

Behavioral Economics and Decision Making
Professor Johnson

Block Seminar September 14-18, 2014

Important note: before coming to the first class or beginning any of the readings, please do *On-line Exercise 1*, from the link in Angel.

Professor: Eric J. Johnson
ejj3@columbia.edu

Email is great, but *please* use *Behavioral Economics* in the subject line.

TA's: Rachel Meng
rm3081@columbia.edu

Course Objectives

The purpose of this course is to inform future managers, analysts, consultants, and advisors of the psychological processes and biases underlying the decisions made by customers, competitors, colleagues, and themselves, with emphasis on how to incorporate such insights into marketing and business strategies.

The seminar has two facets. First, it gives students a broad overview of important results from various behavioral sciences (e.g., behavioral decision research, cognitive and social psychology, consumer research) that clarify how people make decisions. Second, it provides students with advice about applying these findings to topics in marketing, management, and finance (each the focus of approximately 1/3 of the class material). Classroom time will be devoted to a combination of lectures, discussions, and exercises illustrating the main concepts.

Of course, successful marketing and business strategies depend on a thorough understanding of how customers make decisions. However, traditional models of customer decision making, especially so-called normative or rational models, have serious limitations. Rather than making decisions in the manner postulated by these models, customers often use a variety of rules and processes that lead to (sometimes counterintuitive) decision behavior. For instance, customers have an exaggerated tendency to select compromise or middle options when making choices. Customers are also easily seduced by features of a product that seem to differentiate it from other products, even when these features in fact add no value. Seemingly "irrational" customer decision phenomena such as these abound. The premise of the course is that a series of similar findings from research in customer decision-making have powerful business implications.

Format

This class is intended to be intellectually stimulating and challenging. I value class participation and application of the ideas and theories we will be presenting. While you may have been exposed to this material lightly in other courses, we will pursue it in depth, and apply it to topics in marketing, management, and finance, relating course content to both strategic decision-making and customer behavior. While there have been many popular books in the area, sometimes, to learn the newest most important stuff, we will do some reading from primary sources before class.

Particularly important will be a set of demonstrations and exercises, many computer based and to be completed before or during class. Before class exercises will be noted in the syllabus, and I ask you to complete them well before class, to give me a chance to integrate them into that day's class.

Classroom time will be devoted to a combination of lectures, cases, discussions, and exercises illustrating the main concepts. To facilitate students applying these ideas to areas that they care about, several assignments allow you to apply these ideas to your own areas of interest.

Core Course	Connection with Core
Corporate Finance	<ol style="list-style-type: none"> 1. Time value of money 2. Risk
Managerial Statistics	<ol style="list-style-type: none"> 1. Regression 2. Fundamental Concepts of Decision-Making 3. Decision-Making Under Risk
Decision Models	<ol style="list-style-type: none"> 1. Fundamental Concepts of Decision-Making 2. Decision-Making Under Risk
Leadership Development	<ol style="list-style-type: none"> 1. Decision-Making 2. Influence and Persuasion 3. Negotiation
Managerial Economics	<ol style="list-style-type: none"> 1. Strategic interaction among firms and Nash equilibrium
Managing Marketing Programs	<ol style="list-style-type: none"> 1. Conjoint analysis 2. Pricing 3. Sales Promotion

Note: For a block seminar, people find it *very* helpful to have done the readings in advance. This allows you to do the assignments during the course in advance of the discussion.

Materials

A readings packet will be distributed. Readings will also be available in PDF format on Canvas.

Much, but not all, of the material is covered by Daniel Kahneman in his recent best seller, *Thinking, Fast and Slow*. You might want to read the entire book, but I've noted in the syllabus the chapters from the book (shortened to "Thinking") that are appropriate for each topic.

Evaluation

Anonymous grading: All assignments will be graded anonymously.

Participation (25%). In a course like this, the adage "garbage-in-garbage-out" is especially true. Students will only get out of this course as much as they are willing to put in, and lively class discussion is essential for learning this material. It is therefore very important that students take an active role in classroom activities and discussions and come fully prepared. Moreover, given how directly relevant decision making is to everybody's day-to-day life, it is particularly informative when students share their own experiences and introspections.

