The new emerging field of behavioral economics economics essay

Economics

The roots of behavioral economics date back to the 1940’s, when Herbert Simon of Carnegie Mellon University introduced the concept of " bounded rationality". He argued that rational thought was not the sole reason to elucidate human decision-making. For this he won the Nobel in 1978 (Harvard magazine 1996). Conlisk (1996) stresses " the failure to incorporate bounded rationality into economics is just bad economics". Then, in 1979, psychologists Daniel Kahneman, LL. D. ’04, of Princeton and Amos Tversky of Stanford published " Prospect Theory: An Analysis of Decision under Risk". This was a ground breaking paper on how people handled uncertain rewards and risks. The authors put forward an argument that their relative value and consumers decision is profoundly influenced by the ways in which alternatives are " framed". This was a decisive paper in the field of behavioral economics as states that the actual value of alternatives was all that mattered and not the mode of their presentation or in other words " framing", this it did by its rigorous equations that were able to pierce the core assumption of the standard model. In 1981, Tversky and Kahneman presented an example in Science paper, " The Framing of Decisions and the Psychology of Choice" " Imagine that the U. S. is preparing for the outbreak of an unusual Asian disease which is expected to kill 600 people". For this they proposed four alternative solutions every time in pairs of two. Every time the proposal accepted was the one that showed how many lives were saved over how many lives were lost. This proved that departures from rationality emerged both in judgments (beliefs) and choice due to over confidence, optimism, anchoring, extrapolation and making judgments of frequency or likelihood based on salience (the availability heuristics) or

similarity (the representativeness heuristics). Richard Thaler (1980) started to bring in such psychological views into economics, writing a regular feature called " Anomalies" in the Journal of Economic Perspectives which were later collected his own " The Winner's Curse" in 1994. " Dick Thaler lived in an intellectual wilderness in the 1980s", says David Laibson, one of Harvard's most prominent behavioral economists". Even though it took the Behavioral approaches 10 years from 1980 to 1990's to become popular, he still held onto his believes. " It's no longer an isolated band of beleaguered researchers fighting against the mainstream" (Harvard magazine 1996). The Journal of Economic Literature (Rabin 1998) published an article offering an overview of the connections between economics and psychology. The author noted in defense of his findings that, " Because psychology systematically explores human judgment, behavior, and well being, it can teach us important facts about how human differ from the way they are traditionally described by economists". Then in 1999 Andrei Shliefer of Harvard University was awarded the John Bates Clark award for his research on " securities markets and on the role of government in regulating markets and in fostering economic growth" in which he presented the behavioral finance as an alternative to the efficient market hypothesis. In 2001, two years after the award winning Shliefer research, Mathew Rabin was awarded the John Bates Clark award for his outstanding " genius" work on reciprocity, " present-biases" in time discounting, judgment biases, over projection of current feelings into the future and how moral rules differed from moral tastes. In the same year 2001, George Akerlof, Micheal Spence and Joseph Stiglitz shared the Nobel Price for their " analysis of the markets with asymmetric

information". Followed by this was George Akerlof's Nobel Speech in 2001 on " Behavioral Macroeconomics and Macroeconomic Behavior" in which he argued that macroeconomics must be based on behavioral economics and that behavioral phenomena's such as reciprocity, identity, fairness, money illusion, loss aversion, procrastination and herding are major reasons to explain economic problems such as poverty, unemployment and business cycles. Then in 2002 Daniel Kahneman of Princeton University received his Noble award for having " integrated insights from psychological research into economic science, especially concerning human judgment and decision making under uncertainty" However a few economists brought about a different turn in behavioral economics. In their view observed " anomalies" should be explained by expanding the preference domain however identifying preferences that robustly rationalize choices (Gul and Pesendorfer 2001, 2004a, b) as the only legitimate objective of behavioral economics. A same argument was put forward by McCaffrey and Slemford in 2006 where they put forward that " if choices do not unambiguously reveal an individual's notions of good and bad, then true preferences become the subject of debate and ever beneficial restriction of personal choice becomes a fair game". Just a year before in 2005 Bernheim and Rangel had their interpretation of preferences according to the neoclassical approach. This defined that people had well defined preferences and these preferences were: Coherent Preferences: Each individual has well defined preferences. Preference Domain: Each individual's preference ranks according to set of lifetime state-contingent consumption paths. Fixed lifetime Preferences: Each individuals ranking of the Preference Domain remains constant across

