



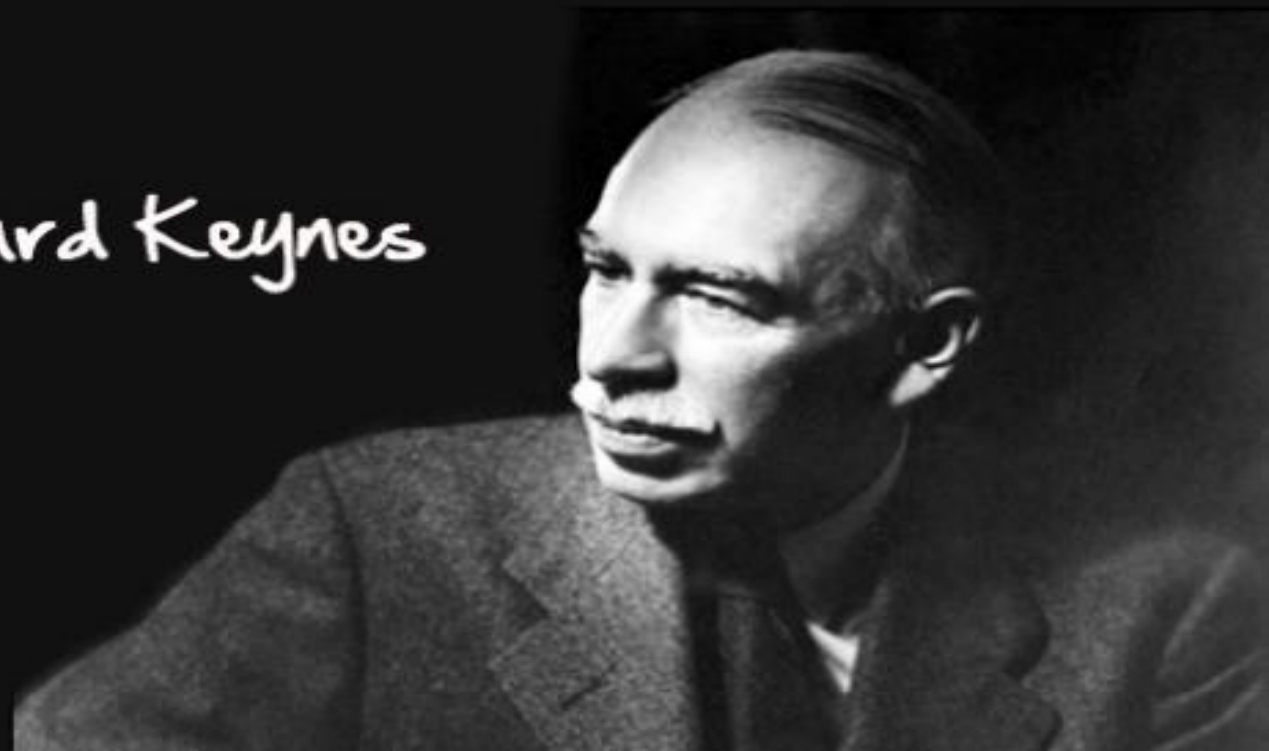
Behavioral Economics

Master-Seminar WS 2018/19

Prof. Dr. Ronald Schettkat

"The difficulty lies not so much in developing new ideas as in escaping from old ones."

John Maynard Keynes



Developing Theories

Logical, mathematical science

Real sciences (physics, biology ..)

“Truth” established by formal deductions based on axioms

“Truth’ established from assumptions not disproved by empirical evidence

See Kornai

Rational Choice

- People choose the combination of goods which maximizes their own utility under a budget constraint
- Utility functions are independent
- Utility functions stable, consistent
- Knowledge of goods (which goods are available, what are their characteristics)
- Perfect information, risk instead of uncertainty
- Real values, nominal unimportant(no money illusion)

Behavioral Economics

- Broad term for economists deviating from homo oeconomicus, rational expectations.
 - Mainly analysis of individual economic behavior
- .. the realism of the psychological underpinning of economic analysis will improve the field of economics on its own terms –generating theoretical insights, making better predictions of field phenomena, and suggesting better policy (Camerer/Loewenstein 2004: 3).

