



Dan Ariely

***The Startling World of Behavioral Economics:
How people really make decisions when money's involved.***

November 16, 2006

Session Summary

NEXT SESSION

December 6, 2006

Dan Pink and Daniel Gilbert

Renewal Day

Year-end starts rolling around and pretty soon you're thinking about New Year's resolutions. Here's one: How about getting yourself a whole new mind? Or, how about figuring out once and for all how to make yourself really, really happy? Our speakers have written wise, funny, inspiring bestsellers on those very topics: Dan Pink is the author of *A Whole New Mind* and Daniel Gilbert's book is *Stumbling on Happiness*.

DAN ARIELY — SESSION SUMMARY



Dan Ariely is the only person ever to hold joint appointments at MIT's business school and also at its famous Media Lab. He has a Ph.D. in cognitive psychology and another one in marketing. His website is <http://web.mit.edu/ariely/www/>.

Some Key Points

Each person will take from this presentation what is most relevant to him or her. Some of the key points Ariely made, which are discussed in more detail in the rest of this document, can be summarized as follows:

- ▶ In contrast to classical economics, which generally studies how people would behave if their decisions were completely rational, behavioral economics studies how people actually make decisions involving money.
- ▶ People don't know their preferences. Ariely demonstrated many ways in which preferences can be "irrationally" influenced.
- ▶ Not knowing their actual preferences, people often fall back on their "default" choices when faced with complicated choices. Defaults can be manipulated.
- ▶ Not knowing their actual preferences, people attempt to create the appearance of rationality in their decisions by trying to be consistent with earlier choices. This phenomenon is known as "self-herding."
- ▶ We all have two aspects: a rational, "cold" cognitive aspect and a "hot," emotional aspect. The emotional aspect often takes over our decision-making.
- ▶ Expectations strongly impact what we experience – in fact, psychological expectations *change* the nature of sensory experience. One of the more significant experience-altering facts for business is that people think, unconsciously, that a discounted item is less powerful than the full-price version.
- ▶ In another test of the impact of expectations, Ariely showed that people are very suspicious of "free lunches."

A Free Lunch

Ariely said that whereas classical economics assumes that "there is no free lunch" because individuals' actions tend to maximize the rationality of all transactions so that what is spent is equal to what is gained, behavioral economics sees "free lunches" – imbalances that favor one party or another, resulting from irrational decisions – everywhere. Behavioral economics, he

said, “contrasts how people really think and do things against how economics, from a normative theory, suggests that they should be thinking.”

We Don't Know What We Want

Ariely showed several ways in which preferences are easily manipulated. For example, if one group of people is asked to list three reasons why they love their spouse, and another group is asked to list ten reasons, and they then are asked individually how much they love their spouse, members of the group asked for three reasons will report loving the spouse more. Being asked for ten reasons suggests that's the right number, but people usually can't come up with that many, so they conclude they must not love their spouses very deeply. The very process of answering questions leads to a shift in perception and a redefinition of preferences.

The same phenomenon applies when people are asked for ten reasons to buy a BMW, suggesting among other things that market research doesn't just measure opinion, but can shape it, too.

In another example, he showed how introducing a “dominated alternative” into a decision – an alternative that is worse in every way than one of the other choices – shifts preferences. Presented with two hard-to-evaluate choices – for example, two comparable one-week vacation packages, one of which is in Paris and the other in Rome – people will, overall, split evenly about their preferences. However, when a third, worse, choice is included – for example, a one-week vacation in Rome for the same price but with fewer amenities – the closer superior alternative – in this case, the Rome trip with all amenities – will be chosen far more often than the Paris trip.

He noted that this kind of shift of preferences occurs even more dramatically when people are told that they will have to explain their decision, because the dominated alternative provides a handy “story to tell” about why they chose as they did. He said that in this sense “accountability can be a double-edged sword,” sometimes pushing people to make worse choices. He showed an example of the use of a dominated alternative in an offer from *The Economist* magazine, and showed how without the “decoy” of the dominated alternative, preferences shifted dramatically.

Complexity and Defaults

A table offering samples of jams was set up in an upscale grocery store. Sometimes the table held six different jams; sometimes it held twenty-four jams. After trying whatever jams they wished, customers were given a coupon for a discount on any jam in the store (not just from the sample table). Among those who had approached the table when it held six jams, 30 percent used the coupon. Among those who had approached the table when it held twenty-four jams, just 3 percent used the coupon.

With twenty-four jams, the choice had been made so complex that people fell back on the default position that was typical of their regular shopping – to buy no jam at all.

Another experiment demonstrated how defaults could be manipulated. Subjects were given descriptive information about six products. On a form listing the products, they were asked to

write the last two digits of their social security numbers next to each product and then to indicate whether they would be willing to bid more than that dollar amount, or less than that amount, for each of the items in an upcoming auction. When the auction was held, those with higher social security numbers bid far more for all the products than those with lower numbers. Their “defaults” had been set higher from the beginning.

