

Introduction: The Origins of Behavioral Economics

Dan Ariely's groundbreaking work challenges traditional economic theory by demonstrating that human irrationality is not random—it's **systematic and predictable**. Drawing from personal experience recovering from severe burns, Ariely developed a keen interest in understanding how people consistently make poor decisions despite good intentions.

Core Thesis

We are not only irrational, but predictably irrational. Our irrationality happens the same way, again and again. Understanding these patterns provides a starting point for improving decision-making and changing behavior for the better.

Key Behavioral Economics Principles

1. The Truth About Relativity

Key Insight: We judge things in relative terms, not absolute terms. Humans lack an internal value meter and rely on comparisons.

- **The Decoy Effect:** The Economist subscription experiment showed how adding a dominated option (print-only at \$125) made the print+web combo (\$125) seem like an irresistible deal
- **Application:** Everything from job satisfaction to product pricing is influenced by what we compare it to
- **Danger:** Relativity drives jealousy, envy, and endless pursuit of "keeping up"

3. The Power of FREE!

Key Insight: Zero is not just another price—it has special emotional power that makes us behave irrationally.

- When chocolates were 15¢ vs 1¢, 73% chose truffles; when 14¢ vs FREE!, 69% chose the inferior Kiss
- We forget the downside when something is FREE!
- Amazon France: Shipping at 1 franc was ignored; FREE! shipping caused dramatic sales increase

5. Procrastination & Self-Control

2. Anchoring & Arbitrary Coherence

Key Insight: Initial prices are "arbitrary," but once established in our minds, they shape all future price expectations.

- **Black Pearls Example:** Salvador Assael made valueless black pearls precious by anchoring them to diamonds and rubies
- **Social Security Experiment:** Students' bids correlated 216-346% with the last two digits of their SS numbers
- **Implication:** First impressions and initial decisions have lasting effects—like goslings imprinting on the first thing they see

4. Social Norms vs Market Norms

Key Insight: We live in two worlds—social (warm/fuzzy) and market (transactional). Mixing them destroys social relationships.

- Lawyers refused \$30/hr for retirees but said yes to FREE!
- Daycare fine experiment: Fines turned guilt (social) into a commodity (market), increasing late pickups permanently
- **Warning:** Once market norms enter, social norms rarely return

Key Finding: Self-imposed deadlines help but aren't as effective as external deadlines. Students with dictated deadlines got the best grades; those with complete freedom got the worst.

Solution: Precommitment devices—from automatic savings deductions to limiting options upfront—help overcome our tendency to choose immediate gratification over long-term goals.

6. The Endowment Effect

Key Finding: Ownership dramatically increases value. Duke students who won basketball tickets valued them at \$2,400; those without tickets would only pay \$175.

Three Quirks: (1) We fall in love with what we own, (2) We focus on what we'll lose, not gain, (3) We assume others see the same value. The "IKEA effect" shows effort invested increases attachment.

7. Keeping Doors Open

Key Insight: We irrationally struggle to keep options open, even worthless ones, at great cost.

- Computer game experiment: People earned 15% less when doors could "close"
- Like Chinese commander Xiang Yu burning ships—we need to close doors to focus

8. The Power of Expectations

Key Insight: Beliefs change our actual physiological experience, not just perception.

- MIT Brew (beer with vinegar): Without warning, most preferred it; with warning, most rejected it
- Timing matters: Telling people AFTER tasting had no effect

9. The Placebo Effect of Price

Key Finding: Expensive placebos work better than cheap ones. A 50¢ aspirin relieves pain more effectively than a 1¢ aspirin—purely through expectation. Price serves as a quality signal that triggers real physiological responses. This has profound implications for healthcare costs and insurance.

10. Dishonesty & The Fudge Factor

Key Finding: We all cheat—but only a little. Most people cheat just enough to benefit but still feel honest.

- **Moral Reminders Work:** Recalling the Ten Commandments or signing honor codes virtually eliminates cheating
- **Distance from Cash Matters:** People won't steal cash from the fridge but will steal equivalent Cokes. Tokens made people cheat twice as much as cash
- **Implication:** Distance from money (expense reports, stock options) enables rationalization and increases dishonesty

Famous Experiments Summary

Economist Subscription Decoy: Print-only at \$125 made print+web at \$125 irresistible (84% chose it vs 16% for web-only)

Social Security Anchoring: Random digits influenced bids by 216-346%

Chocolate Experiment: FREE! transformed preferences completely despite unchanged relative value

Sexual Arousal Study: Students failed to predict how arousal would change their decisions (72-136% more risky)

Practical Applications

- **Personal Finance:** Use automatic deductions, precommitment devices, question first purchases that create anchors
- **Business:** Understand decoy effects in pricing; don't mix social and market norms with customers or employees
- **Policy:** Make critical preventive healthcare FREE!; use moral reminders and honor codes to reduce dishonesty
- **Relationships:** Never mention prices on dates; avoid putting market value on social exchanges

- **Decision-Making:** Recognize that "hot" states (aroused, hungry, angry) dramatically change preferences; close worthless doors to focus resources

Key Takeaway

We are not the rational actors that traditional economics assumes. Our predictable irrationalities are systematic, not random. By understanding these patterns—from the power of FREE! to the danger of mixing social and market norms—we can design better systems, make better personal choices, and create policies that account for actual human behavior rather than idealized rational models.

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