BEHAVIOURAL ECONOMICS
A special report published by:
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This special report is one of a series produced for faculty members. In each report we give a review of a topical theme within finance and management, offering both analysis of the relevant theory and a review of the practical application of appropriate management techniques.

If you have any comments or suggestions, please send them to Jennifer Chong.

The information contained in this and previous issues of this publication is available (to faculty members only) on the faculty website at icaew.com/fmfac

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FOREWORD

THE 'ART' OF INFLUENCING BEHAVIOUR

'If we are persistently irrational, perhaps the behaviour is not irrational' – Professor John Kay, renowned British economist.

The study of human thinking has uncovered a number of psychological patterns in our reasoning processes. Traditional neo-classical economic theory assumes that we act in a rational way which will maximise our self-interest. In reality, humans do not always act rationally. We can be persuaded and often make inconsistent choices based on our biases, emotions and different attitudes to risk.

Behavioural economics is an emerging (but not entirely new) area which challenges the basic tenets of neo-classical economic theory. By combining economics and other social sciences such as psychology and sociology, behavioural economics explains the psychological factors behind why and how we make our choices.

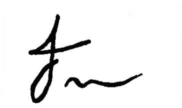
Organisations including companies and public policymakers are recognising the potential benefits of allocating more investment into understanding the context of human behaviour in their target audience. The huge challenge is to strategise these processes to achieve a favourable result. One of the key techniques is the power of 'context' in conveying information – this is how choices are framed. For example, which product is better – 2% fat or 98% fat free? Studies under behavioural economics have shown that we are more likely to react to labels with 98% fat free as opposed 2% fat – even though the fat content is the same. By restructuring choices, this becomes an effective way to alter our behaviour.

This report is not a comprehensive guide but has been produced to highlight the importance of understanding the human behaviour in our choice selection. It introduces the key behavioural principles that you should be familiar with as business professionals. Business applications are explored through practical examples including project appraisal, pricing and securing investment.

Recent developments in closely related fields include behavioural accounting and behavioural finance – where the techniques of behavioural economics can be further applied. These topics will be covered in future faculty publications.

This report has highlighted the main idea that, by being aware of your audience and knowing our own behavioural tendencies, we can consciously take action to overcome the inclination towards irrationality.

I hope you find this report thought-provoking and a useful basis for future business discussions. Please contact me if you have any comments.



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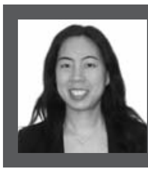

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ABOUT THE AUTHOR

Leigh Caldwell is chief executive of Inon Pricing Advisers (www.inon.com). Originally a mathematician, his work at Inon includes creating a unique behavioural pricing software platform and setting up a consultancy service which helps businesses in both consumer and business-to-business markets to set their prices.

Leigh writes a blog on behavioural economics at www.knowingandmaking.com, and contributes to the pricing blog www.pricingrevolution.com

His new book, *The Psychology of Price*, will be published in spring 2012.