



# Behavioural Economics Project

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# Can Behavioural Economics Improve Economies?

By Nicolas Chow

Are consumers rational? Do they truly consider maximising their benefits and utility and minimising their potential and future costs? According to classical theories, consumers have tendencies to make rational decisions. Most of the classical theories revolve around the presumptions that individuals make choices that result in optimal level, bringing benefits to them instead of harming themselves. However, this is not always the case. Often do people let their emotions and irrational decision-making dominate, they make mistakes that can be harmful to them. It is palpable that not all people possess the rationality trait stated in the neoclassical theory. Believe it or not, there are numerous examples or real-life situations, indicating that not every consumer or even producer is rational and countering the neoclassical theory. On that note, behavioural economics is proposed to find out the human behaviours and how decisions are made with numerous factors involved.

Behavioural economics has a long history which crucial ideas already existed in the 18<sup>th</sup>-century. Adam Smith was an economist who proposed the idea of “Invisible Hand” that drives the economy to flourish if every economic agent act in their best interests. Meanwhile, he realised that people are arrogant about their own capabilities and often overestimate themselves, are pessimistic about most things and often neglect long-term benefits and returns while focusing on the present benefits they can receive. The “Father of Behavioural Economics”, Richard Thaler challenged that people are rational and always maximise profits and minimise losses, believing that “anomalies” do exist in human behaviour (Gino, 2017). Ideas of behavioural economics began to spread globally, gaining recognition since it gives individuals, businesses and economies insights into the human behaviour and they can utilise it to implement policies and strategies to achieve their objectives.

Behavioural economics observes human behaviours which have demonstrated that economic agents do not always make optimal decisions, even though they have relevant information and capability. In view of their habits, some may choose to take the tube instead in spite of knowing the cost. Behavioural economics is defined the difference between actions they should take and the actions they take and the outcome of the actions they take, by University of Chicago scholar and Nobel laureate Richard Thaler. It observes the human behaviour, unlike neoclassical theories. It manifests the idea that people do not actually act rationally or make optimal choices given that the relevant information and instruments required are provided.

One of the ideas in behavioural economics is “Nudges” and was brought into the field of policymaking. Choice architecture, who formulates incentives or deals, utilise nudges and alter environments to manipulate and influence people choices. A perfect example would be a situation where cafeteria managers consider the placement of different food and salad is positioned near the entrance of a cafeteria so that customers would choose to grab salad before picking up the less healthy food like chips and burgers and this is when cafeteria managers become choice architectures. That being the case, policy makers take into account of the idea of incentives when crafting new legislations and regulations in hope of manipulating people’s decisions indirectly and not in a mandatory way. It has been recognised as an impactful instrument to facilitating behaviours of people to ameliorate the UK economy as a whole, environmental protection particularly.

Another one is default option. What it means is the option that will be automatically chosen if the consumer does nothing. It is the pre-set courses of action if nothing is specified by the decision maker (Thaler & Sunstein, 2008). When decision makers are struggling to choose, a default choice tactic is recommended to resolve such issue. For example, the opt-out system requires people to opt out if people do not wish to donate their organs (Johnson & Goldstein, 2003). Automatic enrolment also utilises the similar idea and is when an employee who meets certain requirement is made a member of a workplace pension scheme without needing to ask. Initially, it was workers’ decision to join employer’s pension scheme. But after 2012, employers are required to automatically enroll their

eligible employees into their workplace pension scheme. Subsequently, more people are able to accumulate savings and afford their spendings after retirement age.

Many factors come into play when an individual economic agent decides. It may be due to manipulation, alteration, interpretation, or others. Often are external costs (the cost to a third party for which no appropriate compensation is forthcoming) neglected during production and consumption, exacerbate the damage to the environment, living standard and even the economy. This exactly contributes to the study of behavioural economics, which combines elements of - economics and psychology to further understand factors that influence and alter one's decision. Surely, this is totally different from the neoclassical theory and that is why ideas such as nudge theory, default choice and cognitive bias are important- to explain and help us understand human behaviours. Acknowledging the imperfections in human behaviours, we can tackle social issues such as air pollution. Without a doubt, air pollution has been an ongoing issue that not only the UK faces, but also other countries. On top of that, behavioural economics can be made use of when promoting educational level especially since UK is facing stagnant productivity growth. I cannot stress enough that that policy makers must take into account of behavioural economics and formulate policies that can manipulate people's behaviours and decision instead of just strictly using dominance and inflexible policies. Otherwise, it can exacerbate existent damage and cause devastating consequences. The following section will examine the use of behavioural economics when implementing policies, and evaluate its degree to which the policies are practical.

Regarding air pollution, it has been a severe issue and can damage the health of Skopje citizens. According to the Western Balkan Regional Air Quality Management Report, it is estimated that there are around 1600 deaths every year due to diseases caused by air pollution in proximity in North Macedonia. In addition, UNDP's survey conducted in January 2017 mentions that only 21% are connected to and use the central heating system regarding the residential heating practices in all 17 municipalities in the Skopje Valley. While trying to create a policy that could tackle the issue, many factors must be taken in account of and numerous obstacles and psychological barriers can diminish the effectiveness of policies. One of the barriers policymakers may counter is that it is hard for people to relate to the dangers and jeopardies other countries and animals are facing such as the risk of polar bear extinction and glaciers melting but instead it is easier for us to focus on our current well-being and situation. On top of that, if making changes in order to improve the environment is time-consuming and requires a lot of effort, our likeliness to act is normally low due to inertia- we cannot be bothered.

