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Theories of Behavioral Economics Elucidated with Examples

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ABSTRACT: Contrary to the rational economic beliefs that people are self-interested and businesses aim to maximize shareholder profit, behavioral economics offers three options for managerial consideration. One is that people's decision-making is bounded rationality as a result of their own emotions, biases, and the influence of others. Managers must develop cultures and environments that understand individuals' limited cognitive resources and establish safeguards to protect both groups and individuals from poor decision-making. The second point is that people are motivated by intrinsic factors other than money, although they can be easily overshadowed. The purpose of management is to combine inherent motivators such as autonomy with social support and the desire to learn, integrate, and find significance while also acknowledging that addressing these requirements is heavily influenced by the environment. The third possibility is that the firm's goal is to maximize collective value over the long run. This shift in perspective broadens the responsibilities of managers by requiring them to include an ecosystem of business partnerships and other types of capital as critical variables in business decisions.

KEYWORDS: Rational economic beliefs, Businesses, Shareholder profit, Behavioural economics, Bounded rationality, Cognitive resources, Autonomy, Social support, Business partnerships

I. INTRODUCTION

Behavioral economics (Salamone, Correa, Yang, Rotolo, & Presby, 2018) empirically observe human behavior, which has shown that humans do not always make "rational" or "optimal" decisions as considered by neoclassical economists, even when they have all of the necessary knowledge and tools.

Why do people typically ignore or postpone investing in 401(k) or exercising, although knowing that this would help them? Why do gamblers risk more after winning and losing, despite the fact that the odds remain the same regardless of "streaks"?

The area of behavioral economics views people as vulnerable human beings to emotions and impulses and who are impacted by their surroundings and conditions by posing questions like these and determining answers through experiments.

Models of traditional economics have characterized humans as either completely rational actors—who have flawless self-restraint and never lose track of their long-term aims or people who periodically make inconsistencies that cancel out in the long haul.

Behavioral economics research has revealed some concepts that have assisted economists in understanding better human economic behavior. Corporations and governments have created policy frameworks based on these concepts to persuade people to make specific decisions.

II. THEORIES OF CUSTOMER'S BUYING BEHAVIOR

Consider the last time a customer (Gigerenzer, 2018) bought a laptop computer. He could have made his decision easier by choosing a well-known brand or a brand he has already chosen and then could have placed his order on the manufacturer's website. But his decision-making process didn't end there; he had to now customize his model by



selecting from a variety of product parameters (processing speed, screen size, hard drive capacity, and so on), and he wasn't sure which features he truly required. Most technology makers will present a base model with choices that can be adjusted based on the buyer's preferences at this point.

The way these product options are displayed to a purchaser will have an impact on the final purchase he makes, and it shows numerous behavioral economic (BE) theories.

To begin, the base model displayed in the customization engine is a default option. Customers are more likely to choose the default if they are unsure about their choice, especially if it is expressly provided as a suggested setting. Second, using the 'add' or 'remove' customization mode, the manufacturer can frame choices (or something in between).

1. **Add mode:** Customers begin with a basic model and then add additional or better features.
2. **Delete frame:** Customers must remove features or reduce from a fully-loaded model in the delete frame; thus, an opposite process occurs.

When customers are in a delete mode rather than an add mode, they select a wider number of features.

Ultimately, the decision framing style will be associated with various price anchors prior to personalization, which may influence the product's monetary value. The cost will be perceived as more tempting if the final configured product costs £1500 instead of £1000. Sellers will seek a sweet spot—a manner of option framing that maximizes sales while setting a default price that discourages the vast majority of potential buyers from ever considering a purchase.

III. DIFFERENT THEORIES BEHIND CUSTOMER'S BUYING BEHAVIOR

- **Rational Choice**

In an idealistic world, consumer decisions (Day, McIlvennie, Brackley, Tarantini, Piselli, Hahn, ... & Pisello, 2020) would be influenced by existing preferences and a thorough weighing of costs and benefits. We would always make the best choices. The economist Gary S. Becker notably presented a series of theories recognized as the foundations of rational choice theory in his 1976 book 'The Economic Approach to Human Behavior.' Human actors are assumed to have consistent interests and participate in maximizing conduct, according to the theory. The 1970s, on the other hand, saw the beginnings of the opposite stream of thought, as explored in the next section.

- **Prospect Theory**

According to prospect theory (Beerbaum, & Puauschunder, 2019), gains and losses are regarded separately; therefore, individuals make choices based on perceived rewards rather than losses. This theory, also known as the "loss-aversion" theory, is that if an individual is given two equal alternatives, one presenting potential rewards and the other presenting potential losses, option one will be picked.

