



Social psychology in Economics

Chapter 6

Learning Objectives

Understand the relationship between economic behaviour and social psychology

Identify social motivations in decision-making

Evaluate the role of moral sentiments and emotions in economic decision-making

Understand how institutions affect behavior

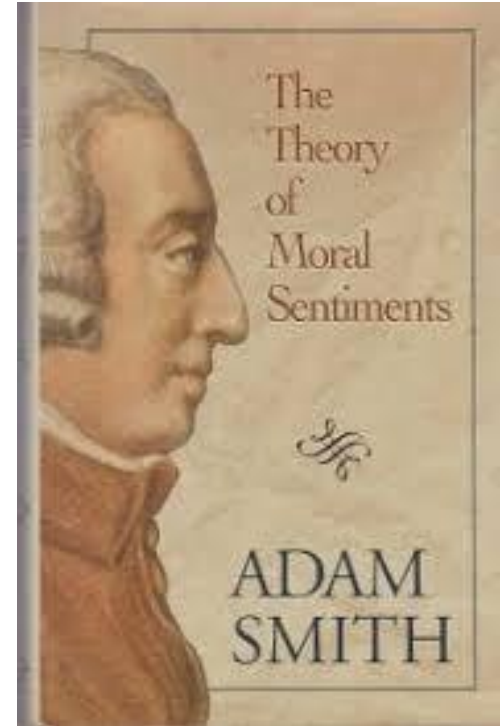
Assess the economics of empathy-induced altruism

Identify biases and blunders

Understand the choice architecture

Social psychology and economics

- Adam Smith's *The Theory of Moral Sentiments* (1759) presents a complex view of human behavior that integrates psychology into economics.
- Smith highlighted psychological elements such as loss aversion, willpower, and fairness.
- He proposed that behavior results from a struggle between two forces:
 - **Passions** – basic drives and desires.
 - **The impartial spectator** – an internal moral mechanism that helps individuals judge their own actions objectively.
- This view suggests that economic decisions are influenced by both **emotion and moral reasoning**, not just rational self-interest.
- Smith's framework anticipates a dual-process model of behavior, blending emotional impulses with rational self-control.



Social psychology and economics

Implications:

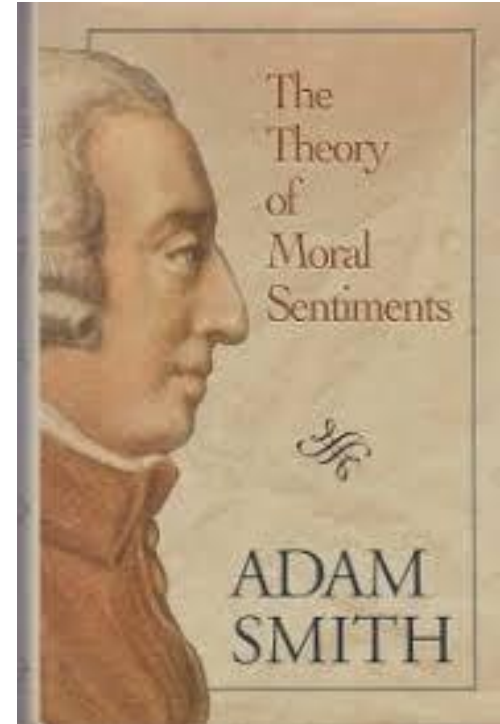
Rationality is Limited: Economic decisions are not purely rational; they are shaped by emotions, desires, and moral considerations.

Moral and Social Constraints: People do not act solely based on self-interest; they are also influenced by social norms, ethics, and their concern for how others perceive them.

Behavioral Economics Connection: This aligns with modern behavioral economics, which challenges the idea that individuals always make rational choices and highlights the role of psychological and social factors in decision-making.

Adam Smith's Theory of Moral Sentiments: This concept originates from Adam Smith, who, in *The Theory of Moral Sentiments*, argued that individuals have an innate ability to judge their own actions, often restraining selfish impulses to maintain social harmony.

Economic behavior is not purely mechanical or self-serving but is deeply embedded in human psychology and social context.



Is your choice rational?



BDT 100



BDT 150

Is your choice rational?