Ariely said that this finding should affect what businesses initially charge for a product or service, and he said it can explain why it’s so difficult to ask people to pay for a product (information provided over the internet, for example) that initially was free. (Later in his talk he discussed how Starbucks, which he described as “just Dunkin’ Donuts but three times more expensive,” was able to set and maintain its price expectations. It had to show that it was *not* Dunkin’ Donuts, he said, by the décor, by the items sold in the store (such as French presses), by the pastries (e.g., biscotti, not donuts), and by using exotic names for things. He said, “You convince people that we shouldn’t take the regular history of our decision-making and transfer it to Starbucks. This is a different universe. It’s crucial when you start a new thing that you define the space around it – what you want to be compared to.” Now that people have “self-herded” (see next item) to Starbucks, he said, it has changed, and it does offer, for example, donuts.)

Self-Herding

Since so many of our choices are arbitrary, Ariely said, we need to create a coherent sense of who we are by following paths set by our earlier choices. If you once go into a Starbucks, he said, you can begin to think of yourself as “the kind of person who buys coffee at Starbucks.”

He said, “Self-herding relies on two principles. One is that we don’t know our preferences that well, and two is that we remember our actions and we try to be consistent with our memory because we infer preferences from what we’ve done.”

Our “Hot” and “Cold” Selves

“We’re really not one person, but two,” Ariely said. “We have the cognitive person – calculated, thoughtful – and the emotional self. The very purpose of emotions, from an evolutionary standpoint, is to hijack your system.” By that latter observation, he meant that when danger or opportunity presented themselves to our evolutionary ancestors, they did not have time to sit around and think cognitively, they had to react, emotionally. That “wiring” is still in our systems.

He described how rational decision-making goes out the window when students are placed in a “hot,” sexually-charged situation. He also said that when people are asked whether they want a half-box of Godiva chocolates right now or a full box a week from now, they will generally choose the half-box now, but if they are asked whether they want a half-box a year from now or a full box a year and a week from now, they’ll select the delayed full box. He explained that we make plans in a “cold” state, but we usually make decisions in a hot state. We need incentives and/or disincentives set up in advance to keep us from “hot” behavior – for example, if we are dieting, telling the waiter in a restaurant, in advance, that we do not wish to be shown the dessert tray.

Expectations and Experience

Ariely described two theories about the relationship between what we expect and what we experience, and then discussed research that points in the direction of one of the theories. One theory is that we evaluate an experience as a combination of the experience itself and our knowledge about it. For example, if we taste a soft drink and like it and then learn it was Coca-Cola, that new knowledge may cause us to decide we like the beverage even more than we first thought we did. The second theory is that knowledge actually changes the nature of the experience, because our brains program us toward a different experience. Ariely explained: “My tongue is waiting for it to be Coke, and it’s primed to have a fantastic experience, so the experience is better. The actual reality is modified.”

In one experiment, subjects were served two samples of beer and told that they could have a full glass, for free, of the one they liked most. One sample was of a popular beer brand; the other was of the same brand of beer with some balsamic vinegar added. This sample was called “MIT Brew.” About 60 percent of the “blind” tasters, who knew nothing about what they were sampling, preferred the MIT Brew. When they were told the ingredients of that brew, 50 percent still decided to take the full glass of MIT Brew: knowledge *after* the tasting did not substantially change their preferences. In contrast, among those who were told what the two samples contained *before* they tasted them, only 23 percent said they preferred the MIT Brew: knowledge in advance did substantially affect their experience and change their preferences.

Another set of experiments showed how discounting a product reduced its perceived effectiveness. In one, people at a health club were sold energy drinks. Some were sold at full price, while some – exactly the same as the others in all ways except for price – were sold at discounted prices. In interviews and questionnaires after their workouts, the people who had drunk the discounted drinks reported themselves as less energetic and less satisfied with their workouts than those who had drunk the full-price version.

The same result was shown in an experiment involving a placebo drug supposed to reduce pain, with a further twist. Even though they did not actually pay for the drug, those who received information that the drug was expensive reported far better pain relief than those who were told that the drug could be purchased inexpensively. (Ariely also noted that some people in these tests were informed that the drug was developed and produced in China, whereas others believed it had been made in North Carolina. For reasons he has not yet been able to explain experimentally, those who received the placebo supposedly made in China found it more effective for pain relief. That result held true in both categories – for the “high-priced” drug and the “low-priced” one.)

Reputation is also a factor in how experience is perceived. Subjects asked to evaluate a high-end sound system were given a review of the system to read. The identical review was provided, but in some cases subjects were told that it was from *Consumer Reports*, and in the other cases it was said to be from a well-regarded local audio store. Those who were told that the review they read was from *Consumer Reports* liked the sound system more, and bid more for it in a subsequent auction.

A Free Lunch? No, Thanks.

Ariely and his researchers set up a booth in a mall with a big sign, "FREE MONEY." Under that sign a dollar amount was posted. The dollar amount was changed to vary the test: sometimes it read \$50, and sometimes other amounts, down to one dollar. A stack of real money equivalent to what was on the sign was placed on the counter of the booth, and the booth was empty. Practically none of the shoppers in the mall even approached the booth, and of those who did, virtually no one took the money.



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