

Answer Notes for Revision Questions Considered in Tutorial 12b

These notes mostly are far shorter than they would be if fleshed out into 40-minute essay answers, but they should at least give an idea of the things covered in the course that could be deployed to construct good answers. Question 1 has more detailed notes but they are still a bit shorter than what it's possible to write legibly in 40 minutes if you are really on top of the material.

- 1 How do behavioural/evolutionary analyses of pricing differ from those normally offered in economics textbooks?

By 'pricing', we mean the thinking behind the prices that sellers ask for their products. This can be explored in terms of what is known about the bases for setting prices in reality, or in a more 'normative' manner, in terms of what behavioural research suggests firms ought to do when setting prices. An example of the former is the discovery that firms seem to set prices via a mark-up on average variable costs at a target level of output, and that they don't try to make short run profits by increasing prices when there is a sudden surge in demand, contrary to a standard $MC=MR$ perspective. An example of the latter is that keeping prices steady, unless there is a change in costs that is expected to continue, is a wise thing in order to maintain goodwill and make it easier for customers to make their decisions (consider the problem of going out for a meal if restaurants didn't work with fixed menu prices and instead kept changing their prices depending on how many diners were coming in that night). In other words, the view of pricing offered by PWS Andres and Alfred Marshall needs to be part of the analysis. An old behavioural perspective could also bring in Cyert and March's behavioural theory of the firm view of prices as being set and changed with simple decision rules. Their view can accommodate the mark-up pricing view, but they also use it to model how department stores decide when to put products at 'sale' prices to clear excess inventories. The old behavioural view also notes that big organizations would be expected to adjust prices rather slowly anyway, since information would tend to have to pass through many people before it reached the actual decision maker.

This question also provides an opportunity for students to apply material from Chapter 7 (Bargains and Rip-Offs) of Thaler's book *Misbehaving*. Central to this chapter is the idea of a reference price against which actual prices are compared, with the difference between actual and reference prices being the source of additional (dis)utility depending on whether the actual price is (above) below the reference price and hence whether the consumers feel they are getting a bargain. The role of 'recommended retail prices' against which discounts are offered could be explored in relation to Thaler's thinking. Students would be rewarded for employing Thaler's material on the use of 'sales' in particular markets and on 'everyday low prices' versus 'specials'. There are also opportunities to bring in other themes in relation to reference prices, such as Ariely's discussion of presenting consumers with three differently priced products to steer them towards the middle one by making it seem a 'bargain' by comparison, and of the role of anchoring bias when prices

are assessed relative to the product initially examined. Material from Earl's *Lifestyle Economics* can be employed to, with prices being used in tie-breaking, judging quality, affecting whether products are examined at all (where a budget range is set), and in relation to status. Earl offers a different view of 'rip-offs' based on the idea that consumers may relate actual prices to their sense of what the product may cost to supply. The 'rip-off' notion needs to be discussed in relation to the early work by Marshall and Andrews on cost-based pricing, which emphasizes the limited scope suppliers have for charging inflated profit margins. There, the focus was on the risk of encouraging entry in the long run, though it was also emphasized that buyers were far more willing to switch than theories of imperfect competition portrayed them to be.

2. In his book *Misbehaving*, as he writes about the development of Prospect Theory, Richard Thaler claims that:

'Simon had coined the term "bounded rationality", but had not done much fleshing out of how boundedly rational people differ from fully rational ones. There were a few other precedents, but they too had never taken hold'.

Discuss the accuracy of Thaler's claim regarding Simon's contribution and critically assess Thaler's coverage of the 'precedents' to which he alludes.

The key point to bring out here is that Thaler neglects altogether Simon's development of the 'satisficing' notion and the broader work on organizational choices for which he won the 1978 Nobel Prize. Thaler also neglects Simon's development of bounded rationality idea and problem solving into his analysis of seemingly intuitive decisions (the only part of Simon's work recognized by Kahneman in *Thinking, Fast and Slow*). The one 'precedent' that Thaler considers is Baumol's sales-revenue maximization model of the firm and students need to point out that Thaler completely ignores Cyert and March's Behavioral Theory of the Firm, which takes Simon's framework further, along with Winter's work on decision rules and evolutionary fitness, all of which were covered in class. Worse still, given that Thaler's remarks are in the context of explaining how Prospect Theory was developed, he is completely oblivious of Shackle's Potential Surprise model of choice under uncertainty, which offered a model of choice that has some features in common with Prospect Theory thirty years before the latter. However, students can certainly argue that Thaler is correct when he says that none of the 'precedents' took hold prior to Prospect Theory, at least not within economics (Simon, Cyert and March are very widely cited in Business School research output).

3. Human decision makers have finite attentive capacities. They also have finite capacities to imagine how the future will unfold, yet their powers of imagination can also result in them giving attention to imagined events that never actually happen. What do these human shortcomings imply for theorizing about the choices that people make?