Think about the situation where an investor receives two proposals for the same mutual fund. The first advisor introduces the fund to the investor, emphasizing a three-year average return of 10%. Meanwhile, a second advisor informs the client that the fund has produced above-average returns over the last decade but has been declining over the past four years.

The investor is more inclined to select the first advisor because the second advisor portrays the fund as having high returns but also losses, as per this theory.

- **Bounded rationality**

Bounded rationality is the theory (Cohen, Bingham, & Hallen, 2019) that customers' reasonable decision-making abilities are constrained due to three key factors: cognitive aptitude, time constraints, and poor information. Customers will make suboptimal selections when placing an order at a restaurant, for example, because they feel pressured by the waiter.



- **Mental Accounting**

Richard Thaler's mental accounting theory, introduced in 1999, asserts that the value of money and the influence which each individual associates with the available finance is based on subjective factors, which can lead to irrational expenditure. The examples of mental accounting bias are as follows:

1. Tax refunds
2. Bonuses
3. Birthday money
4. Safety capital
5. Lottery winnings
6. The amount of money that is affordable to lose
7. Confusing Identical Purchases
8. Money already spent

- **Too Much Information: Choice Overload**

Choice overload, also known as over choice, happens when customers are presented with too many options. It has been linked to dissatisfaction, decision fatigue, defaulting to the default option, and choice postponement of making a decision completely, including not purchasing a product. The number of alternatives and qualities, time restrictions, decision accountability, alignment and complementarity of options, and consumers' preference ambiguity are all elements that may rise to apparent choice overload.

Choice overload can be alleviated by reducing choice qualities or the range of options provided.

- **Limited Information: The Significance of Feedback**

Thaler and Sunstein point to experience, good knowledge, and prompt feedback as crucial variables that enable individuals to make effective judgments in their 2008 book *Nudge*. General feedback intended to encourage behavioral change has traditionally been confined to facts spanning from the economic expenses of the harmful behavior to its prospective health effects. More current behavior change initiatives, such as those that use smartphone apps to help people quit smoking, now typically provide optimistic and individualized behavioral feedback, such as cigarettes not smoked and money saved, as well as details on health improvement and disease prevention.

- **Information Avoidance**

People are assumed to be boundedly rational actors with a restricted capability to comprehend knowledge in behavioral economics. In behavioral economics, information avoidance refers to instances in which people refuse to access freely available information. Physical avoidance, inattention, skewed information interpretation, and even some forms of forgetting are all examples of active information avoidance.

In the long run, information avoidance is usually counterproductive since it deprives people of possibly helpful information for decision-making and feedback for future actions, and it can promote polarization of political beliefs and media bias.

- **"Irrational" Decision Making**

Traditional economics also believe that humans have total self-control, but they would buy cigarettes by the pack rather than the carton, even if the carton saves them money, in order to reduce their usage. To put it another way, we guard ourselves against our biggest temptations at a cost. Behavioral economists are addressing this by devising strategies for people to avoid succumbing to these temptations. This involves nudges towards more and more sensible behavior instead of government-imposed regulations. Due to procrastinating or feeling intimidated by the various options, up to 20% of new employees do not instantly enroll in retirement savings plans. Some businesses are implementing a new system in which workers are currently enrolled until they "opt out." Nobody really opts out of this program, and workers start saving early in their careers when it is most important for retirement.



- **Dual-System Theory**

Daniel Kahneman devised the dual-system theory, which he popularized in his book Thinking, Fast and Slow. Individuals possess two distinct decision-making processes, according to this theory:

1. The first is quick, impulsive, and emotional, acting without thinking and relying on heuristics and prior knowledge or experience.
2. The second part of the decision-making system is a much more purposeful, cognitive thinking process that may draw in more information than just our own personal experience.

It implies that when our impetuous tendency is at its most active, people can make erroneous decisions. Buying 'impulse buys' with a low return, for example.

- **Example: Choosing a career**

This decision can be split down into sections, some of which are more suited to System 1 thinking and others to System

2. Questions like "Will I gel with the other workers working within this job?" and "Will this workplace environment enables me to work effectively?" can be addressed with system 1.

System 2 appears to be adequately examined by asking questions such as "Where will I develop the most useful skills?" "What variables link most with job satisfaction?" and "Which organization is developing the fastest?" System 2 thinking is appropriate for assessing significant considerations and picking a correct career because experience is a necessity for evidence gathering to provide meaningful feedback.

