

# Behavioural Economics The Very Short Introductions Podcast

## – Ep 60

**Rebecca Parker** 00:07

Welcome back to the Very Short Introductions Podcast. From public health to Buddhist ethics, soft matter to classics, and art history to globalization, we'll showcase a concise and original introduction to a wide range of subjects, for wherever your curiosity may take you. So here is today's very short introduction.

**Michelle Baddeley** 00:26

My name is Michelle Baddeley and I'm a behavioral economist based at the University of Technology, Sydney, and a professor of economics there, and also director of the UTS Center for Livelihoods and Wellbeing. The title of my very short introduction is Behavioral Economics: A Very Short Introduction. What behavioral economics does is bring together economics with insights from psychology, sociology, behavioral sciences, for a wide range of different disciplines to take on a different understanding of how people choose and decide, for focusing particularly on the ways in which people maybe make mistakes in their decision making. And this topic builds on standard economics and that standard economics assumes rational choice, so that everyone makes the decision almost as if they're mathematical calculating machines. They take the information in, they consider the information carefully and objectively, and then they come up with a decision that is in their own best interests, taking into account not just their own best interests now, but their best interests for the future as well.

**Michelle Baddeley** 01:39

Now, intuitively, we all know that that is not how people choose and decide, and so what behavioral economics does is it takes on some of the key strengths of economics and being quite analytical, and adds in sociology to psychology, all the different ways in which we can understand how and why people don't always do what's in their best interests. So that's broadly the topic. And what first got me interested in the subject was one of the key drivers of people's behavior is social influences. So we're very responsive to what others around us are doing or peer pressure, or what we're being advised by our friends and family, colleagues, bosses at work. And I got very interested in social influences because, early in my career, I was quite interested in macroeconomics and financial instability. One of the things about financial instability is that it can be triggered by speculative bubbles. So one of the most famous speculative bubbles was tulip mania, when tulip bulbs sold for astronomical prices. It was a speculative episode in 17th century Amsterdam. At the time, I was exploring this from a very macro perspective, looking at the whole picture. And what I realized was that, really, we have to try and understand what the individual people are up to what they're deciding what they're choosing what they're thinking. And so that triggered me to start looking into behavioral economics.

**Michelle Baddeley** 03:16

My PhD supervisor had also suggested that it would be a good thing to start to look into psychological influences, because as well as economics degrees, I have a psychology degree too. And I went along

to a conference, the American Economic Association, it also aligns with the Social Science Association meetings--thousands of economists turn up. And there was a really interesting session there on behavioral economics and also neuro economics, which brings together neuroscience and economics. And it was at these meetings that sort of got a bit of a lightbulb moment that the way to understand why people copy one another, what can explain speculative bubbles, what can explain herding and social influences in all sorts of other contexts, is by bringing the economics together with the behavioral sciences, such as psychology, sociology, neuroscience. So that's how I first got interested in the subject using behavioral economics to try and explain why people are so affected by social influences. So since then, I've got very deeply into behavioral economics. I guess the timing was right in the sense that when I first started really concentrating my research and teaching on behavioral economics, which happened in about 2005, behavioral economics has become very fashionable.

**Michelle Baddeley 04:41**

And so all sorts of people from all sorts of different disciplines were wanting to talk to behavioral economists about how people blend together their rational choices with some of these psychological and social influences. And the big theme at the time, which is still quite predominant in public policymaking to is the idea of nudging, using insights from behavioral economics and behavioral science to nudge people towards making particular choices that might be to their benefit or to society's benefit, or to government's benefit. And that sort of nudging idea draws really strongly on key insights from behavioral economics, that soften the idea that people are choosing rationally, and allows that psychological influences come in. And in thinking about the psychological influences, some of the key aspects that everyone should know about the subject of behavioral economics--and it's a diverse subject, not all behavioral economists would necessarily agree with what I say now, but this is my view of it--is that we start with the idea that people want to do what's best for themselves. And that's an essential insight from economics, which in my opinion, is unarguable, that people genuinely do want to do what's best for themselves in principle, but when they're making decisions in situations that are very uncertain, or very risky, when the information is not very good, they make mistakes. And these are what behavioral economists call behavioral biases.