While missing many classes will ensure a poor participation grade, coming to all classes will not guarantee you a good class participation grade. Of course, class attendance is required, but you will not receive a high participation grade unless you speak in class and make a contribution to the class discussion.

The class participation grade will be determined by

- Class attendance and the quality of the student's involvement in the class's activities and discussions (20%)
- Participation in the in-class and out-of-class computer-based exercises, including submitting two suggested exam questions (5%)

Short Writing Assignments (40%). To reinforce the learning process, short individual assignments will be available for most classes. You are required to do at least 3 of these assignments. If you do a fourth, it can substitute for one of the four exam questions. You can either do 4 exam questions and a fourth assignment, in which case your grade will be based on the 4 highest scores, or just do 3 exam questions.

About the specific assignments: The primary reason for the short papers is to get you thinking seriously about the topics for the week so that the class discussion is more informed and sophisticated. There are many short writing assignments to choose from

in the syllabus. These assignments are, therefore, due before the class in which they are listed. Please submit them to the drop-box for that session.

“Wildcard” short writing assignment (can only be used to fulfill ONE assignment). In addition to the specific options offered, you may also submit ONE assignment which in 600 words does one of the following:

- Announce a new decision making heuristic, bias, or other empirical regularity. Give examples of how it happens, explain why, and make suggestions for how to make use of this new insight.
- Present an application of a principle in this course to your current or future business.

Extra Credit (Up To 5%): You can receive extra credit if you find an example from the current press that illustrates an idea or ideas from the course. (The “clippings” should be “recent”, within three months.) Please provide a writeup (a paragraph or so) indicating why you think that this article is a good example of something we talked about in class. You must submit the writeup to me electronically by email (bedmcourse@gmail.com). Please remember to begin your subject line with Behavioral Economics. Please use the following format:

COMMENTARY

Your paragraph goes here... (e.g., “This article relates to what we talked about in the mental accounting discussion...”)

ARTICLE

URL for the article... (e.g., <http://nytimes.com/interestingarticle.htm>)

Article pasted if possible

If the example is really good and appropriate, we will award you extra credit (maximum of 1% per example; maximum of 5% for the semester). We award extra credit for about 50% of submissions.

Grading System: All assignments (and the final exam) will be graded using a five point system. The grades can be interpreted as follows:

- 1= Some evidence of reading, but little understanding of the psychology or how it works, and minimal application of the course concepts to the actual question that was asked.
- 2 = An attempt at applying the course material, but with little or no depth of analysis (possibly just repeating ideas from the reading).

- 3 = A solid application of the course material, with some good points but few creative insights; the majority of papers will receive this grade.
- 4 = A deeper level of thinking than the obvious answer, clearly written, perhaps with creative examples.
- 5 = An exceptional paper, with an original insight and clear analysis. Such papers make us say “I wish I had thought of that!” Very few of these grades are given.

I will accept assignments after they are due, but since the real benefit is to prepare for the class in which we discuss the material, any assignment handed in after that class would receive a maximum grade of 4, and will average 1 point less than assignments handed in on time.

Final Exam (35%). By noon on September 17th, everyone must submit 2 exam questions suitable for use in an all essay, in-class exam using the submission dropbox on Canvas. I will select some and will be compile and distribute a list via email latter that day. Expect to receive a list of 20-40 potential exam questions. The final will consist of a subset of these questions with some choice, e.g., answer 4 of these 6 questions. Exam will be available at the end of the class meeting on Friday, and I urge you to complete it as soon as practical. In any case, all exams should be done by 11pm, EDT Tuesday, September 23rd. If you choose to take the exam as a take-home, I ask that you limit yourself to the same time as given for in-class administration.

Course Roadmap

Sunday, September 14

Topic 1	Your Two Brains: Econs vs. Humans.
Readings	Thinking Chapters 1-3
Due	<i>Please do the online survey before class</i>

Topic 2	Losses: Why they have more impact, and how to apply this insight.
Readings	Thinking Chapters 26 and 27
Writing Assignment, Option 1	<ul style="list-style-type: none"> One of the lessons of this course is that framing "matters". Some people have learned that lesson better than others. Find an example of inept framing in the news and fix it. That is, find a quote or argument by anyone being quoted in any news source that you think could be improved had they known how to "frame" and rewrite it in a way that you think will be superior. Explain why you think your approach is better.

