Behavioral Economics: Decisions and Strategies

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Background

Over the past 30 years, psychologists and economists have joined forces to study how people process information and actually make decisions, rather than how they would make a decision if they were fully rational, selfish and had unlimited willpower. This research program (dubbed behavioral economics) has provided an understanding of how people's decisions deviate from "optimal" choices as well as the consequences of such deviations. This course is devoted to understanding the nature, causes, and implications of these limitations.

Objectives

The course is intended for future managers, industry analysts, consultants, and advisors, and has two main objectives. First, it provides a broad overview of important results from behavioral economics that clarify how people really make decisions. Second, it seeks to improve the ability of the student to influence the behavior of others, be they consumers, employees, or people outside of a business relationship altogether. This will be accomplished by building on the toolbox that standard economics provides for influencing behavior (namely, incentives and information) with the insights from the aforementioned stream of research in behavioral economics.

Format

The course is intended to be intellectually stimulating and challenging. I value class participation and application of the ideas and theories we will be discussing. Classroom time will be devoted to a combination of lectures, discussions, a guest speaker, and group presentations illustrating the main concepts.

Readings

I have put together a book of readings that will be distributed at the first class. There is no required textbook.

Grading

Midterm exam (25%)
Final exam (30%)
Group presentation (15%)
Class participation (10%)
Writing assignments (20%)

For the midterm and final, each participant is permitted to bring one sheet of paper (8½ by 11 inches) with notes on both sides, to refer to during the exam.

Class participation will be evaluated on the basis of contributions to class discussions. In the evaluation, quality is more important than quantity. In addition, the evaluation of class participation could be affected adversely by lack of attendance or creating negative classroom externalities.

Responsibilities

We are all adults.

- As the teacher I have the *responsibility* to organize and present the material and to facilitate your learning.
- As a student you have *responsibility* for your own learning.
- You are responsible for complying with Stern's Honor Code. The Honor Code requires each student to act with integrity in all academic activities and to hold his or her peers to the same standard. No lying, cheating, or plagiarism of published work, work posted on the web, or work done by other students will be tolerated. Any suspected case will be referred to the School's student discipline committee.
- Actions that have negative effects on others will not be tolerated in the classroom. If you must arrive late or leave early, you must do so as quietly as possible. No cell phones should be audible during class sessions.

Course Website

I will maintain a website for the course using NYU Classes. The website will include announcements and downloadable files with all the class handouts.

Course Teaching Fellow

Please note that there is no Teaching Fellow for the course. I will be responsible for all grading.

Group presentations

Everyone will take part in a group presentation (3-4 people per group) that applies course material to a business problem. One possibility is to report on something you have read that is relevant to the course, a problem that course concepts would solve, or a small research project. These should be practically minded and of the form "how has this course helped me think about possible explanations and/or solutions to this problem or puzzle?"

Writing assignments

<u>Choose 1 or 2 and submit by Class 6 (March 26)</u>

1. Consider the following fact: 80% of small businesses fail within their first three years of operations. A friend is unaware of this fact, and wishes to quit his job as an investment banker and open a restaurant in New York. As a good friend, you want to be sure that overconfidence is not playing a significant role in his decision. You decide a letter is the best way to communicate the dangers of overconfidence. Compose a latter to your friend, for the purpose of helping him navigate the pitfalls of overconfidence. Before writing this letter, you might consider the following questions: Why might your friend be overconfident about the success of this venture? What are the most important sources of overconfidence? Which of these sources do you believe will be most resistant to your persuasion?

2. You have been hired as a special consultant to the director of Human Resources at McKinsey (or some other firm that hires many MBA graduates). Based on the principles of mental accounting, how should McKinsey structure their compensation package to maximize the number of offers accepted (recruiting)? (Note: Of course, we are not looking for the following answer: "Increase salaries." Consider the total pool of compensation fixed). How should McKinsey structure compensation to retain employees? Again, take total compensation to be fixed. Does mental accounting suggest why different compensation packages might be required for recruiting and retention?

