

BEHAVIORAL ECONOMICS FOR KIDS



By
Neil Bendle &
Philip Chen

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www.neilbendle.com

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BEHAVIORAL ECONOMICS FOR KIDS

The aim of this book is to illustrate what we already know.

People behave in predictable ways that don't always reflect the ideal behavior that social scientists like to theorize about. On the negative side sometimes our choices are short-sighted, incoherent, self-destructive or even malicious. On a more positive note, sometimes we are more sociable than might be predicted by a traditional economic view of decision making. Furthermore most of us seem to do a surprisingly good job of coping with a ridiculously complex world.

The behaviors that violate various social scientists' ideals can be seen even amongst children. Indeed this little book starts from the premise that while adults do grow up a little we all remain big kids. The actions that we see our children doing can help to explain our own behavior. Of course we could do a dense tome with lots of footnotes, pompous words and caveats but we figure that like kids most of us prefer it when pictures explain the world.

In the following pages we detail some of the most significant elements of modern behavioral research. This should be of interest to students, teachers, researchers and even children who want to know why their sister always wants the last M&M.

This is Behavioral Economics for Kids.

Neil Bendle and Philip Chen, 2018

THE ENDOWMENT EFFECT

1

The Endowment Effect



The doll we own has more value to us than a stack of identical dolls.



People are willing to pay less to buy something they don't own than they are willing to accept payment for an identical item they own. "Possessing" something makes it more valuable.

Trades are harder to make than implied by traditional economics. This is because where we start from in any trade matters to the outcome

Read: Jack Knetsch (1989), The Endowment Effect and Evidence of Nonreversible Indifference Curves, The American Economic Review, 79 (5), 1277-1284.

SUNK COST BIAS

2

Sunk Cost Bias



Past losses matter when deciding whether to commit to one more heave.



"Fight on. We can't give up now else the second battalion's sacrifice will be in vain."

People consider sunk costs. Sunk costs are irrecoverable whatever option is chosen. They are therefore irrelevant to the decision at hand. People “pour good money after bad”, fight on in wars they should abandon and double down on failing projects. Prior investments drive people’s new investments not just the predicted results of the investment.

Read: Barry Staw and Ha Hoang (1995) Sunk Costs In The NBA: Why Draft Order Affects Playing Time And Survival In Professional Basketball, *Administrative Science Quarterly*, (40) 3, 474-494

HYPERBOLIC DISCOUNTING

3

Hyperbolic Discounting



A marshmallow in the hand is worth two promised later



When offered a cookie today or two cookies tomorrow waiting seems intolerable and we eat today. When offered one cookie in 365 days or two in 366 days the wait seems easy and we say we will wait.

People more heavily discount the immediate than distant future. The implications go well beyond dieting. Such inconsistency threatens much of social science. It suggests what we want depends upon when you ask us.

Read: Stefano Della Vigna and Ulrike Malmendier, (2006), *Paying Not To Go To The Gym*, *The American Economic Review*, 96 (3), 694-719

REFERENCE DEPENDENCE



4

Reference Dependence



That you already have an ice cream doesn't matter. What matters is the additional sprinkles you must have.



"I'm sorry, they didn't have any sprinkles."



"This is the worst thing ever!!"

We evaluate offerings not on an absolute scale but relative to what we already have (or were expecting).

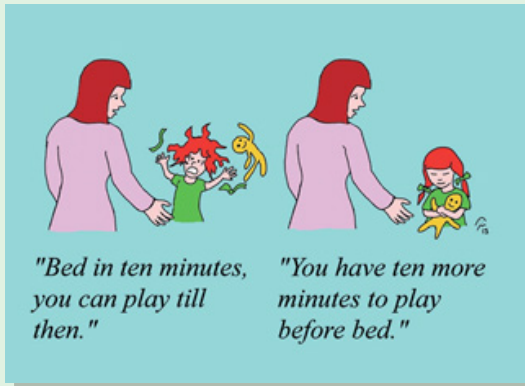
We acclimatize to our current state. What was once a wonderful feature of a product becomes something boring that consumers simply expect.

Read: Amos Tversky and Daniel Kahneman, (1991), Loss Aversion in Riskless Choice: A Reference-Dependent Model, The Quarterly Journal of Economics, 106 (4), November, 1039-1061

Framing



I prefer mummy sharing the bad news about bedtime strategically.



The person being communicated with can perceive the same information as different depending upon how the information is presented.

Your choice of communication strategy matters to the decision that will be made. Losses are not the mirror image of gains.

Read: Amos Tversky and Daniel Kahneman, (1981), *The Framing Of Decision And The Psychology Of Choice*, *Science*, 211, 4481, January 30, 453-458

TRUST

6

Trust



She is surprisingly trustworthy but beware some leaps of faith.



"Jump, I'll catch you."

Your sister, friend or even a random stranger is often much more trustworthy than economists assume.

Assumptions of rampant opportunism are too simplistic. Trust, if clearly defined, may be a useful concept in economic analysis. (That said we don't want to be too panglossian. Sometimes trust isn't a good idea especially if the person isn't capable of helping you even if they want to).

Read: Joyce Berg, John Dickhaut and Kevin McCabe, (1995), Trust, Reciprocity, and Social History, Games and Economic Behavior, 10 (1), 122–142

FAIRNESS

7

Fairness



Being fair matters but who wouldn't take the leftover chocolate egg?



"Two for me, One for you"

We free-ride in social situations but also show evidence of wanting to stop behavior that is perceived as unfair. To this end we may seek to punish those whose behavior is perceived as unfair. People don't seem to be merely profit maximizers but have social preferences. They care, at least somewhat, about fairness.

