7 principles of behavioural economics

7 principles of behavioural economics provide a fascinating insight into how human beings make decisions, often in ways that deviate from traditional economic theories. These principles combine insights from psychology and economics to better understand the complexities of human behaviour in financial contexts. By examining these principles, we can gain a greater appreciation of how and why people sometimes make irrational choices, and how these choices can be influenced by various factors. In this article, we will explore the seven key principles of behavioural economics, detailing their impact on decision-making processes.

1. Anchoring

Anchoring is the cognitive bias that causes individuals to rely heavily on the first piece of information they encounter when making decisions. This initial "anchor" can heavily influence subsequent judgments and choices, even if the information is irrelevant.

Examples of Anchoring

- Pricing: When a product is marked down from $100 to $70, consumers may perceive the discount as a better deal, anchored by the original price.
- Negotiations: In salary discussions, the first number mentioned often sets the stage for what is considered a reasonable offer.

2. Loss Aversion

Loss aversion refers to the psychological phenomenon where losses are felt more acutely than gains of the same size. This principle suggests that the pain of losing $100 is more intense than the pleasure of gaining $100.

Implications of Loss Aversion

- Investment Choices: Investors may hold onto losing stocks longer than they should to avoid realizing a loss, leading to poor financial decisions.
- Insurance Purchases: People are often willing to pay more for insurance to avoid potential losses rather than to achieve gains.

3. The Status Quo Bias

The status quo bias is the tendency to prefer things to remain the same rather than change. This bias can lead individuals to resist new options, even when they might be better than the current situation.

Why Status Quo Bias Matters

- Retirement Plans: Employees may stick with their default retirement plans, even if superior options are available.
- Consumer Choices: Many people continue to purchase the same brands out of habit, ignoring potentially better alternatives.

4. The Endowment Effect

The endowment effect occurs when individuals assign more value to items merely because they own them. This principle explains why people are often unwilling to trade or sell possessions, even at a fair market price.

Real-World Applications

- Sports Tickets: Fans may demand a much higher price for tickets they own than they would be willing to pay if they were purchasing the tickets.
- Real Estate: Homeowners often overvalue their properties, making it challenging to sell in a competitive market.

5. Mental Accounting

Mental accounting refers to the cognitive process by which individuals categorize and treat money differently based on its source or intended use. This can lead to irrational financial behaviours and spending patterns.

Examples of Mental Accounting in Action

- Bonus Spending: People may be more likely to spend a year-end bonus on luxury items, treating it as "extra money" rather than part of their overall budget.
- Savings vs. Spending: Individuals might treat money saved in a dedicated savings account differently than money in their checking account, leading to inconsistent spending behaviours.

6. The Halo Effect

The halo effect is a type of cognitive bias where the perception of one positive quality (such as attractiveness) leads to the perception of other positive qualities (such as intelligence or competence). This principle can significantly influence consumer behaviour and decision-making.

Impacts of the Halo Effect

- Branding: Companies often use attractive packaging or celebrity endorsements to create a positive association with their products.
- Hiring Practices: Employers may favor candidates who possess one outstanding quality, assuming they possess other, unrelated strengths.

7. Choice Overload

Choice overload occurs when individuals are presented with too many options, leading to feelings of anxiety and indecision. This principle suggests that having too many choices can ultimately result in dissatisfaction or paralysis in decision-making.

Consequences of Choice Overload

- Consumer Purchases: Shoppers may feel overwhelmed by too many brands or product variations, leading them to avoid making a purchase altogether.
- Dietary Decisions: When presented with a vast array of food choices, individuals may struggle to choose, impacting their overall eating habits.

Conclusion

The **7 principles of behavioural economics** provide valuable insights into the often irrational nature of human decision-making. By understanding these principles, individuals, businesses, and policymakers can better navigate the complexities of human behaviour, leading to more effective strategies for influencing choices. Whether it's in marketing, finance, or personal decisions, acknowledging these principles can help us make more informed and rational choices. As we continue to explore the intersection of psychology and economics, the lessons learned from these principles will remain essential for understanding how people think and act in an increasingly complex world.

Frequently Asked Questions

What are the seven principles of behavioral economics?

The seven principles of behavioral economics include: 1) Bounded Rationality, 2) Loss Aversion, 3) Status Quo Bias, 4) Anchoring, 5) Mental Accounting, 6) Social Norms, and 7) Hyperbolic Discounting.

How does 'bounded rationality' influence decision-making?

Bounded rationality suggests that individuals are limited in their ability to process information and make rational decisions due to cognitive limitations and time constraints, leading them to rely on heuristics.

What is 'loss aversion' and why is it important?

Loss aversion refers to the psychological phenomenon where losses are felt more intensely than equivalent gains. This principle is important as it explains why people may avoid risks even when potential rewards are significant.

Can you explain 'status quo bias' and its impact on choices?

Status quo bias is the preference for the current state of affairs, leading individuals to resist change. This can impact choices by causing people to stick with familiar options rather than exploring potentially better alternatives.

What role does 'anchoring' play in decision-making?

Anchoring refers to the tendency to rely heavily on the first piece of information encountered when making decisions. This can skew perceptions and lead to biased judgments based on initial anchors.

How does 'mental accounting' affect financial decisions?

Mental accounting is the tendency to categorize and treat money differently based on its source or intended use. This can lead to irrational spending behaviors and poor financial decision-making.

What are 'social norms' and how do they influence behavior?

Social norms are the accepted behaviors within a group. They influence behavior by creating expectations for how individuals should act, often leading to conformity and impacting choices significantly.

What is 'hyperbolic discounting' and its implications?

Hyperbolic discounting is the tendency to prefer smaller, immediate rewards over larger, delayed rewards. This principle explains why people may struggle

```
with long-term planning and make impulsive decisions.
```

7 Principles Of Behavioural Economics