Behavioural Economics

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Overview

• Definition of Behavioural Economics
• Consumer Behaviour
• Inertia and Financial Decisions
• Consumer Search, data and privacy
Behavioural Economics

- Psychology applied to economic decisions
- Behavioural finance, neuroeconomics, economic psychology
- Limited rationality and self-control
- Increasing influence in UK, EU and US policy
Key Concepts

• Loss aversion and endowment effect
• Reference dependency
• Mental accounting
• Heuristics and Biases
• Time discounting
• Affective forecasting
• Betrayal aversion
Case Studies

• Irish pension Autoenrolment
• DG Sanco Consumer Empowerment work
• UK Cabinet Office "MyData" project
I – Determinants of Retirement Saving contd.

• Habit Formation and Inertia
  – Irish example: Finn and Harmon find very strong “initial conditions” effects on health insurance
  – Status-quo bias (Choi et al 2001)
  – Default as investment advice (Madrian and Shea 2000)

• Social Interaction
  – Esther Duflo (MIT)
  – Parental, Sibling, School, Town and Neighborhood Effects
  – Media and Social Amplification of Risk and Quality
  – Reorganisation of financial affairs - cognitive bulk buying
II- Behavioural Economics Interventions

• Mandatory Pension Contributions Frequently mentioned as a possibility
• Less Discussion of Behavioural Economic Approaches
• However, growing international literature on the use of behavioural interventions
Example 1

Save More Tomorrow (SMarT) – Thaler and Benartzi

- **Key Features**
  - Employees opted in to a programme
  - Savings Retained from Future Pay Increases

- **Key Results**
  - a high proportion (78 percent) of those offered the plan joined,
  - the vast majority of those enrolled in the SMarT plan (80 percent) remained in it through the fourth pay raise, and
  - the average saving rates for SMarT program participants increased from 3.5 percent to 13.6 percent over the course of 40 months.

- The results suggest that behavioral economics can be used to design effective prescriptive programs for important economic decisions.
Example 2
Automatic Enrolment - Madrian and Shea (2001)

• Key Features
  – Opt in rather than opt-out
  – Either with or without employee contributions

• Key Results
  – Find that participation is substantially higher under automatic enrolment
  – A substantial proportion of people retain the default amount even though this default amount varied among participants in the scheme.
  – boosted 401(k) participation rates among some plans as follows:
    • Women from 35% to 86%
    • Hispanics from 19% to 75%, and
    • Low income groups from 13% to 80%
Example 3

• Quick Enrolment - Choi, Laibson and Madrian (2006)

• Key Features
  – Low-cost manipulation
  – Designed to simplify the 401(k) enrollment process. Employees are given the option to make an election to enroll in their 401(k) plan at a pre-selected contribution rate and asset allocation mechanism
  – Simplifies the savings plan decision process.

• Key Results
  – Quick Enrollment™ tripled 401(k) participation rates among new employees three months after hire.
  – When Quick Enrollment™ was offered to previously hired non-participating employees at two firms, participation increased by 10 to 20 percentage points among those employees affected.
1. Pension Autoenrolment

- Soft-mandatory for employee
- UK and Ireland
- Based on theories of inertia
- Mandatory for employer
- Autoenrolment
- 4 per cent, 2 per cent and 2 per cent in Ireland
- 4, 3 and 1 per cent in UK
Survey Results

• Substantial degree of under saving
• Respondents not focused on the future
• Aware that they are saving too little
• Strong feelings of inertia
Over half (58%) state they will need an annual income of €20,000-€40,000 on retirement while 3 in 10 (32%) state they will need more than this amount. 2 in 5 (43%) state they are likely to achieve the amount they will need however worryingly a large number (35%) state they are unlikely to have what they will need.

(Q.18, Q.19)
Benefits of Policy

- Adds new entrants to schemes
- Ensures retirement provision
- Allows some element of free choice
- May have knock on effects on other behaviours
Potential problems

- Shove rather than nudge
- Mandatory for employer
- Increase in wage effectively
- Substitution away from other savings
- Less discerning financial consumers
- Slippery Slope?
2. DGSanco

- Has led interest in Behavioural Economics in Europe
- A number of high-level conferences
- Recent work on retail investment products
- Recent work on consumer empowerment
Attitudes and Behaviour - I

(Base: All Adults 18+ - 301)

I would switch providers quickly if spotted a better deal

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I shop around carefully to keep mobile bill as low as possible

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<td>(4) 37</td>
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I regularly make sure to claim tax benefits I am entitled to, including filling out forms to claim back medical tax allowances and related tax advantages

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Actions indicate prudence is evident. 2 in 3 (66%) would switch providers if they spotted a better deal. 3 in 5 (58%) would shop around to keep mobile bills as low as possible. Nearly 3 in 5 (58%) make sure they claim tax benefits that they are entitled to.

(Q.9)
Retail Investment

• Major study commissioned by Sanco
• 6,000 respondents in 6 countries
• Very high degree of suboptimal strategies pursued by consumers
• Very low degree of option-seeking
• Crucial role of financial advisor
3. UK Cabinet Office

- Behavioural Insights team
- Health psychology, social marketing, behavioural economics
- Heavily influenced by work of Richard Thaler
- MINDSPACE
Examples

• Food labelling
• Safety certificates
• Energy labels
• Complaints data
• Making online information available instore
MyData

• Reduce Asymmetry if information between consumers and firms
• Firms upload data held on consumers to government run website
• Consumers can then use as a recommender site
Consumer Information Working Group

• Aims of Information Framework
  – Tailor to individual’s goals
  – Delivery Should facilitate engagement
  – Information should be free of bias
Consumer Information Working Group

- Multitude of factors influence financial decision making
- Including:
  - Age
  - Life Events
  - Levels of Engagement
  - Sources of Information/Methods of Sourcing
Consumer Information Working Group

• Help in delivering information to consumers
• Beyond ‘Plain English’ approach
• Delivery and content are important
• How do social, cognitive and emotional factors influence financial decision making?
• **Information Overload**
  – People are turned off if there is too much information/it is too complicated

• **Inertia**
  – Awareness that default option is highly influential for individuals

• **Ambiguity Aversion**
  – Will try to avoid uncertainties in financial outcomes
• Availability Heuristic
  – Easier to imagine benefits of present consumption than future retirement needs.

• Regret & Loss Aversion
  – Make imprudent decisions to avoid losses,

• Consumption vs. Savings Decisions
  • Less willing to reduce current consumption to satisfy distant gains
Resources

• Brookings Institute Book on BE and Policy

• Consumer Empowerment DG Sanco
  http://ec.europa.eu/consumers/consumer_empowerment/index_en.htm

• Behavioural Insights Team Cabinet Office