Social psychology and economics

- In the **1960s and 1970s**, economists realized that purely rational social interactions were unrealistic.
- Traditional economic theories failed to accurately predict or explain real human behavior (Thaler, 2000).
- To better understand economic behavior, theories needed to include **emotions, motivations, cognitions**, and the **social context** of interactions.
- **Herbert Simon's (1957) model of bounded rationality** emphasized that people's decisions are limited by cognitive constraints and that self-interest alone cannot fully explain behavior.



Social psychology and economics

Imagine a **voter** deciding which candidate to support in an election.

- There are many parties, policies, and candidates, each with complex positions on economic, social, and foreign issues.
- Instead of carefully analyzing all political platforms and policy details, the voter:
 - Chooses a candidate based on **party loyalty** or **family tradition**.
 - Votes for the person who **appears trustworthy or charismatic** in the media.
 - Relies on **simple cues**—such as slogans, endorsements, or popular opinion—rather than detailed research.

Why this shows bounded rationality:

The voter faces limited time, information, and cognitive capacity, making it impossible to fully evaluate all political options.

Thus, they make a “good enough” decision based on shortcuts and heuristics instead of perfectly rational analysis—illustrating Herbert Simon’s concept of bounded rationality in political behavior.



Utility and psychology of preference

Think about the ordinal utility theory:

Coffee (utility 20) > Tea (utility 10).

Preferences cause the numbers that are assigned to them, not vice versa. Although it is tempting to claim that coffee was chosen over tea because coffee had a greater utility than tea.

It is because coffee was chosen over tea that we infer that its utility was higher. **The utility did not cause the choice.**



Utility and psychology of preference

Suppose you have three favorite songs:

Song A – a slow romantic

Song B – an upbeat pop

Song C – a calm acoustic

According to **utility theory**, you might think your ranking is: **Song A > Song B > Song C**, so by **transitivity**, Song A should also be preferred over Song C.

But in real life, your choices depend on the situation:

- **When you're relaxing at night**, you prefer the **romantic (Song A)** over the pop song → **A > B**
- **When you're working or travelling**, you prefer the **pop song (Song B)** over the acoustic one → **B > C**
- **When you're stressed and want calm music**, you prefer the **acoustic song (Song C)** over slow romantic → **C > A**

This creates a cycle: **A > B, B > C, but C > A.**

Does transitivity work? These preferences are completely intransitive, and it is impossible to assign numbers to the items.

Utility and psychology of preference

- **Preferences and judgments are relative**, not absolute; people evaluate situations in comparison to something else.
- **Individuals compare their outcomes to others**, to their own past experiences, or to preset goals.
- Thibaut and Kelley introduced the idea of a **Comparison Level (CL)**.
- The CL is a hedonic neutral point—a **baseline against which people judge whether an outcome feels good or bad**.
- Outcomes **above the CL** are experienced as **positive**; outcomes **below the CL** are experienced as **negative**.
- The same outcome can be viewed as positive or negative depending on where the CL is set.
- Concepts like **worth, value, goodness, and utility are not inherent in objects or actions**—they depend on how those attributes compare to the CL.
- The comparison level aligns with other relativistic preference theories, such as adaptation level and level of aspiration.

Utility and psychology of preference

Imagine two employees, **Tabana and Tulip**, both earning **\$50,000 per year**.

Tabana's Comparison Level (CL) is High	Tulip's Comparison Level (CL) is Low
• Tabana previously worked at a company where she earned \$70,000 per year. • Many of her friends earn \$80,000 in similar roles. • Result: She perceives her current salary as low and feels dissatisfied.	• Tulip previously earned \$40,000 per year. • Her peers earn around \$45,000. • Result: She sees her current salary as high and feels satisfied.

Adaptation Level: Over time, people adjust their expectations. If Tabana stays at \$50,000 for years, she may adapt and feel less dissatisfied.

Aspirations Level: If Tulip starts aiming for a six-figure salary, her **comparison level** may rise, leading to reduced satisfaction.

Value, worth, and utility are not absolute—they depend on expectations, experiences, and social comparisons.

Utility and psychology of preference

A branded jacket costs \$100.

Case A: Positive (Below CL)

Shopper expected to spend \$150 for this brand.
\$100 feels like a great deal.

