Importance of Behavioural Economics

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Behavioural economics is a discipline that incorporates perspectives from psychology, economics, judgment, and decision-making, and neuroscience to better understand, predict, and eventually improve human behaviour in ways that none of those disciplines could offer on their own. Understanding behavioural economics is important for marketers because it helps them to gain a greater understanding of the human mind.

In a perfect world, people will always make the best choices that favour them and give them the most pleasure. When humans are faced with multiple choices in a scarcity situation, the rational choice theory claims that they will select the option that maximizes their individual satisfaction. This theory suggests that people will make reasonable decisions based on their desires and constraints by effectively comparing the costs and benefits of each choice available to them. The final decision would be the best option for the person concerned. The rational person has self-control and is unaffected by impulses or outside influences because he decides what is best for him. However, behavioural economics suggests that humans are not always rational and might fail to make rational decisions. Behavioural economics combines psychology and economics to investigate why people make irrational choices and why and how their behaviour differs from what economic models expect. Behavioural economics attempts to understand why people tend to choose certain options in their day-to-day lives over others. Heuristics, or the use of rules of thumb or mental shortcuts to make a fast decision, is one application of behavioural economics. Heuristics, on the other hand, may lead to cognitive bias if the decision taken is incorrect.

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As game theory runs experiments and analyses people's decisions to make irrational choices, behavioural game theory, an emergent class of game theory, can also be applied to behavioural economics. Behavioural finance, which aims to understand why investors make rash decisions while investing in the financial markets, is another area where behavioural economics can be applied. Behavioural economics is constantly being used by businesses to boost product sales. The 8GB iPhone was first released in 2007 for $600 and was soon reduced to $400. What if the phone's intrinsic value was $400 anyway? If Apple had launched the phone for $400, the market's initial reaction to the price would have been negative, as the phone would have been perceived as too expensive. However, by launching the phone at a higher price and then lowering it to$400, customers assumed they were having a decent offer, and Apple's profits soared. Consider a soap company that makes the same soap but sells it in two separate packets to cater to different demographics. One kit caters to all soap users, while the other caters to those with sensitive skin. If the packaging had not mentioned that the soap was for sensitive skin, the latter target would not have purchased it. As businesses recognize that their customers are irrational, a successful way to incorporate behavioural economics into the company's decision-making policies affecting internal and external stakeholders can prove worthwhile if done correctly.

Richard Thaler, a professor of the University of Chicago who won the Nobel Memorial Prize in Economic Sciences is considered the father of behavioural economics. The conviction that most, if not all, human actions can be easily explained by relying on the premise that our interests are well-defined, consistent over time, and rational has long distinguished economics from other disciplines. Thaler started questioning this view in the 1990s by writing about behavioural anomalies that could not be explained by mainstream economic theory. He co-authored Nudge: Improving Decisions about Health, Wealth, and Happiness with Cass Sunstein in 2008, which argues that there are many ways to "nudge" people's actions by making subtle adjustments to the context in which they make decisions. Nudges can help with a wide range of issues that both governments and companies consider relevant. General Electric, for example, decided to fix the problem of smoking a few years back, claiming that it had harmed its workers. They performed a randomized controlled trial in partnership with Kevin Volpp and his co-authors. Employees in the recovery program were paid $250 if they quit for six months and $400 if they quit for a year. No incentive was provided to those in the control group. The treatment group had a three-fold higher success rate than the control group, and the effect lasted even after the rewards were eliminated after a year. General Electric modified its strategy and began using this methodology for its then 152,000 workers as a result of this research. This shows that behavioural economics can have a significant social impact. Behavioural economics can be applied in ways leading to exploitation as well if the company's interests are not aligned with the worker's interests. However, there are also instances where the priorities are matched so the business profits from higher levels of success and motivation, but so do the employees, who are happier with their jobs.

Organizations in both the private and public sectors have used behavioural economics insights to solve a wide variety of issues in recent years, from minimizing tax avoidance, job tension, and attrition to promoting healthier lifestyles, growing retirement savings, and increasing voter turnout.

> When you reach the end of your rope, tie a knot and hang on.
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> – Franklin D. Roosevelt