time and states of nature. No mistakes: Each individual will always select the most preferred alternative from feasible set. The above stated preferences will be used in the later part of this research when comparisons will be made with the reasons of customer choice biases due to competition given by Dr Patrick Xavier Adjunct Professor of Economics and Finance of the Curtin University Business School in 2011 However following are a few insights about actual consumer behavior and consumer biases identified by behavioral economics and used by Dr Xavier. These will be explained in detail in the later part of the paper but the point of view will be according to telecommunications market. These may help to reason why most consumers are making irrational decisions to switch service provider and to enter particular types of contracts that not only go against their own good will. Choice overload - A consumer has the burden to choose from a mass range of products and services and features that leading them into confusion, random choice, or even failure to make any choice. Heuristics – consumers often tend to do what others would tell them to finding this as a short cut. This they do when the decision making process and the surrounding are unnatural to them and when the choices are too difficult for their mental capabilities to be able to compute. Endowment –A consumer may be reluctant to give up what he/she has now and choose to continue using the same product because they would value something more that they already own over something they would switch to, this could also be due to failure to acknowledge the poor choices they have made or due to some misplaced loyalty. Defaults – a default inertia may automatically jump in because choosing to enter into a new contract will be more easier than choosing to

move out of one which the consumer maybe very reluctant to do. Hyperbolic discounting – consumers and service providers both are very short-sighted and this results them to overvalue costs and/or benefits that will occur in the present situation against those that may occur in the future due to this. Framing biases – the way the information is " framed" to the consumer has always influenced his/her choice. Which means if the same information is presented in a different ‘ frame’, the decision could be completely different. Risk/Loss aversion – consumers always prefer to avoid losses prefer for gain. This becomes a great reason to not ‘ switch’ from one provider to another. This could also be due to the paranoia that experience with the new provider is unfamiliar and may not come out as good as the previous one. Just as we traced down the works of economists who competed for the field of Behavioral Economics, there have also been a few very valid reasons why it took so much time to surface itself as a prominent field and a very important branch of Economics. Jeremy Bentham, Irving Fisher, William Jevons and even the great Adam Smith had their work drawn over psychological intuitions but the gap was the lack of development of mathematical tools of economic analysis, consumer theory and general equilibrium(Ashraf, Camerer and Loewenstein 2005; Colander, 2005). We will note that throughout the works done in the field of Behavioral economics there will be traces of classical and neoclassical economics theories however this time a different approach given to them. For e. g. Smith (1759, III, ii, pp. 176-7) said that pain in almost all cases is a stronger and more prominent feeling than pleasure. In the same way Kahneman and Tversky used the positive and the negative way of telling a news comparing pain as a negative feeling which

caught the attention more than pleasure as a positive feeling. Smith (1759, II, ii, p 121) also anticipated Thaler's (1980) paper that was considered the start of Behavioral economics which analyzed the insensitivity to opportunity cost and compared them to out-of –pocket costs by saying that theft and robbery are greater crimes to us than a breach of contract. However the greatest question arises is if there were so many similarities between the Classical Economists work and the work of early Behavioral Economists why is it that these ideas were left out of the neoclassical revolution? The best answer possible to this is by Bruni and Sugden (2005), that Vilfredo Pareto won an argument amongst the early economists in the 1900's in which he argued that keeping psychology out of economics was very necessary. He was against the idea of assuming " the subjective fact" and stern advocate of " objective fact". Even though Behavioral economics is a relatively new branch but works on consumer patterns and behavior and affects of competition over them have been under the limelight for decades now. Following will be some literature that have not been done according to the Behavioral Economics approach but the work done will be included as it has had renounce affect on protecting consumers and recognizing the reasons why consumption decisions and patterns have changed over time and especially due to the influence of competition and marketing over them. One very prominent work is by John B. Kirkwood (2009) and Robert H. Lande (2009) under the name of " The fundamental goal of antitrust: Protecting consumers, not increasing efficiency". In this they try to point out that the ultimate goal of antitrust is to protect consumers from behavior trends that would lead them to not enjoy the benefits of competition over the increase in