**Michelle Baddeley 06:17**

But these behavioral biases linking with people's fundamental incentives and motivations. So many people might think, well, economists think that all people are driven by money is the key motivator. But that's not true. And behavioral economics really fills this out a bit in terms of the incentive inputs and motivations that drive people to do things. So one key thing about these incentives and motivations is that we're driven by a complex range of incentives and motivations. Sure, money, what we get paid, is a key driver. It's what we would describe as an extrinsic motivation. It's some reward is coming from outside, from the world beyond us, that motivates us to behave in a particular way. Other extrinsic motivations might be what other people think of us, we behave in a certain way, because we think people will approve of our behavior or our choices. But we're also intrinsically motivated to, so we have certain things that we like to do, because we take pride in our job, for example.

**Michelle Baddeley 07:24**

So we want to work for an industry or a charity, or an institution that helps serve the public purpose. And that's an intrinsic motivation. That's something that comes from within us. So that's the first

principle I think that's really important in behavioral economics, is to understand that we've got these incentives and motivations, and they're a bit of a mixture of economic, psychological, social incentives, and motivations. And if we take that as our starting point, the next step is in thinking about the sorts of mistakes we might make when we're trying to pursue these incentives and motivations. So getting back to what I was saying before, about behavioral biases, so we've decided we want to do something, we collect a lot of information together, but we might get overwhelmed by the vast range of information that comes our way, there might not be very good information around. And so we're making risky choices. And we don't know how to deal with a new situation. And when we're confronted with these problems, which behavioral economists call choice overload, we're surrounded by too many choices. Anyone who's ever had to try and buy a mobile phone, or a computer, or any sort of technical product, knows what it's like to be confronted by thousands of different options.

**Michelle Baddeley 08:49**

How on earth do we decide? So that's the choice overload, but also the information overload. And for example, to say someone buying a car, all the information about, you know, its fuel consumption, its engine, you know, everything about it. So a lot of information overload. In these sorts of situations, it's very difficult to make rational choices, and to look at all the information and objectively and pull it all together in a sort of mathematical way. And so what we do is we rely on heuristics. So these are quick decision making rules of thumb. And these quick decision making rules of thumb enable us to abstract ourselves out of all this complex information and all these complex choices. And just make a quick decision, a quick simple decision based on a rough assessment of the information. And this is when some of the psychological and social influences start to come in because, for example, one heuristic we use is called the affect heuristic, which is when emotions guide our decisions. So for example, if we see a lion running towards us, the emotion of fear is what drives us to run away. So emotions are a powerful heuristic that guides our choices. And that might be very, in one sense, rational thing in a primitive context. But when emotions start to interact with our decision making in the modern world, it doesn't necessarily work so well.

**Michelle Baddeley 10:19**

Another key set of heuristics we might rely on a social heuristics, so we look to others around us to decide what we're going to do. You know, if our friends or family are buying a particular product, say, an iPhone or an Android phone, then maybe we'll be guided by them. Or we might know someone who knows a lot about computers and we might be guided by them in deciding which computer we wanted to buy. And there have been a lot of experiments around these sorts of ideas that were very driven by social influences. And some of the key behavioral experiments in this space have drawn on the idea of restaurants, which is a very intuitively appealing example of how social influences affect our behavior and the choices that we make. So if you imagine that you're choosing between two restaurants next door to one, another one is really crowded, the other is really empty, which one you're going to go into? So you might think, in some ways, going into the empty restaurant, at least means you get served more quickly and maybe you have a more pleasant experience, because you're not in a crowded, noisy restaurant. But that's not how people decide, they will pick the restaurant which is full of people. And that's not necessarily a stupid thing to do because maybe all the people in that restaurant know that it's a good restaurant, and you're sort of inferring, from others behavior, what's a better choice for you.