Behavioral Economics

- Most prominent contemporary researchers:
 - Daniel Kahneman (Nobel Prize)
 - Robert Shiller (Nobel Prize)
 - George Akerlof (Nobel Prize)
 - Richard Thaler (Nobel Prize)
 - Robert Frank

But former contributor

- Herbert Simon (Nobel Prize)
- Tibor Scitovsky (joyless economy)
- Thorstein Veblen (theory of the leisure class, keeping up with the Joneses)
- institutionalists

Thaler

<https://www.youtube.com/watch?v=t0uRjM6z90g>

Important finding of Behavioral Economics

- Expected utility may deviate from experienced utility
- Utility depends on reference points (status quo)
- Nominal values (wages) are important
- Magnitudes affect decisions
- Discount rates are not *rational*

Behavioral Economics

- Nominal values (wages) are important

Money Illusion?

2 persons graduated at the same time at the same college and they receive the same Starting income but they face different growth in income and inflation.

Who is economically in a better situation (real income)?

Who is more satisfied?

Who would more likely accept an alternative job offer?

Person	1 st year		end year pay rise	2 nd year		respondents thought:		
	Salary	inflation		Salary nominal	real	better off economically	happier	prop. to quit
A	30,000	0%	2%	30,600	30,600	71%	36%	65%
B	30,000	4%	5%	31,500	30,300	29%	64%	35%

Source: compilation from [Shafir/Diamond/Tversky \(1997\)](#) cited in [Wilkinson \(2008: 32/33\)](#).


