Behavioural Economics: A Fairly Recent Development that has become a Little Too Overrated

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Behavioural Economics theoretically deals with the impact that psychological, cognitive, emotional, cultural and social factors can have on the economic decisions that are taken by rational agents. Behavioural Economics combines elements of economics with psychology and neuroscience to understand how and why rational agents behave the way they do. As opposed to Neo-Classical Economics, Behavioural Economics carries forward the thought that consumers are not absolutely rational and their economic decisions are affected by various factors and externalities. Behavioural Economics also studies how agents should act and the consequences of not acting the way they should.

Behavioural Economics rests on the concept of bounded rationality which implies that no individual is completely rational while making economic decisions. Their rationality is limited by their understanding of the decision problem, their cognitive limitations, the time available, and the structures of the environment. While making a decision, a rational agent first chooses a reference point and then compares outcomes to the reference point in order to classify them into gains and losses. Loss aversion explains how individuals attempt to avoid losses more than seek equivalent gains. Rational agents are unable to foresee the future which explains their cognitive limitations and consequently, their poor judgment.

Consumers are assumed to be "rational" agents however, it is quite obvious that irrationality helps shape consumer behaviour, and the study of Behavioural Economics helps predict trends in irrationality. Marketers apply principles of Behavioural Economics to nudge prospective buyers towards their products, to improve their market research, and to analyse their marketing mix. The Nudge Theory was popularised by Richard Thaler and Cass Sunstein in 2008. They defined their concept as the following: "A nudge, as we will use the term, is any aspect of the choice architecture that alters people's behaviour in a predictable way without forbidding any options or significantly changing their economic incentives".

Nudges are not mandates because they influence consumer behaviour without coercion. This gives rise to the concept of libertarian paternalism. For instance, in my college campus, the academic block where the lectures are conducted is closer to the library compared to the canteen. In fact, the canteen is located outside the campus and demands a slightly longer walk. This creates an environment that nudges the students to spend time during recess reading books in the library rather than idly relaxing or socialising in the canteen.

Advertisers, while conducting research on how to improve their advertisements, often find themselves in a dilemma. Successful marketing involves extensive research centred on a set of marketing tools, namely product, price, place, and promotion, to realise marketing objectives. In more ways than one, Behavioural Economics guides marketers into tricking or manipulating consumers. The following are two marketing strategies that are the most commonly implemented. Firstly, payments, like all losses, are inherently painful. A consumer, in almost every purchasing decision, has the option and the willingness to save their money for a later date. Thus, delaying the payment, even by small periods, can lessen the pain of having to part with one's money. The time value of money makes future payments less costly than current payments which is why

consumers are more willing to pay in the future for an item purchased in the present.

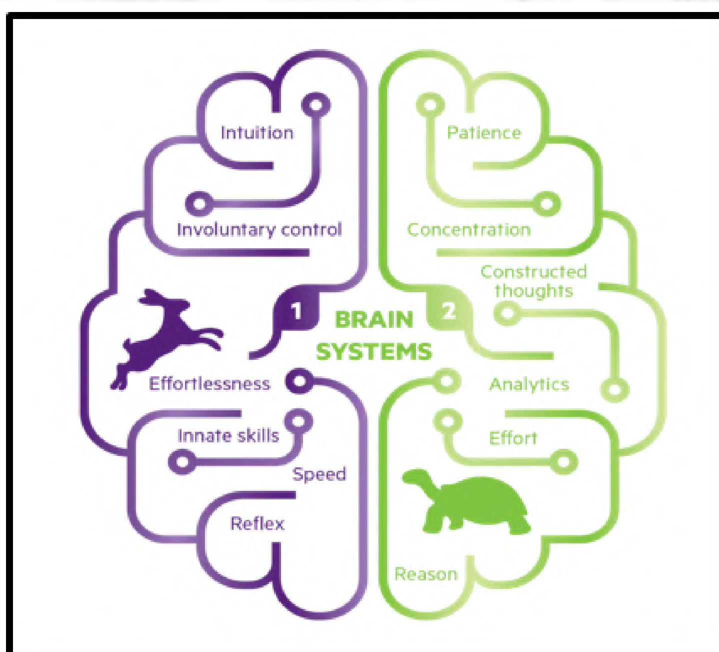
Secondly, consumers should not be overwhelmed with too many choices. Choice overload causes choice fatigue which may incentivise a consumer to depart without purchasing any item. Reducing the number of choices not only helps a consumer reach a particular decision with ease but also maximises the utility derived from his choice. Choice fatigue is extremely human to experience and, as mentioned previously, even marketers experience the same while exploring more creative ways of promoting their products.
Decisions are made by rational agents through an approach called heuristics. A heuristic technique is an approach to problem solving that employs knowledge from past experiences to make a decision using a calculated guess. For a decision to be made, there needs to be a minimum of two options. Behavioural Economics then employs search heuristics to explain how people evaluate their options and come to a decision. While heuristics aid decision-making, people are often affected by numerous biases and fallacies. Loss aversion is one such bias that acts as a negative catalyst in the process of decision-making.