Read: Ernst Fehr and Klaus M. Schmidt, (1999), A Theory Of Fairness, Competition, And Cooperation, The Quarterly Journal of Economics, (114) 3, 817-868

LOSS AVERSION

8

Loss Aversion



The chocolate you lost can never be replaced.



"I lost my chocolate."



"I found a chocolate."



"I wish I hadn't lost my chocolate."

Surely \$10 is \$10? We know differently. If you lose \$10 and win the same amount you may be unhappy. "If only I had been more careful and not lost the money".

This basic effect underlies a number of findings. It creates messy asymmetries in economic models. It has been suggested as the reason for the relative expensiveness of safe investments. (You effectively pay not to experience the pain of losses which comes with volatile stocks).

Read: Shlomo Benartzi and Richard Thaler, (1995) Myopic Loss Aversion and the Equity Premium Puzzle, *The Quarterly Journal of Economics* 110 (1), 73-92

MENTAL ACCOUNTING



9

Mental Accounting



Ice-cream money is very different from money for doll's clothes.



We don't perceive money as totally fungible. How we label income and expenditure matters. Money received as a windfall, e.g. a bonus, is more likely to be spent on treating oneself than ordinary salary. People don't maximize their utility across dimensions but hold themselves to budgets in different categories.

Read: Richard Thaler, (1985), *Mental Accounting and Consumer Choice*, *Marketing Science*, 4 (3), 199-214.

DISHONESTY

10

Dishonesty



Taking one chocolate isn't cheating.



"I only eat one piece."

We like to think of ourselves as honest but can be surprisingly inventive in deciding what constitutes honesty.

If you want to reduce dishonesty don't just focus on increasing punishments. Structure the decisions to reduce people's ability to be dishonest without feeling bad about their actions.

Read: Nina Mazar, Om Amir and Dan Ariely, (2008), *The Dishonesty of Honest People: A Theory of Self-Concept Maintenance*, *Journal of Marketing Research*, (45) 6, 633-644

BASE RATE NEGLECT

11

Base Rate Neglect



She looks like a princess, not a doctor.



When judging probabilities we often ignore frequencies and concentrate on appearance cues. The tiny number of princesses in the world means even the poshest woman you meet is unlikely to be one, especially if she is going into a hospital benefit dinner.

People make mistakes in judging probabilities. This has quite scary implications for medical decision making and witness testimony in trials.

Read: Amos Tversky and Daniel Kahneman, (1974), Judgment Under Uncertainty: Heuristics And Biases, Science, 185 (4157), 1124-31.

COMPETITOR ORIENTATION

12

Competitor Orientation



Its not about how many toys I have. It is about having more toys than my sister



Beating others is sometimes a goal in itself. I don't care as much about what I get as I care about getting more than someone else.

This conflicts with the economic view of a decision maker as profit maximizing. The competitively orientated person prefers earning \$100 while another person earns \$0, to earning \$200 when the other person gets \$300. Relative success matters.

Read: J. Scott Armstrong and Fred Collopy, (1996) *Competitor Orientation: Effects Of Objectives And Information on Managerial Decisions And Profitability*, *Journal of Marketing Research* 33 (2) 188-199

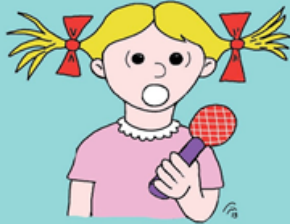
OVERWEIGHTING OF SMALL PROBABILITIES

13

Overweighting of Small Probabilities



One in a million approximately equals one in a hundred.



"I'm going to be a pop-star!"

People exhibit problems understanding the difference between unlikely and practically impossible. That this young girl will become a doctor is merely unlikely, that she will become the next Hannah Montana practically impossible. Lottery tickets are bought despite fact there is no reasonable chance "it could be you".

Read: Daniel Kahneman and Amos Tversky (1979), Prospect Theory: An Analysis of Decision Under Risk, Econometrica, 47 (2), 263-292

OVERCONFIDENCE

14

Overconfidence



Nothing is impossible to a big girl.



"I do it."

We sometimes exhibit seemingly unreasonable assessments of our probability of being correct or nothing going wrong.

People may be willing to spend too much pursuing goals that are objectively unlikely to ever be achieved. This may help explain failed plans, poor investment decisions and even doomed corporate acquisitions.

Read: Ulrike Malmendier and Geoffrey Tate, (2005), CEO Overconfidence And Corporate Investment, The Journal of Finance, (60) 6, 2661

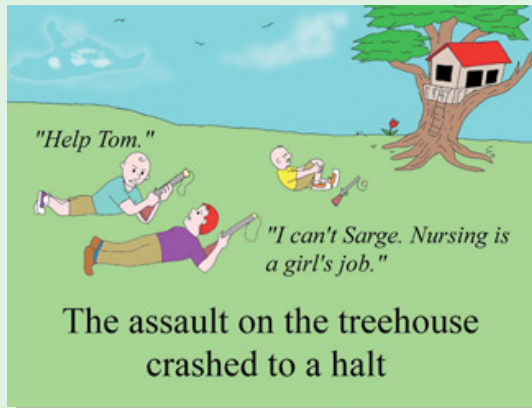
IDENTITY

15

Identity



Sometimes we make questionable choices to preserve our group identity.



We forgo profitable and enjoyable opportunities to preserve our attachment to a specific group identity. Men who would make great nurses, and women who would make great firefighters, don't do it. They feel that is not what their gender does. Economic and social outcomes are reduced. People do what they feel they should do not what they are best at, or what is most needed.

Read: George A. Akerlof and Rachel E. Kranton (2000), Economics And Identity, The Quarterly Journal Of Economics, 115 (3), 715-753



Thank
you

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