MUCO

MORAVIAN UNIVERSITY COLLEGE OLOMOUC

Behavioral Management

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CONTENT:

1. Basics of economics
2. Rational and irrational managerial decisions
3. Introduction to Behavioural management
4. Scientific connection between economics and psychology
5. Mental accounting
6. Decision paralysis

COMPULSORY LITERATURE:

R. H. THALER: Unexpected behavior.

N. WILKINSON a M. KLAES: An Introduction to Behavioral Economics.

1. BASICS OF ECONOMICS

- **Economy:**
  - has many definitions;
  - narrower definition: deals with the production, distribution and consumption of products and services;
  - answers the questions:
    - what to produce;
    - for whom to produce;
    - how to produce.

1. BASICS OF ECONOMICS

- **Economy:**
  - **traditional neoclassical microeconomics as a definition of economics:**
    - **the product is produced by efficient use of production factors (balancing factors are rare);**
    - **main inputs: natural resources, labor, capital goods;**
    - **choice of combination of production factors = choice of technology.**

1. BASICS OF ECONOMICS

- **Economy:**
  - closely related to mathematics, but also to the social sciences, especially psychology and sociology;
  - broader definition: the science of human decision-making and action in a world of limited resources and needs;
  - two types of decision making:
    - rational;
    - irrational.

2. RATIONAL AND IRRATIONAL MANAGERIAL DECISIONS

- **Rational decision making:**
  - **decision-making on the basis of balance, or reasonable purposes and objectives, which can be defended by exact arguments;**
  - **positive and negative.**

2. RATIONAL AND IRRATIONAL MANAGERIAL DECISIONS

- **Irrational decision making:**
  - **decision-making that is, except the reasonable purposes and goals, also motivated by emotions and intuition;**
  - **positive and negative.**

3. INTRODUCTION TO BEHAVIORAL ECONOMICS

Behavioural economics and behavioural management deals with negative irrational decision making.

3. INTRODUCTION TO BEHAVIORAL ECONOMICS

Behavioural economics and behavioural management examines the confrontation of rationality with irrationality (statistics and experiences of urge).

3. INTRODUCTION TO BEHAVIORAL ECONOMICS

- **Behavioral management:**
  - examines the influences of social, cognitive and emotional factors on the economic decision-making of economic entities;
  - standard economics: examines human decision-making and its consequences under the assumption of rationality;
  - behavioural economics: examines human decision-making and its consequences under the assumption of irrationality (limited rationality).

3. INTRODUCTION TO BEHAVIORAL ECONOMICS

- **Behavioral management:**
  - therefore explains the irrational decision-making of economic entities;
  - combines economics, psychology and sociology in order to explain people's irrational behavior when operating with money;
  - is becoming increasingly important – possibilities and risks related to the money management become more and more significant (the increase in financial possibilities is still related to the increase in ambiguities and risks - the number of financial errors increases with each transaction).

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

Why is it important to refer to the aspects and principles of the connection between economics and psychology?

Because this will make it easier to understand the principles of behavioral economics.

Before we begin, it is important to realize the paradox that the vast majority of people are not aware of their negative irrational decisions at all.

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **Economists at various times have more or less refused to include psychology in their theoretical models, mainly for these two reasons:**
  - **striving for the most exact character of economic models (snobbery);**
  - **methodological differences in research activities (pretence).**

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **Historically, economists have solved the absence of a psychological dimension in models of economic decision-making using the following three approaches:**
  - **ignorance (Friedman);**
  - **establishment of an average (statistical) sample of research (Jevons);**
  - **Darwinism = only economic approaches and decisions that are purely rational and exact have the ability to survive in the long run - economists may not be interested in other approaches and decisions (classical models do not describe reality, but it does not matter, because only decisions that are rational will survive in the long run).**

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **The most important differences in research methodology between economists and psychologists:**
  - **the nature of hypotheses:**
    - **economics: only qualitative, ie describing the reaction of the value of the quantity Y to the change of the value of the quantity X (at constant values of all other quantities);**
    - **psychology: complying with permanent changes in the values of all quantities.**

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **The most important differences in research methodology between economists and psychologists:**
  - **data source for verification of the resulting models:**
    - **economics: public official statistical documents;**
    - **psychology: own questionnaire survey.**

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **The most important differences in research methodology between economists and psychologists:**
  - **paradigm (basic assumption):**
    - **economics: maximization of benefits;**
    - **psychology: own questionnaire survey.**

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **The most important differences in research methodology between economists and psychologists:**
  - research methodology (experiments with respondents):
    - economics: always true information and repetition of experiments;
    - psychology: the respondent often receives information that is also untrue, and each experiment is performed with the respondent only once (in order to avoid adaptation the respondent's answers and the respondent's behavior).