Topic 3	Perception of Risks The use of heuristics in judgment and decision-making How consumers and managers think about risk
Readings	Thinking Chapters 11-13

Topic 4	Confidence
In Class	The overconfidence game
Readings	Thinking, 19 and 20
Writing Assignment, Option 2	<ul style="list-style-type: none"> Consider the following fact: 80% of small businesses fail within their first three years of operations. A friend is unaware of this fact, and wishes to quit his job as an investment banker and open a restaurant in New York. As a good friend, you want to be sure that overconfidence is not playing a significant role in his or her decision. You decide a letter is the best way to communicate the dangers of overconfidence. Compose a letter to your friend, for the purpose of helping him or her navigate the pitfalls of overconfidence. Before writing this letter you might consider the following questions: Why might your friend be overconfident about the success of this venture? What are the most important sources of overconfidence? Which of these sources do you believe will be most resistant to your persuasion?

Monday, September 15

Topic 1	Impatience How people really discount.
Readings	Lowenstein & Thaler (1990): "Intertemporal choice"
Writing Assignment, Options 3 and 4	<ul style="list-style-type: none"> To deal with self-control problems, many people use the equivalent of sunk costs to commit themselves to an activity. Examples include paying a large annual health club fee rather than paying per visit, or buying season tickets for the theater. Can you suggest other products that might benefit from using prepayment as a self-control device? Devise a marketing strategy to implement this plan. Although people usually procrastinate by postponing the completing of unpleasant tasks, there are also situations in which people procrastinate the enjoyment of something enjoyable, such as drinking a special bottle of wine or and the activity is continuously postponed. Suppose that you are a seller of luxury goods that have this problem (such as fine wines). How do you get your customers to quit delaying consumption?

Topic 2	Mental Accounting How to partition payment streams.
Readings Writing Assignment, Options 5 and 6	Thaler (1999): Mental Accounting Matters Thinking Chapter 32 <ul style="list-style-type: none"> • Mental accounting, to the extent that it violates fungibility, is (according to economic theory) irrational. Do you think there are any circumstances where mental accounting makes people better off nonetheless? How? • Use mental accounting to develop a new pricing strategy for some product or service.

Topic 3	Choosing Helping Consumers with Risk
Readings Writing Assignment, Option 7	Simonson & Tversky (1992): Choice in Context: Tradeoff Contrast and Extremeness Aversion Toro No S'no case <ul style="list-style-type: none"> • Read the Toro Case. The case raises issues that involve many of the concepts we have studied during the course Show us that you have been paying attention during the quarter by writing a memo to Pollick giving him some insights on what Toro should do the following year and why. 600 words (of course).

Topic 4	Emotion, Affect and Consumer Choice
Readings Writing Assignment, Option 8 and 9	Cialdini (2001): Harnessing the Science of Persuasion Thinking, Chapter 3 Selling CFLs at Wal-Mart: Case <ul style="list-style-type: none"> • Apply one of Cialdini's principles to a business problem of personal interest. Do not use more than 600 words. • Submit a 600 word case write-up addressing the questions in the "Selling CFL's" case.

Tuesday, September 16

Topic 1	Memory and Decisions
Reading	Thinking, Chapters 4 and 5

Topic 2	How to Innovate based on Behavioral Principles
Readings	HBS: Gourville (2003): Why Consumers Don't Buy: The Psychology of New Product Adoption

Topic 3	Application to organizations making decision.
Readings	Thinking, 23 and 24 Jon Krakauer (1996): Into Thin Air, Outside Magazine
Writing Assignment, Option 9	<p>Many of you are familiar with the 1996 Everest disaster that claimed the lives of several people including experienced climbers and expedition leaders Rob Hall (of Adventure Consultants) and Scott Fischer (of Mountain Madness). I strongly recommend that you read the book if you have not. This disaster illustrates how certain pressures lead to decision errors for individuals and organizations.</p> <p><u>Preparation Questions (to be discussed in class; Also may be prepared as a written assignment):</u></p> <ol style="list-style-type: none"> 1. Why are the climbers up there? Consider the motivation and incentives facing each participant. What are the implications for potential decisions biases and corrective measures? 2. What are the defining characteristics of the decision-making environment on Mt. Everest? Setting aside the extreme physiological conditions, what are the biggest challenges for good decision making? 3. Describe the decision process used by Hall and Fischer. What mistakes did the guides or members of the climbing teams make during the climb to the summit? Why were these mistakes made? How do these mistakes relate to concepts we have discussed in the course? 4. If you were advising a friend interested in organizing an expedition to the top of Everest (or some other large but potentially dangerous mountain), what advice would you give him or her based on the concepts of this course?