**Michelle Baddeley 11:47**

And so that's examples of social influences, and all sorts of other ways in which we are quick rules of thumb, which help us decide and behavioral economics really takes these on and explores them in detail, using, most often, some sort of experimental method in order to measure and capture the way these biases and heuristics drive our behavior. In theoretical terms, in terms of understanding how these different influences on our behavior are important, a key insight that has been popularized by Daniel Kahneman, in his book *Thinking Fast and Slow*, and Kahneman with Amos Tversky, was one of the big leaders and pioneers in behavioral economics and economic psychology more broadly. And Daniel Kahneman's idea, which I think is very powerful and is essential in many ways to behavioral economics, is it's like we've got two people within us, we've got one self which is driven by what is called system one thinking--this is very quick, emotional, impulsive decision making--and then we've got another system of decision making, another self if you like, which is system two thinking, which is slower, more deliberative, more careful. And the essential insight about this is that these two systems of thinking come together in our economic decision making.

**Michelle Baddeley 13:17**

Neither is right, neither is wrong, they're complementary, they work together, but in certain situations may be the impulsive system one thinking dominates us and distorts our thinking. And it means we're deciding too quickly. And in the modern world, when things are so fast moving, particularly where we do so much by social media, this system one has too much power and influence over it, over us and we decide to quickly and impulsively. But the idea from Daniel Kahneman and many other behavioral economists is these systems of thinking should work together, and should come together to help guide our choices in in a relatively complex way. So it's a very large subject, and there's a lot to cover in it. But I guess the big question with any academic discipline is is so what? And behavioral economists are able to answer the so what question really quite well, in my opinion, because these behavioral insights are really helping policymakers to improve their policymaking, especially at a micro economic level. And by that I mean at the level of the individual.

**Michelle Baddeley 14:30**

So if we know that people are better, for example, trying to exercise regularly or eat certain sorts of healthy foods, we can use behavioral economics and behavioral science more generally, to try and understand what sort of heuristics, what sort of quick rules of thumb people use when they are choosing their food, or deciding about an exercise program, for example, and use these insights to design policies that help form people's behavior, so they're behaving in ways that are better for them. And one example of this is using something that's called pre commitment devices. So for example, I think most people would identify the example of going to the gym. So we sign up for our gym, and we pay a good chunk of money and then we never end up going, because what we've tried to do is bind our future selves by spending a lot of money and think, "If I spend a lot of money, then my future self is going to think, 'oh, I spent all that money. Therefore, I knew really need to make the most of it by going to the gym three times a week'". But that's not how we behave. And so if behavioral insights can be used to sort of nudge into going to the gym, we might get a reminder from a mobile app, for example, that we need to get to the gym, and reminding us of how much we paid on it, for example, might nudge people towards behaving in a better way for their own selves.

**Michelle Baddeley** 16:03

In the context of energy in the environment, for example, social nudges have been used a lot. So energy bills, by now, it's fairly standard on an energy bill, to get a social nudge. You're, you're told how your neighbors are using energy, or whether your neighbors are recycling, whether your neighbors are paying their tax bills. And the idea is that when we're told how other people behave, that forms a norm that we try to follow ourselves. And there's been a large volume of experimental evidence verifying that many people are quite affected by the social matches. So if we can tell people what the normal behavior is, then perhaps we can encourage people to follow along behind. So it's a very diverse, wide ranging subject. But the essential insight and, from my view, as a behavioral economist, is that these insights from social psychology, psychology, sociology, really enhance economics so much, because economics on its own, traditional economics, is quite mathematical. It's quite stark. It's not especially intuitive. It doesn't necessarily fit very well with, with how we know real people think and decide. But it's got an analytical structure to it that's, that's quite powerful and very useful.

**Michelle Baddeley** 17:27

If you blend that together with these insights about--from psychology and sociology, etc.--about how people behave, then you've got a really powerful tool and set of theories to help us understand how real people choose and decide about their everyday choices. So it has a lot of power in a policy context as well. I hope that this has sparked your interest in what is a fascinating subject that brings together the social sciences and the behavioral sciences in a really powerful way that helps us understand what we do every day and why, and helps policymakers to use these insights to help us make better decisions around our everyday decision making for the benefit of us and the world around us as well.

**Rebecca Parker** 18:21

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