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **Three degrees of psychological aspects appearing in economics:**

  1. **Perception:**

     - **monetary illusion: (to the nominal wage growth is given the importance of the real growth) - a reason to respect psychological aspects;**
     - **availability heuristics: more significant perception and remembering of perceptions that I have experienced personally or repeatedly - I give them more weight (the growth of my salary is more significant than the growth of prices);**
     - **other psychological effects: the curse of knowledge, the effect of primacy and the effect of recentness, etc.**

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

Monetary illusion = a powerful tool of behavioral economics and behavioral management

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **Three degrees of psychological aspects appearing in economics:**

  2. **Intellection (reflecting):**

     - **consists of two aspects: calculations and estimation;**
     - **it is estimation that is the subject of psychological research;**
     - **anchor heuristics: estimation realized by deviation from a known value (anchor); the respondent's opinion (deviation) is determined by the direction and intensity (the respondent may choose wrongly, because in his estimates he is often influenced by a completely irrelevant anchor - it is easy to bias our estimate if we are bad at the solved issue (if we are not familiar with the issue)).**

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **Three degrees of psychological aspects appearing in economics:**

  2. **Intellection (reflecting):**

     - **anchor heuristics are part of the market struggle, where supply determines demand (price exaggeration);**
     - **sometimes the consumer is able to face this pressure, sometimes he is not;**
     - **other psychological effects (relating to intellection):**
       - **the hypothesis of statistical expectations (we expect what has been true in the past);**
       - **the hypothesis of adaptive expectations (estimation based on past values, whereas older values have a weaker effect);**

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **Three degrees of psychological aspects appearing in economics:**

  2. **Intellection (reflecting):**

     - **hypothesis of rational expectations: the assumption that the consumer is absolutely informed and that he is able to fully understand the operating of the market (expectations created in accordance with the operating of the model);**
     - **most economists have adopted this model (this model overestimates human predictive abilities, but overestimates these predictive abilities less than previous models underestimated these abilities).**

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **Three degrees of psychological aspects appearing in economics:**

  3. **Decision making:**

     - **Relative way of decision making:**

       - **we are not interested in the final state (we are interested in the change of the final state compared to the current state);**
       - **example: deciding on the purchasing of a block of shares (it is more important for investors to know how much the value of their portfolio will change than how much this value will total);**
       - **this phenomenon facilitates the decision-making process in economics.**

4. SCIENTIFIC CONNECTION BETWEEN ECONOMICS AND PSYCHOLOGY

- **Three degrees of psychological aspects appearing in economics:**

  3. **Decision making:**

     - **Aversion to the lost:**

       – **the happiness we feel when we move above the present state is less than the dissatisfaction we feel when we move to the same extent but below the current state;**

       – **example: a higher volume of trading on stock exchanges during periods of rising stock prices than during periods of falling prices.**

5. MENTAL ACCOUNTING

- Dealing with two identical losses in different ways;
- a tendency to perceive the value of some money as lower compared to the value of other money (then waste it);
- developed by: Richard Thaler.

5. MENTAL ACCOUNTING

- **Examples:**
  - casino (the value of the dollar we won at the casino is lower than the value of another dollar - that's why we reinvest this dollar in gambling again - casinos therefore always earn);
  - payment in foreign currency;
  - payment by credit card (plastic hurts less than banknotes);
  - money in the "tank".

6. DECISION PARALYSES

- The more attractive (comparably high quality) offers, the less people decide;
- people want more attractive offers, but the task of choosing the right ones is discouraged by many consumers;
- economic progress in the form of a choice from an ever-expanding range of products, services and opportunities breeds not only joy but also anxiety.

6. DECISION PARALYSES

- **Typical procedure:**
  - **deciding between several tempting offers;**
  - **solving indecision = I'll wait and see - I'll find more time later and figure out exactly what to do = save money in the most conservative investment;**
  - **later, however, there is no change (eg the discovery of new, more profitable options, however, there is a rebellion against change = keeping the deposit for a conservative investment).**

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THANK YOU FOR YOUR ATTENTION