The Sunk-Cost Fallacy is a phenomenon in business decision-making whereby a person is reluctant to abandon a particular course of action because they have heavily invested in it although it is clear that abandonment would be more beneficial. For instance, at my college canteen, they sell sandwiches. The other day, I decided to deviate from my usual choice of a cheese sandwich and ordered a grilled garlic cheese sandwich.

I expected to have a light, garlic butter seasoned sandwich with melted cheese however what I received was a gnarly, lumpy sandwich with chunks of whole garlic. Having paid a cent rupees for it, I continued to gobble it down when I recollected learning about the concept of sunk costs. Despite being a dedicated Economics student, I decided to finish

the whole sandwich and not throw it away. I could have invested in something better with the same money. Here, the concept of opportunity cost steps in.

Most students are fascinated with Behavioural Economics. It is a brilliant way to learn at the intersection of economics and psychology, and ask how both fields of study might become better. Behavioural Economics is neither wrong nor dangerous but is most likely to be misused, given the very real biases and heuristics that all of us are susceptible to and use. While the field of Behavioural Economics and the power of nudges cannot be undermined, one must be cautioned of the limitations of Behavioural Economics. There lies the worry if the field has become a little too overrated.

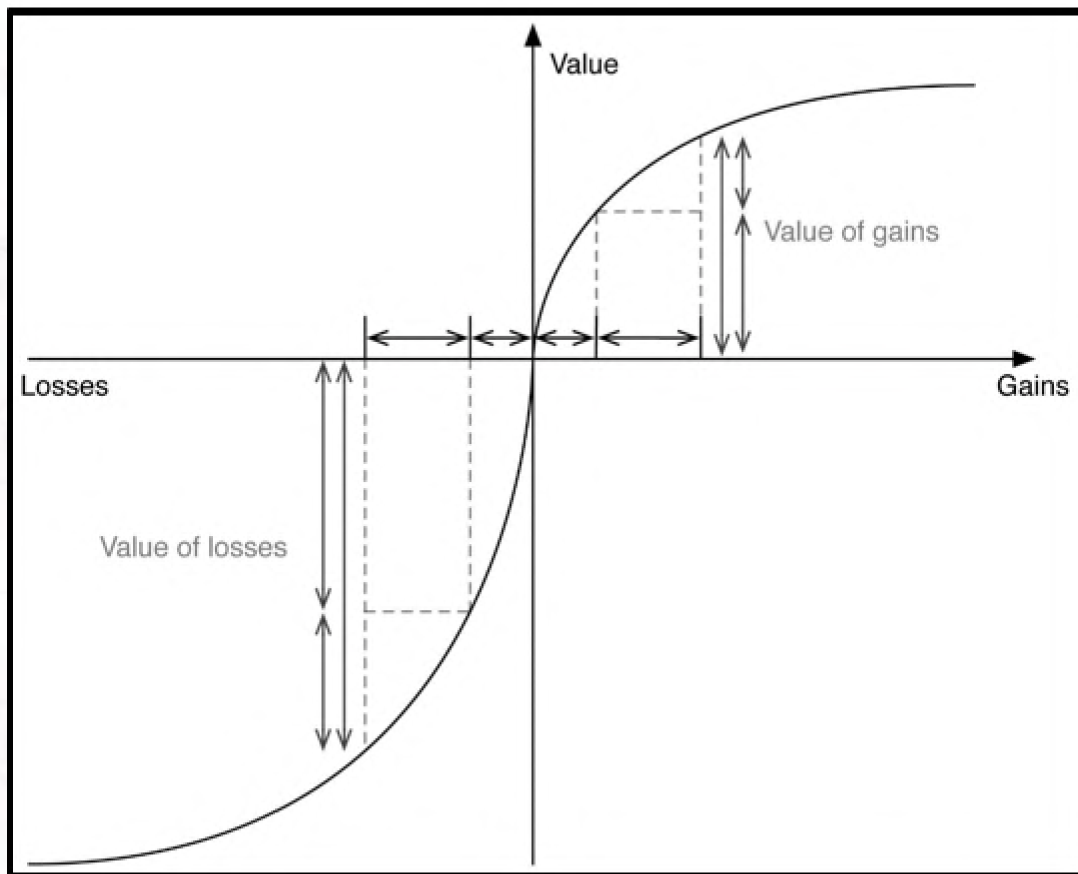


BEHAVIOURAL ECONOMICS VERSUS NEO-CLASSICAL ECONOMICS EXPLAINED

Table 1. A taxonomy of policy interventions

	Type of intervention		
Rationale for intervention	Traditional economic (e.g. taxes and subsidies)	Hybrid policies (e.g. carefully 'framed' taxes and subsidies)	Behavioural
Traditional economic (e.g. externalities, asymmetric information)	A (pure economic theory)	B	C
Hybrids (e.g. company optimally responding to consumer biases)	D	E	F
Behavioural economic (e.g. internalities, bounded rationality)	G	H	I (pure behavioural economics)

EXCESSIVE DEPENDENCE ON NUDGES EXPLAINED



FALLACIES: LOSS AVERSION EXPLAINED