<u>Choose 3 or 4 and submit by Class 11 (April 30)</u>

3. Although people usually procrastinate by postponing the completing of unpleasant tasks, there are also situations in which people procrastinate the enjoyment of something enjoyable, such as drinking a special bottle of wine or finishing a box of gourmet chocolates. For some reason, no occasion ever seems special enough to finish it off, and the activity is continuously postponed. Suppose you are the seller of luxury goods that have this problem (such as fine wines). How do you get your customers to quit delaying consumption?

4. Describe a situation from business where non-cooperative game theory would predict a different outcome from what is observed. What is rationality, and would you say that the people are acting irrationally? What is missing from the theory that, if added, describes the situation? Is welfare helped or harmed because of this factor?

Course Schedule

Class 1: **Introduction** **February 13**

Reading: Lambert, Craig (2006), 'The Marketplace of Perceptions,' *Harvard Magazine* (March/April).

Class 2: **Prospect Theory** **February 20**

Reading: Barberis, N.C. (2013), 'Thirty Years of Prospect Theory in Economics: A Review and Assessment,' *Journal of Economic Perspectives*, 27(1): 173-196.

Class 3: **Heuristics and Biases** **February 27**

Reading: Tversky, Amos and Daniel Kahneman (1974), 'Judgment under uncertainty: heuristics and biases,' *Science*, 185: 1124-1131.

Belkin, Lisa (2002), 'The Odds of That,' *The New York Times*, August 11.

Class 4: **Choice** **March 5**

Reading: Loewenstein, G. and R. Thaler (1989), 'Anomalies: Intertemporal Choice,' *Journal of Economic Perspectives*, 3: 181-193.

Class 5: **Mental Accounting + Midterm** **March 12**

Reading: Thaler, R.H (1999), 'Mental Accounting Matters,' *Journal of Behavioral Decision Making*, 12: 183-206.

Midterm in second half of class

Class 6: **Fairness** **March 26**

Reading: Fehr, E. and S. Gachter (2000), 'Fairness and Retaliation: The Economics of Reciprocity,' *Journal of Economic Perspectives*, 14 (3): 159-181.

Blanding, Michael (2014), 'The Business of Behavioral Economics,' *Harvard Business School Working Knowledge*, August 11.

Guest Speaker (second half of class): Mr. Jordan Goldberg, CEO, StickK

<u>Class 7</u>: **<u>Emotions</u>** **<u>April 2</u>**

<u>Reading</u>: Loewenstein, G. (2000), 'Emotions in Economic Theory and Economic Behavior,' *American Economic Review*, Papers and Proceedings, 90 (2): 426-432.

Group presentations

<u>Class 8</u>: **<u>Motivation</u>** **<u>April 9</u>**

<u>Reading</u>: Ariely, D., Gneezy, U., Loewenstein, G. and N. Mazar (2009), 'Large Stakes and Big Mistakes,' *Review of Economic Studies*, 76 (2): 451-469.

Ariely, Dan (2008), 'What's the Value of a Big Bonus?' *The New York Times*, November 20.

Group presentations

<u>Class 9</u>: **<u>Behavioral Game Theory</u>** **<u>April 16</u>**

<u>Reading:</u> Camerer, C.F. (1997), 'Progress in Behavioral Game Theory,' *Journal of Economic Perspectives*, 11(4): 167-188.

Group presentations

<u>Class 10</u>: **<u>Behavioral Economics of Poverty</u>** **<u>April 23</u>**

<u>Reading:</u> Bertrand, M., Mullainathan, S. and E. Shafir (2004), 'A Behavioral Economics View of Poverty,' *American Economic Review*, Papers and Proceedings, 94 (2): 419-423.

'Poor Behaviour,' *The Economist*, December 6, 2014.

Group presentations

<u>Class 11</u>: **<u>Happiness</u>** **<u>April 30</u>**

<u>Reading</u>: Fox, Justin (2012), 'The Economics of Well-Being,' *Harvard Business Review*, January.

Group presentations

<u>Class 12</u>: **<u>Course wrap-up + final exam</u>** **<u>May 7</u>**