INTRODUCTION TO BEHAVIOURAL ECONOMICS (EC200)

**Course duration:** 54 hours lecture and class time (Over three weeks)

**Summer School Programme Area:** Economics

**LSE Teaching Department:** Department of Economics

**Lead Faculty:** Dr Matthew Levy and Dr Gianluca Benigno (Dept. of Economics)

**Pre-requisites:** Introductory macroeconomics and microeconomics.

**Aims:**

This course will provide students with a clear introduction to the principles and methods of Behavioural Economics. Behavioural economics considers the ways that people are more social, more impulsive, less adept at using information, and more susceptible to psychological biases than the standard economic models assume. We will explore key departures, and the consequences for individuals, firms, and policy.

- To provide students with an introduction to the principles and methods of Behavioural Economics.
- To provide an overview of how behavioural principles have been applied to economic problems both in microeconomics and macroeconomics.

**Objectives:**

By the end of the course students should be able to:

- Identify and evaluate evidence for systematic departures of economic behaviour from the predictions of the neoclassical model, and psychological explanations for these anomalies.
- Incorporate psychologically motivated assumptions into economic models, and interpret the implications of these assumptions.
- Explain how these models change the predictions for equilibrium behaviour and welfare analysis, and assess the implications for optimal policy.
- Compare the predictions of neoclassical and behavioural models, and evaluate the best method for approaching a given topic.

**Content:**

This course provides an introduction to the foundations of behavioural economics. The focus of the course is on the understanding of the principles behind the behavioural approach in addressing economics problems and on the development of up-to-date analytical tools, drawn from recent research, and their application to a variety of economic situations.

The course will be thematically organized as ‘behavioural macroeconomics’ and ‘behavioural microeconomics’. In the behavioural macro part, there will be an introduction on the rational expectations
framework and then there will be an overview of a variety of applications of behavioural models to finance, labour market, saving choices and monetary policy to address “anomalies”. We also plan to cover models of learning and applications of sunspot theories. Behavioural micro will focus on departures from the assumptions of selfishness, time consistency, rational inference, and strategic sophistication with applications to markets, policy, and strategic settings. Behavioural game theoretic models (e.g. “level-k”) will be introduced (Nash equilibrium not required as a prerequisite).

Assessments:

**Formative assessments**

One problem set for each part of the course (Behavioural Microeconomics and Behavioural Macroeconomics) will be graded. For Behavioural Microeconomics the assessment will be problem set 2 and the feedback will be provided by Monday of week two. For Behavioural Macroeconomics the assessment will be problem set 2 and the feedback will be provided by Monday of week three.

This will not count towards students’ final overall grade, but should provide good preparation for the summative assessments.

**Summative assessments**

**Mid-session examination**

A two-hour mid-session exam (worth 50% of the overall grade) will take place on Tuesday of week two. Results will be released by Monday of week three. The precise time and location of the exam will be circulated during the programme.

**Final examination**

A two-hour final exam (worth 50% of the overall grade) will take place on Friday of week three. Results will be released within a week of the exam. The precise time and location of the exam will be circulated during the programme.

Reading:

One suggested (non-mandatory) textbook for the course is *An Introduction to Behavioural Economics* by Nick Wilkinson and Matthew Klaes. Another good reading is *Animal Spirits* by George Akerlof and Robert Shiller.

Almost all of the journal articles in the reading list can be accessed via the LSE Library electronic journals collection. Hyperlinks are given for working and discussion papers. CC refers to Course Collection.

**General:**

Review:

Please note:
You should not attempt to read everything on the reading list; the supplementary readings are provided for students interested in pursuing a particular topic in more depth or for those seeking an alternative approach. It is not important to read a huge amount, but vastly important to really understand what you do read.

PART I – Behavioural Microeconomics

1. Introduction: what is behavioural economics?
Introduction to the themes and methods of behavioural economics. Anticipation and information avoidance as introductory example.


How to people really make choices when faced with uncertainty? The role of reference-dependent preferences in both risky (loss-aversion) and risk-free (the endowment effect) choices.


3. Social Preferences
How do people care about those around them? Both distributional social preferences (altruism, inequality aversion) and intentions-based social preferences (reciprocity, fairness). The possibility of self-deception.

4. Heuristics and Biases

How do people make predictions about the world around them? The heuristics and biases displayed in judgment and decision-making.


5. State-Dependent Preferences and Mis-Prediction

How do people make predictions about their own future utility? State-dependent preferences (e.g. habit-formation and addiction) and projection bias.


6. Behavioural Game Theory

How do people make predictions about their opponents in strategic interactions? Models of limited social inference (level-k reasoning, cursedness).
7. Nudges, Policy, and Happiness

How and when should governments intervene if people are “behavioural”? The theory of nudges, and happiness as an outcome.


PART II – Behavioural Macroeconomics

8. Background: Rational Expectations and Neo-Classical Synthesis in Macroeconomics

Review of the principles behind rational expectations and its implications for macroeconomics. In particular, we are going to focus on its implications for theory of macroeconomics fluctuations (business cycle), labour market equilibrium (unemployment), the role of monetary policy and the determination of asset prices.


Animal Spirits

9. Animal Spirits

(i) What are animal spirits? (ii) How does Human Psychology drive the economy? We overview five different aspects of animal spirits and how they affect economic decisions.

10. Theory of Economic Fluctuations

Phillips curve and the macroeconomic framework in a low inflation environment. Theory of economic fluctuations based on sunspots.


11. Money Illusion and Monetary Policy

(i) New Keynesian rationalization of price stickiness and its implications for the effectiveness of monetary policy as a stabilization tool.


12. Consumption and Savings behaviour

Why do people save too little? Hyperbolic discount factor and its implication for consumption and saving behaviour.


13. Labour market

The efficiency wage labour market. How does it work and comparison with the neoclassical counterpart.

14. Asset prices and Behavioural Finance


- Pagel, Michaela “Expectations-Based Reference-Dependent Preferences and Asset Pricing”, *Journal of the European Economic Association*.