When the actual price is **below** this neutral point (CL) → **satisfaction**.

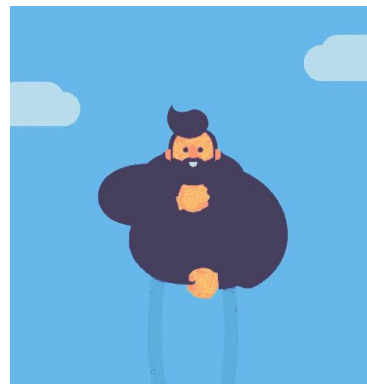
Case B: Negative (Above CL)

Shopper's friends bought the same jacket for \$70 last week. Now \$100 feels too expensive.

When the actual price is **above** this neutral point → **dissatisfaction**.

The jacket's price does not have inherent value—its evaluation depends entirely on the standard the shopper uses to judge it.

Positive or negative experiences depend on the CL, not the actual attribute of the object.



Prospect theory of Kahneman and Tversky (1979)

Prospect Theory formalized three major insights:

Insight 1: Value is Based on a Reference Point. People experience value as the comparison of an object to some standard, which could be the status quo, for instance. People evaluate outcomes as changes from a baseline (status quo), not absolute end states. This challenged traditional economic assumptions. **Economics vs. Psychology:** Traditional economic models assume people only care about **final wealth levels**, but **prospect theory** shows that people evaluate outcomes **relative to their expectations and past states**. Imagine **two investors, Jerry and Jamie**, who both started with **\$10,000** in investments.

Jerry's Outcome:

- Jerry's portfolio grew from **\$10,000 to \$15,000** (+\$5,000 gain).
- **Comparison Standard (Status Quo):** The starting amount (\$10,000).
- **Emotional Reaction:** Jerry feels **happy** about the gain.

Jamie's Outcome:

- Jamie's portfolio was at **\$20,000** but dropped to **\$15,000** (-\$5,000 loss).
- **Comparison Standard (Status Quo):** The previous high of \$20,000.
- **Emotional Reaction:** Jamie feels **disappointed**, even though they still have \$15,000—the same as Jerry.

Prospect theory of Kahneman and Tversky (1979)

Prospect Theory formalized three major insights:

Insight 2: People are more sensitive to changes that are below the standard than to those above the standard. This is the idea that losses loom larger than gains. Both losses and gains must be specified with regard to some baseline or standard. This notion has been called the differential slope hypothesis. People evaluate outcomes relative to a baseline and feel **more sensitive to losses than equivalent gains**, supporting **prospect theory** and the **differential slope hypothesis**. Imagine a company offering **yearly bonuses** to its employees based on performance: The bonus amount is not judged **absolutely**; employees compare it to **last year's standard (\$5,000)**.

Employee A (Gain Above the Standard):

- Last year's bonus: **\$5,000**
- This year's bonus: **\$6,000 (+\$1,000 gain)**
- **Reaction:** Employee A is **happy**, but the extra \$1,000 doesn't drastically increase satisfaction.

Employee B (Loss Below the Standard):

- Last year's bonus: **\$5,000**
- This year's bonus: **\$4,000 (-\$1,000 loss)**
- **Reaction:** Employee B is **much more upset** about losing \$1,000 than Employee A is happy about gaining \$1,000.

Prospect theory of Kahneman and Tversky (1979)

Prospect Theory formalized three major insights:

Insight 3: This notion is called "**decreasing marginal utility**" or "**decreasing sensitivity.**" As wealth (or gains/losses) increases, additional amounts feel **less significant**. People do not perceive gains and losses in a **straight-line** manner—**smaller changes near a reference point feel more impactful** than larger changes far away from it. Imagine you find **money on the street**: The **first \$10** has a much larger impact than gaining **an additional \$10** when you already have \$10,000.

Finding \$10 vs. \$0 (Small Change Near the Standard)

- If you had **\$0** and suddenly find **\$10**, you feel a **strong emotional boost**.
- The change from **\$0 to \$10** is highly noticeable and meaningful.

Finding \$10 vs. Having \$10,000 (Large Change, Far from the Standard)

- If you already have **\$10,000** and find **an extra \$10**, the emotional impact is **much smaller**.
- The change from **\$10,000 to \$10,010** is hardly noticeable.

