electricity, and in a host of other situations. But it pays to be careful: telling people how well others are behaving can get those who already behave "better" to give themselves a freer rein – which may not always be what those sending messages want.

8. PROCRASTINATION

When's the most popular day of the week to start a diet? Tomorrow.

People procrastinate. They put off for tomorrow what they could (and want to) do today. These delays have real consequences: procrastinating on filing taxes costs an average of \$400 in fees and unclaimed returns; putting off that health check may account for men's higher death rates for preventable diseases. Procrastination is one of the ways in which self-control problems manifest themselves.

The more steps involved in the decision or action, the more likely someone is to procrastinate. This is because people must resist the siren song of procrastination all along the path of completing a task. The more complex it is to follow through on the decision to do something by actually doing it, the more opportunities there are to procrastinate.

Other factors can induce procrastination too. If there are too many choices or there is too much detail available, one might be overwhelmed and choose to deal with it later. People also tend to put off starting things that they cannot finish in one sitting; if a form takes 40 minutes to complete and a person only has 20 minutes now, they won't bother starting. The more anxiety created by the decision, the stronger the temptation to relieve that stress by thinking about something else.

There are solutions, though. Providing people with actionable steps, or giving them ways to commit to actions in advance, or even providing them with timely reminders to finish tasks they may have started can all help tackle procrastination.

9. SELF CONTROL

At some point even the most disciplined person will succumb to temptation. Grabbing that piece of chocolate cake when you're on a diet, buying that round of drinks when you should be saving money, and watching one more episode of your favorite sitcom when you know you should get enough sleep before your big meeting in the morning are all common examples of failures of self-control. We have good intentions, but poor follow-through.

This is especially true where some gain in the future (such as better health, or more financial security) comes at the cost of some up-front loss (eating salad, or saving instead of spending). These self-control problems require tightrope-walking balance: too much spontaneity leads to impulsiveness; too much delay leads to procrastination.

Commitment devices such as self-imposed limits on retirement account contribution changes or the ability to withdraw money from one's own bank accounts can constrain impulsive behavior. These give a person's more cautious and prudent "future self" the ability to set limits on what his impulsive, imprudent, pleasure-seeking "present self" does.

10. CHOICE OVERLOAD

Too many choices can be overwhelming. When faced with a huge range of options, many people fail to choose the best option. Worse, they may fail to choose altogether. Too much information – a plethora of product features, combinations or specifications, for instance – can also have a similarly paralyzing effect on people's decision making. An (over)abundance of options can mean that nothing is chosen.

Decreasing the number of choices, limiting the amount of unnecessary information presented and increasing the meaningful differences between choices can all facilitate decision-making and prevent the paralysis induced by choice overload.

11. AVAILABILITY AND REPRESENTATIVENESS

We tend to be poor judges of how likely things are when they are difficult to imagine or too similar to a stereotype. In the former case, we tend to underestimate how likely they are; in the latter case, we err in the opposite direction.

These flaws in our judgments of probabilities can lead to choices that are not necessarily in our best interest. Present the consequences of deciding against a vaccine more vividly than the low chance of contracting the disease and people will flock to take potentially unnecessary preventive actions.

An effective way of combating these tendencies is to ensure that choices are presented in a way that highlights the important context. For example, indicating the life expectancy of a population can help people make better decisions about whether they should claim Social Security benefits at age 62 or 67 and prevent people from miscalculating the probability that they would not benefit from waiting.