Topic 4	Consumer Financial Decision-Making
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Readings	Benartzi and Thaler (1995): Myopic Loss Aversion and the Equity Premium Puzzle De Bondt and Thaler (1995): Financial Decision Making in Markets and Firms: A Behavioral Perspective
Writing Assignment Option 10	<ul style="list-style-type: none">• Make a copy of a regular statement (or web interface) you or someone you know receives from a financial services company such as Fidelity or Vanguard. Do whatever is necessary to make the statement confidential (black out names and/or amounts) and then attach the relevant parts to this paper. Now, based on this week's readings, make some suggestions for how this statement could be improved. Be sure to say explicitly what you are trying to improve

Wednesday, September 17

Topic 1	When do people do better than models? Are experts as good as they think?
Readings Writing Assignments Options 11, 12 and 13	Thinking, Chapters 20-22 <ul style="list-style-type: none"> • During the month of April, Columbia Business School admissions kicks into overdrive, with many events for prospective students. Consider that the way prospective students select business schools may not be entirely rational; they may use rules of thumb, such as elimination by aspects or reason based choice, which can lead to some surprising outcomes. Imagine that you are in charge of recruiting. What will you do about these heuristics? When do they hurt our ability to attract good students, and when can we use them in our favor? • Imagine that you have just taken the job of running the Columbia (or Haas or LBS) Business School admissions office. One of the statistics professors has come to you to suggest that you could do a better job of picking students for the school if the admissions office had less discretion in the selection process. Instead, you could commission the statistics department to fit a model to predict success (somehow defined) and then just pick the students that score highest on this model. What do you think of this plan? What problems do you anticipate? How would you solve them? Is it "fair" (whatever that means)? If you decided to implement this plan, would you make it public? What role would you assign to interviews? • Can you think of how you would apply the idea of a linear model, proper or improper to improve business decisions in your business? What are the barriers to doing so? Why do you think it would or would not work?

Topic 2	How people really think strategically.
Readings Writing Assignment Option 14	Camerer (1997): Progress in Behavioral Game Theory Thaler and Dawes (1992): Cooperation <ul style="list-style-type: none"> • Describe a situation from business or life where non-cooperative game theory would predict a different outcome from what is observed. What is rationality, and would you say that the agents are acting irrationally? What is missing from the theory that, if added, describes the situation? Is welfare helped or harmed because of this factor?

Topic 3	Happiness: How good are we at predicting what will make use happy? —and, for a downer, or indirect advice about where to live, the WSJ Blog Post available here: http://blogs.wsj.com/economics/2010/09/07/what-salary-buys-happiness-in-your-city/
Readings Writing Assignment Option 15	Thinking, Chapter 37 and 38 <ul style="list-style-type: none"> GDP is one of the most-cited measures of well-being across countries. Cite one advantage and disadvantage of using this measure, and drawing on principles from the course, suggest how this measure might be improved.

Topic 4	Defaults and Choice Architecture
Readings	Goldstein, Johnson, Herrmann and Heitmann (HBR).
Writing Assignment Option 16	<ul style="list-style-type: none"> Identify a example of bad choice architecture from the users viewpoint. Why did the designer choose this particular design? Was it intentional? What was its outcome on choices? Propose an alternative design and explain how it would improve choice.

Thursday, September 18

Topic 1	Creativity and Applications
Readings	Ayres and Nalebuff (2003): Why Not?

Topic 2	Course Wrap-up and Conclusions.
Readings	Ayres and Nalebuff (2003): Why Not?

Thursday, September 18 - Tuesday Sept 23 : Final Exam

The format of the exam is a take-home with time limits. It is open book and notes. You will have 90 minutes from the time that you download the exam to finish the exam and then upload your response.