the total wealth of the society but A similar view point will be adopted in this paper however the protection of consumers from the exploitation of competition is the main purpose of this paper. This article is a great expansion on the case law by John B. Kirkwood (2004) " Consumers, Economics and Antitrust" which itself is a part of the " Antitrust Law and Economics". This volume contains ten papers by many prominent authors who have mastered in examining the antitrust concerns of current time. The first paper is a summary of the papers following it and is a presentation on the original research on consumer welfare and buyer power. The next five evaluate if older antitrust laws were able to provide consumer the cushion to increase their welfare. The seventh paper describes a new measure of efficiency that is more inclined towards saving consumer from harm. The next two papers are based on new ways in which vertical foreclosure will enhance the power of a supplier and the technical methods to substitute among different products. The tenth paper includes way in which the patent holder pays the competitor to leave the market. One paper that stands shoulder to shoulder is " The impact of Consumer Protection on competition and competition law, the Case of deregulated Markets" by Kati J. Cseres (2005-2006). The paper argues that the government’s attempt to increase consumer benefits by opening up markets to competition has not been successful. It also has the same assumption that this paper shall be using about consumers having incomplete market information about the diverse number of products available to them or when they face high search and switching costs amongst substitutes. This is when they are not able to take advantage of effective competition and harm their own welfare. A very

relevant paper in the same year on telecommunication market in 2005 by Fischer G. " Consumer rights, Consumer protection problems after liberalization of telecommunication market, National association of consumer protection, VIII" states that for an average consumer the table of tariffs of service providers are opaque subscriber contracts are too long for the consumer to actually pay attention to it all. Here again is the problem of objectivity inaccessibility to information. In 2009, Kati Cseres again wrote about competition and consumers in " Competition and consumer policies: Starting points for better convergence" in which he tells that the potential complementariness and tensions between consumers and competition have been ignored for a long time and how the integration of both should have been developed leaving it open for further research which I believe this paper shall be using in its methodology. Here again the true focus is on provision of good quality information to help consumer make well informed decisions so the information failures cannot distort market competition and consumption patterns. This paper tried to find an optimal balance between the market and the consumer in order to enforce the collaboration and not to ruin each other’s welfare. After all the research there was one paper in which I found a very relevant definition of the word " competition". This is " Reconsidering Competition" by Maurice E. Stucke in the Mississippi Law Journal Vol 81: 2 in which he writes " independent endeavor of two or more persons or organizations within the realm of a chosen market place, to obtain the business patronage of others by means of various appeals, including the offer of more attractive terms or superior merchandise". This argument on what the right definition of competition is has existed through

decades and can be traced by even to the 1960’s when in 1968 Paul J. Mcnulty in his " Economic theory and Meaning of competition" tried to explain competition by stating it as the opposite of monopoly by giving a few traits of competition also traced by Adam Smith in his famous " Wealth of Nations" such as price undercutting by sellers, bidding up of prices by buyers, the right to entry and exit and advertising. Not much detail will be given to what competition is but on what effects it has on the consumer, however it is equally important to be well acquainted in what defines competition if it is to be criticized. Now that we have enough literature on competition and consumer protection we must now turn our attention to how marketing policies will affect the decisions of the poor and how behavioral economics will try reason with the patterns that occur in their consumptions. One targeted research was upheld by Marianne Bertrand, Sendhil Mullainathan and Eldar Shafir in 2006 by the name " Behavioral Economics and marketing in aid of decision making among the poor". The paper states that the poor exhibit the same basic weaknesses and biases that the well off suffer but the market forces have affected the poor more than the rich because they have a lower margin of error and tend to somehow have a shelter from repeating the same mistakes. Even the marketing of products and predatory rates by the firms has forced the poor to go poorer. The paper has observed an integration of social and situational factors that might influence behavioral patterns of the poor which are highly relative to the Pakistani economy. Enough literature is available not only in the field of behavioral economics but also competition and consumer protection so that a valid interaction can be developed between them like the paper by

Bertrand, Mullainathan and Shafir to aid the poor in their consumption decisions so that their irrationality can be addressed.