This question is set primarily as a covert invitation to students to consider Shackle's Potential Surprise model of choice under uncertainty, which assigns key roles to finite attentive capacity and finite powers of the imagination, with those features being ignored by the probabilistic models that Shackle sought to displace. Students will be rewarded for displaying knowledge of how finite attentive capacity fits into Shackle's model (via the 'ascendancy function' and the focusing on pairs of gains and losses that it produces; and via people recognizing their scope for potential surprise, Shackle's alternative to probability estimates. Finite attentive capacity can also be discussed as a key underlying source of bounded rationality in Simon's analysis of problem solving, though the better answers will point out that Simon tended to focus on the solution of closed problems and hence was downplaying the role of the imagination in problem solving. There is also scope for arguing that finite attentive capacity will drive people to use non-compensatory decision rules (as argued in Earl's Lifestyle Economics) and engage in 'fast thinking' with the aid of the kinds of heuristics emphasized by Kahneman, instead of doing cautious, careful deliberation. Anchoring bias could be brought in here. One could also argue that information overload may lead to impulsive choices unless consumers are able to outsource their decision-making to the 'market for preferences'.

4. What lessons should BETA (Behavioural Economics Team Australia) draw from Richard Thaler's account of his work with BIT, the Behavioural Interventions Team set up by the UK government?

This question is in effect an invitation for student to show what they gleaned from Chapter 33 (Nudges in the UK) of Thaler's *Misbehaving*. Thaler provides some good case material on the use of the Nudge approach (supplemented by Cialdini's work on persuasion) to get people to pay their taxes on time. He emphasizes the need for the policy measures to be simple but also that they need to be tested with field experiments. He gives examples of the challenges of doing this and some of these should figure in answers to this question. This was a very popular question in the 2016 final exam and general was done really well.

5. What insights does behavioural economics have to offer for financial market regulators seeking to increase competition in the financial services sector, reduce the lenders' exposures to defaults on loans, and help ensure that consumers have paid off their mortgages by the time they reach normal retirement age?

Students should have noticed Thaler's discussion of the retired-with-mortgage phenomenon when reading Thaler's *Misbehaving*. They should thus discuss it with reference to failures of self control and present bias/hyperbolic discounting, that result in repeated over-spending, aided by credit-line mortgages, with consumers promising to themselves that they will step up their saving a bit further down the track. Cognitive dissonance theory could usefully be employed here. This begs the question of why they are interested in spending, and answers might apply thinking about conspicuous consumption, desires for novelty (cf. Scitovsky), testing hypotheses (cf Kelly),

and attempts to manipulate their emotions by supplier, or merely changes in 'normal' standards of living being used as reference points for what one should expect to consume. The Nudge approach could be employed in relation to policies to promote competition for financial service customers, with reference to Waterson's analysis of the contrast between banks and insurance companies in terms of profits and whether customers are nudged by reminders rather than just having automatic rollover of services from year to year. Reducing default risks is something that can be discussed in relation to the evolution of lending standards, bringing together old behavioural material on decision rules (loan checklists) and Minsky's work on financial instability, covered in lecture 10: regulation of deposit fractions and loan/income ratios may be needed to counter the process that Minsky predicts. There may be potential for shaking the 'safe as houses' view that, partly due to short memories, is widely assumed, and hence for building a Nudge strategy around loss aversion and availability bias by publicizing case studies of how 'people like us' got into a mess and lost their homes.

6. What insights does behavioural economics offer towards understanding the origins of the Global Financial Crisis?

This question presents many opportunities for the students: they can use Simon's bounded rationality ideas to discuss whether those who signed up for 'toxic' mortgage products really understood what they were getting into; the top-end students who have delved into the Earl and Littleboy book on Shackle could discuss apparent shifting risk-taking propensities in terms of shifts in imagined potential yields and shifts in the ascendancy function (especially in its reference point) rather than in terms of an actual shift in risk preferences (this is all set out in Earl and Littleboy). Changes in lending rules of banks could be discussed in terms of satisficing theory as banks' levels of tolerance adjusted upwards before the crash occurred. More basically, students can apply Minsky's financial instability hypothesis, covered in the lectures, and discuss how euphoria emerges to drive a bubble, ideally remembering Schumpeterian perspectives on financial innovation that ratchet up the extent of risk-taking. The competitive, macho behaviour of players in the dealing room could be brought in (as per *The Wolf of Wall Street*) and the possibility that, with finite attentive capacity, thoughts of what one could do with a huge bonus may get in the way of taking good decisions as a banker. Those who have read the set text will have plenty of material to deploy: Thaler's *Misbehaving* has a discussion of the use of home equity loans to fund durables spending in his analysis of the effects of mental accounting, whilst chapters 21-26 apply behavioural economics to financial issues. Keynes's ideas on animal spirits, raised in lecture 3, and Dow video recommended for that week also could be employed.