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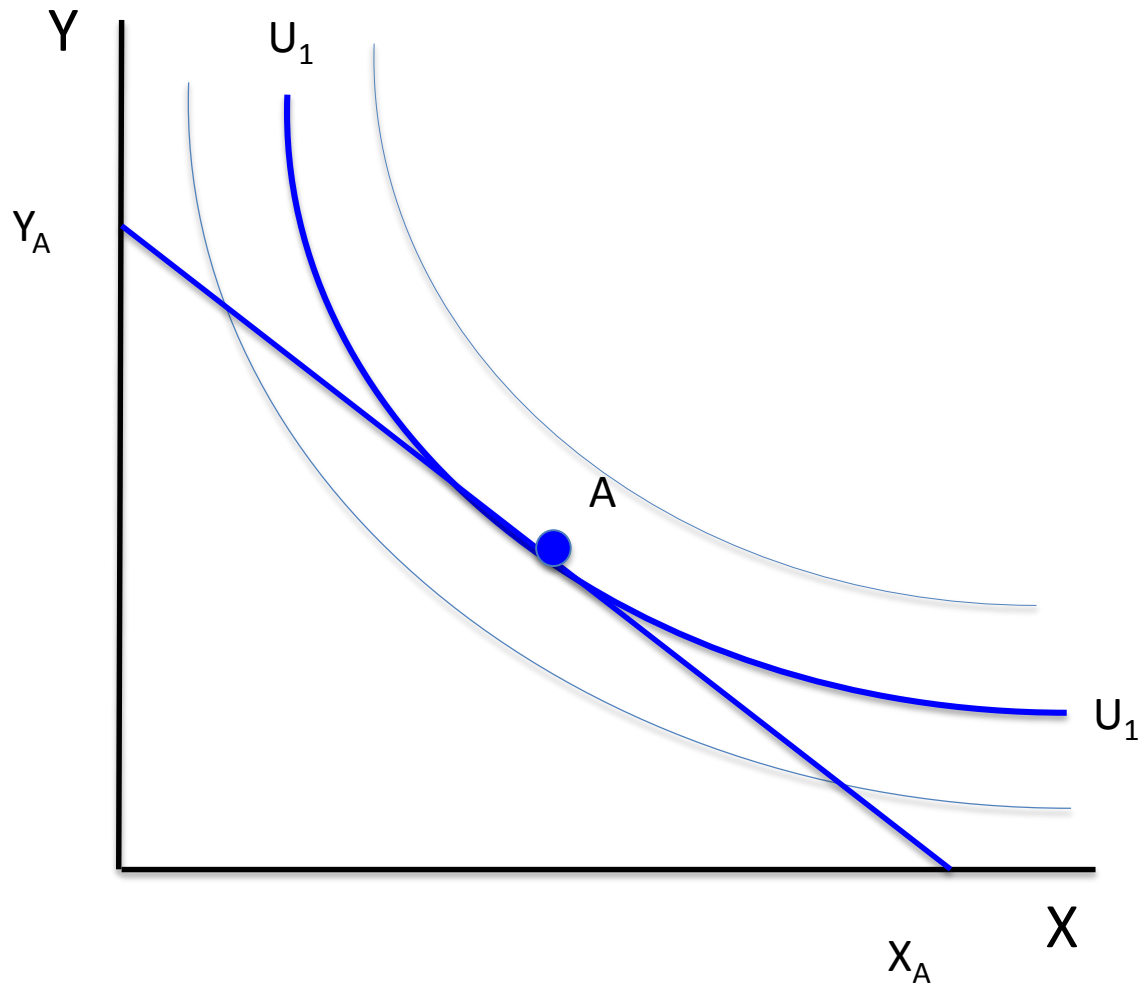
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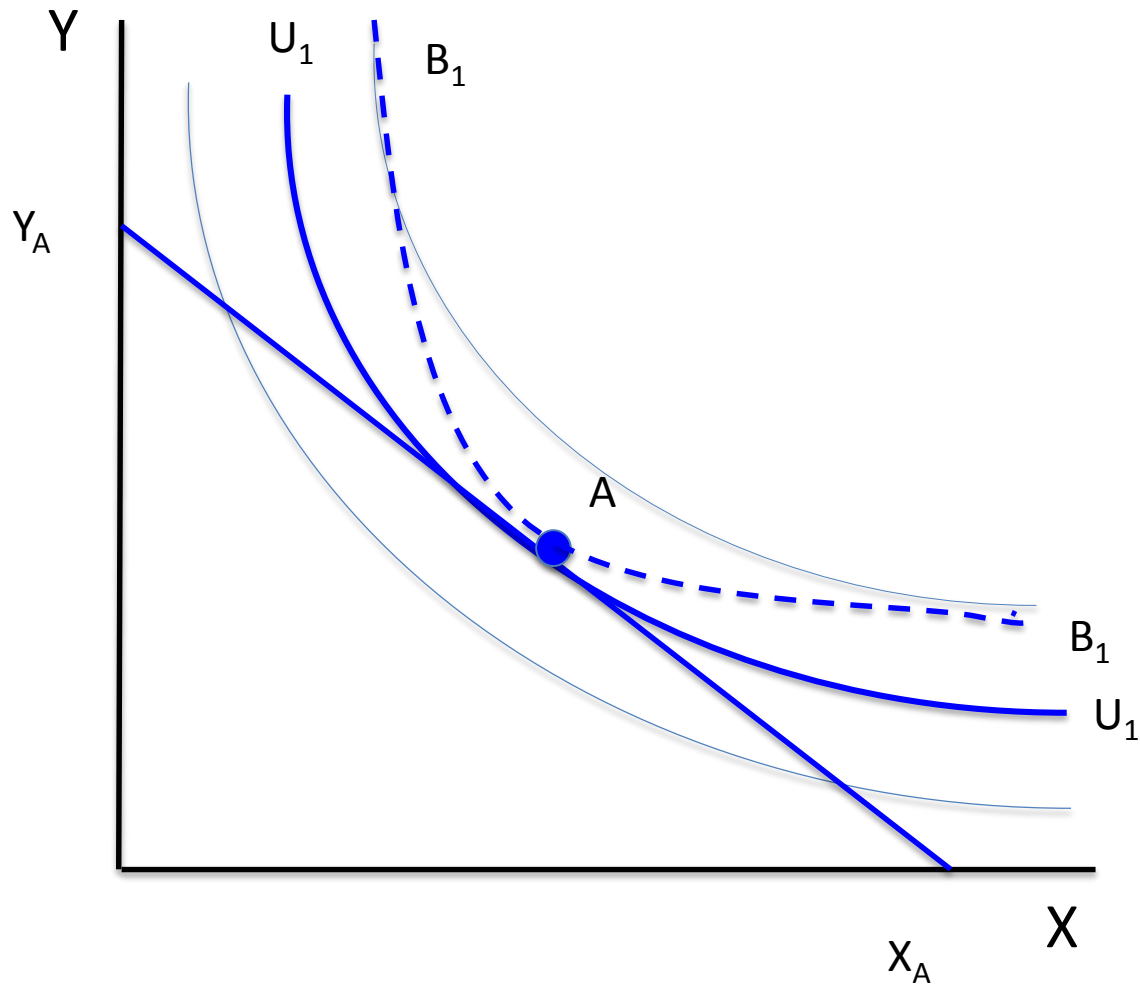
„Call it logical or illogical, that's how it is!“

