

Heuristics in Behavioral Economics

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Introduction to Heuristics

- Heuristics are mental shortcuts or rules of thumb used to simplify decision-making.
- They help in making quick decisions with limited information.
- However, heuristics can lead to systematic biases and errors in judgment.

Representativeness Heuristic

- People assess the likelihood of an event based on how well it matches a prototype or a similar example in their mind.
- Example: Assuming a person who loves reading and intellectual discussions is likely to be a college professor, rather than a truck driver.
- Can lead to overlooking base rates and over-reliance on stereotypes.



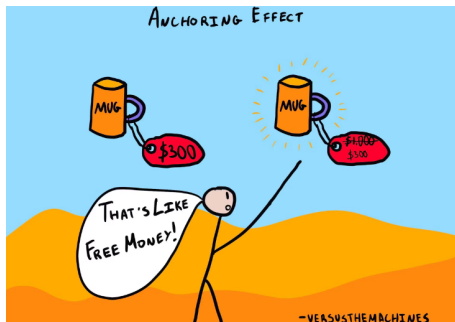
Availability Heuristic

- People estimate the probability of an event based on how easily they can recall similar instances from memory.
- Example: Assuming that shark attacks are more common than accidents involving toasters because shark attacks receive more media coverage.
- Can lead to overestimating rare events and underestimating common ones.



Anchoring and Adjustment Heuristic

- People start with an initial value (anchor) and adjust their estimate based on additional information.
- Example: When asked to estimate the population of a city, people tend to be influenced by a suggested number provided beforehand.
- Can lead to biased judgments, as the anchor affects the final decision.



Availability Cascade

- A self-reinforcing process where the more an idea or belief is repeated or reported, the more it becomes accepted as true.
- Example: A rumor about a celebrity's death spreads rapidly on social media, leading to widespread belief, even if it's false.
- Can lead to misinformation and a false sense of credibility.

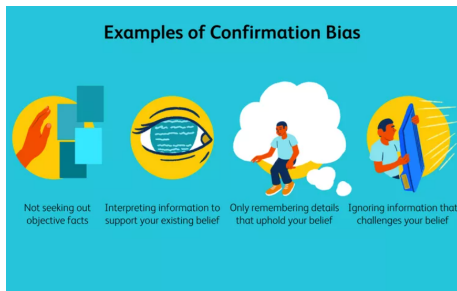
AVAILABILITY CASCADE

Often seen in the share markets-
When a few investors get queasy on a stock,
the entire group is inclined to sell



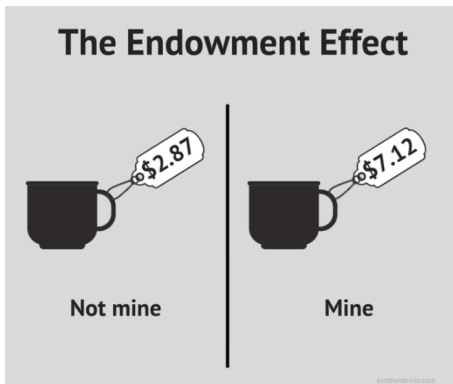
Confirmation Bias

- People tend to seek, interpret, and favor information that confirms their existing beliefs or hypotheses.
- Example: A person only pays attention to news sources that align with their political views.
- Can lead to reinforcing existing biases and ignoring contrary evidence.



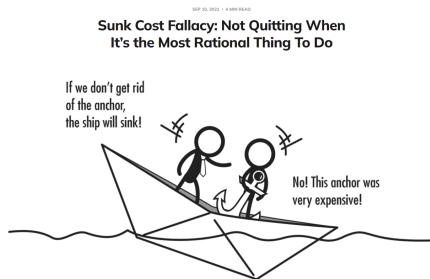
Endowment Effect

- People tend to value an item they own more than an identical item they don't own.
- Example: A person is unwilling to sell a ticket to a concert at the price they would be willing to buy it.
- Can lead to irrational attachment to possessions and difficulties in trade.



Sunk Cost Fallacy

- People continue an endeavour because of the resources (time, money) they have already invested, even if it no longer makes sense to do so.
- Example: Continuing to watch a boring movie just because you've already paid for the ticket.
- Can lead to persisting with poor decisions to justify past investments.



Hindsight Bias

- After an event occurs, people tend to overestimate their ability to predict the event's outcome.
- Example: "I knew it all along!" feeling after an unpredictable sports match.
- Can lead to overconfidence and ignoring uncertainty in future predictions.



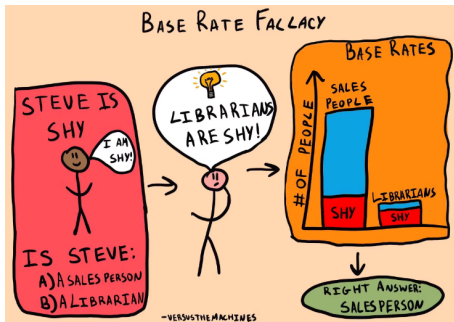
Availability and Affect Heuristic

- People use their emotional response to an event to estimate its likelihood.
- Example: People may think that flying is dangerous after hearing about a plane crash, despite statistical evidence of its safety.
- Can lead to fear-driven decision-making and irrational avoidance.



Base Rate Neglect

- People often ignore the overall likelihood (base rate) of an event and focus only on specific information.
- Example: Ignoring crime statistics in a neighbourhood with a low crime rate but fearing crime due to one recent incident.
- Can lead to misjudging risks and making suboptimal decisions.



- Heuristics are essential cognitive tools that aid decision-making but can also lead to biases and errors.
- Being aware of heuristics can help us make better choices and avoid common pitfalls.
- Behavioral economics sheds light on how human behaviour deviates from traditional economic assumptions.

Thank you for your attention!

Questions and Discussion