We also employ these two processes to make judgments on what is ethical or moral behavior, a concept coined by Jonathan Haidt, who performed much of the initial research. He discovered that moral judgments are primarily based on instinct and that when pushed, we utilize System 2 to give a rationale, with people rarely using conscious thinking beforehand. According to psychologist Paul Bloom, this is problematic because immoral societal norms can quickly corrupt us (and this is how atrocities like slavery were justified).

IV. USE OF BEHAVIORAL ECONOMICS IN MARKETING

Behavioral economics investigates how elements apparently irrelevant to the product affect a customer's purchase decisions. Psychological, emotional, cognitive, cultural, and social aspects all play a role. The primary goal of marketing (Hampton, & Adams, 2018) is to persuade customers to choose your company over a competitor.

By knowing how customer decisions can be impacted, behavioral economics assists marketing initiatives. As a result, even minor modifications to the product, branding, or options available can have a significant impact on customer behavior.

Let's have a glance at eight excellent behavioral economics marketing examples:

- **Subway**

While many brands are abandoning such promotions as buyers have become aware of the ruse, others, such as Subway, continue to offer "Buy one, get one free" bargains for special holidays such as World Sandwich Day.

- **Starbucks**

Starbucks is a genius at creating a sense of scarcity. We're all aware of the frenzy around Pumpkin Spice Lattes (Just, 2022), which is largely due to the fact that they're only accessible for a few months each year.

The coffee behemoth routinely creates limited-edition holiday foods and beverages, with the slogan "Enjoy it while it lasts" prominently displayed.



- **Amazon Lightning Deals**

Amazon's daily Lightning Deals are the clearest example of loss aversion. These are special offers that are available only for a limited time – usually 24 hours or less – and can only be used by a set number of people.

This limitation is one of the reasons why the website's deals page is so prominent since it pushes customers to act swiftly to prevent "missing out."

- **Netflix**

Customers who are a newbie to Netflix can sign up for a 30-day free trial to see whether the service is right for them, which one had thought would be a huge loss for the firm – but it's not.

- **Tesla**

The ads in this fantastic example from Tesla are structured to emphasize the features of the car that make it stand out.

Tesla recognizes that its customers are already familiar with its brand and product; thus these ads focus on particular features (like the car's silent motor) to emphasize how distinctive the product is.

It's a basic message, but the one that lets the consumer build the impression that this product will distinguish it from other car owners.

- **Shutterstock**

Shutterstock offers four subscription plans at various price rates. The pre-selected one costs £99 a month for 350 photos or 28p per image.

In this case, the less-priced options appear to be ploys to make the much more costly subscriptions appear more valuable.

Because the cheapest option is £19 (Earl, 2018) a month for ten images, which works out to £1.90 per image, it makes sense for the customer to upgrade to a more premium membership because they believe they are receiving a better deal.

- **SiteGround**

SiteGround, like several other software-as-a-service providers, gives users three options upon their first time setting up their hosting service. Customers are presented with add-on buys and other services such as managed transfers, SSL certificates, and more once they have been set up. This method improves sales by reducing choice overload.

- **Crazy Egg**

The subscription options for Crazy Egg's heatmap tracking program are a clear illustration of this.

The 'Pro' plan is featured on the left, where it is anticipated to be the first option for customers. This plan, which costs \$99, becomes the benchmark (Zhang, & Clark, 2020) against which all other plans are measured.

You'll also observe that this instance employs a number of other behavioral economic principles, like structuring (showcasing the 'Plus plan in various colors to draw attention to it) and the decoy effect (leading to cheaper but less desirable options).

V.CONCLUSION

Behavioral economics (BE) uses psychological experiments to build ideas about human decision-making, and it has discovered a variety of biases by a virtue of people's thoughts and feelings. BE is attempting to shift economists' perspectives on people's value judgments and indicated choices. People are not always self-interested, benefit-maximizing, and cost-minimizing persons with stable preferences; according to BE—our thinking is hampered by a lack of feedback, knowledge, and processing capability, which is often accompanied by ambiguity and influenced by the perspective in which decision



making is done. The majority of our decisions are not made after much thought. We are affected by widely obtainable memory information, automatically created effects, and prominent environmental information. We also focus on the present because we resist change, are poor forecasters of future conduct, have skewed memories, and are influenced by emotional and physiological conditions. We are social creatures with social inclinations such as trustworthiness, reciprocity, and fairness; we are influenced by social standards and have a desire for self-consistency. Finally, behavioral economics has tremendous opportunities and does not require laboratory study or research. Behavioral economics can be applied in the real world to help businesses enhance their efficiency, save money, and boost sales.

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