Source: Diamond/Tversky (1997) cited in Wilkinson (2008: 32/33).

Reference point (loss aversion)

- ticket for Taylor Swift concert bought for 100\$
- At the concert hall the ticket can be sold for 300\$
- Do people sell their ticket?
- Many (not all!) people don't sell although they would never have paid 300\$ for the ticket
- Other famous examples: Wine bottles, mugs





Inspired by Komlos 2014

Behavioral economics

- Interdependent utility functions

Independent utility functions?



Unabhangige Nutzenfunktionen?





Is he optimizing?

**Is his marginal disutility
of work higher than the
wage?**

**Is he on his labor supply
function?**

Intertemporal optimization?



Intertemporal optimization?

New York cab drivers adjust their working hours according to income levels (satisfying not maximizing)



Topics for papers

- Interdependent utility functions (keeping up with the Joneses)
 - Thorstein Veblen, Robert Frank, ...
- Minimum wage as reference
 -
- Real wage vs. nominal wage orientation
 - Keynes,
- Symmetric vs. asymmetric responses to wage changes
- Habitualization of work (path dependence)
 - Clark/ Summers
- Relative wages
 -
- Intertemporal optimization
 - New York taxi drivers (
- Emotions in decision making
 - Damasio
- Why are employer reluctant to cut (nominal) wage? Efficiency wages
 - Bewley
- Why are wage profiles upward sloping?
- Expected utility vs. experienced utility
 - Kahneman/ Thaler
- Maximizing vs. Satisfying
 - Herbert Simon
- Direct, indirect utility
 - The joyless economy (Tibor Scitovsky)
- Stable preferences? Given or developed needs

Topics for papers

The joyless economy (Tibor Scitovsky)

direct, indirect utility

Interdependent utility functions

Minimum wage orientation

Real wages vs. nominal wages

Habitualization (path dependence) of

work

consumption

Emotions in decision making

Why are employer reluctant to cut (nominal) wage? Efficiency wages

Absolut vs. relative wages

Symmetric vs. asymmetric responses to wage changes

Keeping up with the Joneses

Given vs. developed needs

Stable preferences

Expected utility vs. experienced utility

Time schedule:

- Today, introduction, allocation of topics
- Bilateral consultations
- early end of January 2019 (exact date tba)
conference:
presentation, discussion of paper, presence obligatory
papers due 7 days before conference

Another explanation for wage rigidity: Loss Aversion