A specific instrument would be green defaults which is a pre-selected choice for renewable energy instead of non-renewable ones, while people can opt out and choose non-renewable energy. According to "The power of green defaults: the impact of regional variation of opt-out tariffs on green energy demand in Germany", consumers have had a variety of choices regarding energy providers and tariffs. Average private households can choose among 124 energy providers as well. Germany's electricity market is divided into different grid areas with one basic supplier for each which is pre-selected corresponding to the grid area, and they are legally obligated to provide electricity unless another contract has been made. If a household does not choose an energy supplier or a tariff. On that note, 80% of the suppliers had at least one green electricity tariff in their portfolio in 2017 (UBA, 2019) and only a few of those provide "deep green" energy certified with trustworthy labels. On that note, according to the energy provider, the "green electricity" are based on 100% renewable energy. Although the basic tariff which sometimes can be green normally cost the most for households, 28% of all consumers currently subscribe to it (Bundesnetzagentur, 2019), about 41% subscribe to a different tariff from the local basic supplier and about 31% of them are supplied by a different electricity provider from the local basic supplier, reflecting a strong customer attachment to the local service provider. From the results of the logistic regression of green energy demand on the regional share of green opt-out tariffs among German utilities without and with regional effects, we can tell that the probability of purchasing green electricity increases by 19

percentage points if we compare a region that exhibits no green opt-out tariffs with a region where all basic electricity supplier is offering a green opt-out tariff. It is more likely to switch to green energy in high-supply regions than in low-supply regions.

In terms of education, non-financial incentives or nudges can be used to encourage students to exert more efforts on their academics and enhance their performance by offering different levels of rewards. In a recent study, "The Behavioralist Goes to School: Leveraging Behavioural Economics to Improve Educational Performance", which involves over 5700 students, ranging from primary school to secondary school. The study group chose to offer incentives on a low-stakes computer-based diagnostic test in which results were available instantaneously after students completed the test. Not only that, but the size of the reward was also varied in order to distinguish students' capability in improving their performance from the motivation that the rewards give. The loss aversion concept which encapsulated in the expression "losses loom larger than gains" (Kahneman & Tversky, 1979). The suffering of losing is psychologically about twice as powerful as the pleasure of gaining. It is perceived that potential loss is psychologically more severe than an equivalent gain. It is observed that there is a positive correlation between financial incentives and better academic performance. It required 20 pounds per student to boost achievement which are consistently positive and statically significant at conventional levels. On the other hand, there is little to no impact from the \$10 incentives except in Chicago Heights.

Although the above studies suggest that utilising behavioural economics can be beneficial and auspicious, there are also limitations. According to "The Role of the Future in Student Motivation", highly intrinsically motivated students can be extrinsic in terms of future goal orientations and persist longer while focusing on earning higher grades, obtaining rewards and acceptance from peers. Another study "Effects of Intrinsic and Extrinsic Motivation on Academic Performance" indicates that girls may be more motivated than boys because of their intrinsic traits and thus are less responsive to high-level reward. On the opposite side, findings show that males are extrinsically motivated than females. Furthermore, according to "Gender differences in time preferences", because men may be more impatient than women, they choose a more immediate reward instead of future rewards which bring more utilities and benefits. When considering education policies, gender may limit the effectiveness and policies do not have the same effects on all individuals in terms of education. To fully harness the opportunities of behavioural economics, reward levels must be adjusted to an optimum level. Exceptionally high- or low-level reward would be meaningless and would not influence future habits and behaviour, having an adverse effect. It is essential that teachers need to have the passion for providing interactively educational lessons and emotional support to encourage and motivate students to assert efforts into revision and their academics in order to enhance UK's education level and productivity.

In terms of air pollution, some research has shown that some individuals cannot relate to the current global warming issues and exceedingly high greenhouse gas emissions. They do not have the sense of responsibility to put effort into changing their lifestyle and habits such as switching from non-renewable energy to renewable ones or even recycling. Other than default choice, there are other possible ways to influence one's behaviours towards going green. Framing is one of practical methods which is the principle that information is provided highlighting the positive or negative aspects of a decision.

To conclude, behavioural economics is theorised to be practical when it comes to policymaking. By taking behavioural economics ideas such as 'nudges' and 'default choice' into consideration, policymakers are capable of understanding and analyzing better about various economic agents. One of the examples is education, it is possible that schools can utilise loss aversion concept in class instead of just providing scholarships and financial incentives. For instance, teachers can hold a completion during class and initially give the captivating gifts. At the same time, they can retrieve the gifts from whoever loses or fails to answer questions correctly. Not only can this make the lessons more engaging and interactive, but also it can push and drive students to be more disciplined and well-prepared for class. To some degree, students are influenced as they wish

to hold onto their gifts according to the loss aversion concept. Subsequently, in theory, students' skills and knowledge are in ascendant. Perhaps, the UK economy can benefit from the enhancement of labour capital and productive potential and resolve stagnant productivity and economic growth through behavioural economics, in spite of the drawbacks of it.

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