Motivations in social decision-making

How individuals make sense of their social environment:

What types of information are they looking for?

How much information do people need before making a strategic decision?

How thoroughly does new information that becomes available during interaction get processed and integrated into existing knowledge structures?

Are there any differences between individuals and across situations in how (much) information is processed and worked into a strategic decision?

How does all this influence the nature of the strategic interaction and the quality of the agreements people reach?

Motivations in social decision-making

Both within economics and social psychology, it has been argued indeed that **any social system, however basic and simple, involves cooperative as well as competitive incentives.**

Cooperative incentives steer people toward **collaboration and joint success.**

Competitive incentives, in contrast, lead one to strive for **power and personal success.**

Social situations people face and manage are fuzzy, ambiguous, and messy:

- People do not have a full and accurate insight into the structure of the social situation.
- They lack information about their partner's utility functions in that they do not know what is and what is not important to their partner.
- They do not know the amount of gain or loss their partner faces on specific issues.
- They do not know what goals their partner strives for.
- People have many good reasons to doubt the accuracy and trustworthiness of information about their partner's utility functions.

Motivations in social decision-making

- **The Motivated Information-Processing Model explains how individuals make strategic choices when clear anchors or reference points are absent.**
- In such situations, people must infer or construct their own standards, anchors, or reference points.
- When the environment provides full information, low uncertainty, or low complexity, the model's predictions are similar to standard expected utility theory.
- The model becomes most **relevant in conditions of incomplete information, ambiguity, or uncertainty.**
- Designed specifically to **explain how people make decisions in mixed-motive interdependence—situations involving both cooperation and competition (e.g., negotiation).**
- Shows how negotiators use motivated reasoning, selective attention, and strategic interpretation of information to reduce uncertainty.
- Emphasizes that people's judgments and strategies depend on how they process information, not just on objective payoffs.
- Helps **predict biases, misperceptions, and strategic adjustments** in negotiation when information is unclear or inconsistent.

Motivations in social decision-making

Context: A retailer is negotiating a supply contract with a new manufacturer.

Incomplete Information:

- Retailer doesn't know the manufacturer's minimum acceptable price.
- Manufacturer doesn't know the retailer's budget or willingness to commit to volume.

Constructing Reference Points:

- Retailer estimates manufacturer's costs/margin.
- Manufacturer estimates retailer's budget/order size.

Strategic Information Processing:

- Manufacturer emphasizes quality/timely delivery to justify higher price.
- Retailer emphasizes large orders/long-term partnership to justify lower price.

Managing Uncertainty:

- Initial offers and counteroffers used to **infer the other party's limits**.
- Both parties adjust strategies based on partial information received.

Outcome: With incomplete info → final deal shaped by **perceptions, inferred reference points, and strategic processing**.

Motivations in social decision-making: *Diplomatic negotiations*

- In the 2025 Bangladesh–US trade negotiations, Bangladesh faced **incomplete information and high uncertainty**—unclear US red lines, geopolitical expectations (e.g., reducing reliance on China), and tariff pressures created a complex, high-stakes environment.
- Bangladesh strategically inferred the US reference points, prioritized concessions, and crafted trade-offs—such as boosting US imports (Bangladesh signed a MoU to import **700,000 tonnes wheat annually over five years**) and agreeing to high-profile purchases (Bangladesh committed to purchasing **25 Boeing aircraft**)—to reduce uncertainty and protect its export sector.
- The process illustrates how negotiators **construct reference points, process partial information, and make strategic choices** under uncertainty, rather than relying solely on objective payoffs.



Information processing and decision-making

The motivated information-processing model assumes that **two basic classes of motivation** are critical in the process.

- The first class is referred to as **social motivation** and broadly distinguishes between **proself** and **prosocial motivation**. **Proself motivation** reflects low other-regarding preferences, whereas **prosocial motivation** reflects high other-regarding preferences. Proself versus prosocial motivation in social decision making determines the types of information people attend to and the cooperativeness of their strategic choices.

Proself motivation	Prosocial motivation
An employee takes credit for a team project to get a promotion, even though it disadvantages colleagues.	Sharing credit and bonuses fairly among team members to encourage cooperation.
A company exploits loopholes in a contract to maximize profit, ignoring fairness to partners.	Offering fair terms to a partner to build long-term trust and mutually beneficial outcomes.
Cutting in line to save time, without concern for others waiting.	A person lets someone with fewer items go ahead in the checkout line out of kindness.

Information processing and decision-making

The **motivated information-processing model** assumes that **two basic classes of motivation** are critical in the process.

- The second class is referred to as **epistemic motivation that refers to a person's desire to seek, process, and understand information and ranges from low to high. Higher epistemic motivation** produces more thorough and systematic search for and processing of information. **Social and epistemic motivation** are assumed to be independent- being prosocial or proself says nothing about one's level of epistemic motivation and vice versa-but they conspire to produce information-processing tendencies and strategic choices.

High epistemic motivation	Low epistemic motivation
An employee researches multiple strategies and potential outcomes before deciding on a project approach.	An employee accepts a project assignment without researching the requirements or risks.
A negotiator carefully reviews market data, past contracts, and possible concessions before making an offer.	A negotiator quickly agrees to a deal without analyzing the fine print or long-term implications.
Comparing multiple travel options, reviews, and prices before booking a flight.	Choosing a restaurant based on the first online review rather than checking multiple sources.

Dealing With Information

How can a situation be transformed if the situation is unknown, when individuals lack important insights, and when certain features of the situation are uncertain at best?

- First,, search for and process information consistent with their goals that is, with their prosocial or proself motivation.
- Second, in searching and processing information, people can choose between **two basic strategies for searching and processing additional, new information.**

The first strategy (shallow processing/low epistemic motivation) is to solve logical problems, evaluate persuasive arguments, and form impressions of their counterpart through a quick, effortless, and heuristic processing of information that **rests on well-learned prior associations.**

The alternative strategy (deep processing/high epistemic motivation) is to engage in more effortful, deliberate, and systematic processing that **involves rule-based inferences.**

Whether people engage in shallow or deep processing of information depends on their epistemic motivation-that is, their desire to develop and hold accurate and well-informed conclusions about the world. **The higher a person's epistemic motivation, the more likely it is that he or she will engage in deep, deliberate, and effortful processing of information.**

Regulatory fit to create value

Its market price

The material (gold? silver?)

How much someone would pay for it

Its resale value in the antique market

Traditional (economics) view

If the market price is \$50, then its “value” = \$50. “How much money is it worth?”

A reminder of her love (beliefs)

A symbol of family history (meaning)

A trigger for nostalgic memories (emotion)

Something that represents identity or belonging (hedonic)

Psychological view

Even if it is rusty and worth \$50, you might never sell it. “How much does it mean to you?”



Grandma's watch

Regulatory fit to create value

Value = strength of the motivational force (attraction/repulsion)

A **strong attraction** to keep it

A **strong resistance** to giving it away

Engagement **intensifies** its value beyond pleasure or belief

You handle it carefully

You focus on its details

You think about Grandma's stories when you look at it

You store it securely and check on it

Regulatory Fit (a key source of engagement): Keeping the watch "fits" your motivational style

If you are prevention-focused → it helps you feel responsible and loyal

If you are promotion-focused → it helps you feel inspired or connected to your identity

Higgin's view: value derives not only from the experience of pain and pleasure, but also from the experience of strength of engagement

"I feel a strong pull toward it — it engages me, fits my motivations, and creates a powerful force of value."



Regulatory fit to create value

Regulatory fit theory concerns the manner in which a goal is pursued, and it emphasizes value from process rather than value from outcomes.

Regulatory fit consists of something that is adaptive by supplying what is needed to carry on and feeling right about something.

Value from regulatory fit derives from the relation between the manner of goal pursuit and the current self-regulatory orientation of the person pursuing the goal. **What matters for value from fit is whether individuals' manner of goal pursuit sustains their own current self-regulatory orientation.**

Regulatory fit theory provides evidence that fit is a source of engagement strength that can change the value of a target independent of current or prospective hedonic pleasure/pain experiences.

Regulatory fit is a psychological principle that occurs when a person's **motivational orientation (promotion-focused or prevention-focused)** aligns with the way a decision or action is framed. **When there is fit, people feel more engaged, confident, and satisfied, which enhances the perceived value of their choices or experiences.**

Regulatory fit to create value

Imagine a university launches an **online learning platform** with video lectures, quizzes, and study tools. The platform itself never changes — only the message does. Different students perceive **different value** depending on their motivational orientation.

Promotion-Focused student— aspirations, advancement, growth

- “Learn new skills that help you excel. Get ahead of your classmates. Boost your career opportunities.” (marketing message)
- **Student reaction:** *“This platform will help me stand out and reach my goals.”*
- Regulatory fit: Encourages **eager strategies** (trying new modules, exploring extra content)

Prevention-Focused student— obligation, safety, academic responsibility.

- “Stay on track to avoid falling behind. Ensure you meet deadlines. Strengthen your weak areas and prevent mistakes.” (marketing message)
- **Student reaction:** *“This platform helps me stay disciplined and avoid missing work.”*
- Regulatory fit: Encourages **vigilant strategies** (staying consistent, preventing errors)

Role of moral sentiment in economic decision-making

Historical vs. Contemporary Focus

- Smith and contemporaries: Focused on moral implications of behavior, not just economic outcomes.
- Contemporary economists and psychologists: Focus on whether judgment and decision-making align with normative standards of sound economic reasoning.

Moral Judgments and Emotional Reactions

- Deviations from normative economic reasoning are often seen as illogical.
- Such deviations frequently trigger moral disapproval and strong emotional reactions

Emotions in Economic Decisions

- **Why emotions arise:**
 - Purely economic decisions can provoke strong feelings because people perceive violations of fairness, honesty, or social norms.
- **Why emotions may override self-interest:**
 - Individuals sometimes pursue strategies not in their immediate material self-interest due to moral or emotional motivations.

Role of moral sentiment in economic decision-making

Moral Reasoning and Rationality

- Acting in a morally acceptable manner = deliberate, conscious, rational moral reasoning.
- Falling short of rational/moral standards = seen as influenced by disruptive moral sentiments.

Functions of Emotions

- Emotion researchers conceptualize passions and sentiments in terms of:
 - **Intrapersonal functions:** regulating one's own behavior, guiding personal decision-making
 - **Interpersonal functions:** influencing or communicating with others, enforcing social norms

Emotion theorists have identified at least **two important clusters of moral sentiments:**

(a) self-focused sentiments such as shame, embarrassment, regret, and guilt: Self-focused emotions emphasize an evaluation of the appropriateness of one's own behavior

(b) other-focused sentiments such as contempt, anger, disgust, and schadenfreude: other-focused emotions tend to direct one's attention to the appropriateness of others' behavior.

Role of moral sentiment in economic decision-making

Self-Focused Sentiments

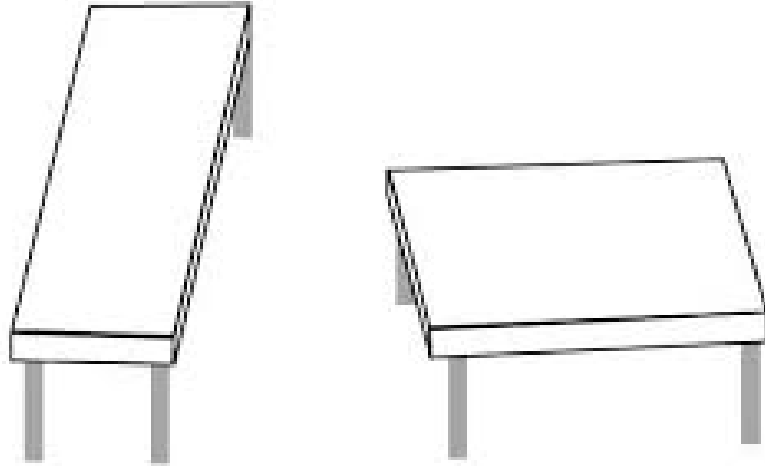
Emotion	Example Scenario
Shame	You miss an important work deadline and feel ashamed for letting your team down.
Embarrassment	You give a wrong answer in class and blush in front of peers.
Regret	You sell stocks too early and later see their value skyrocket.
Guilt	You lie to a friend and later feel guilty for betraying their trust.

Role of moral sentiment in economic decision-making

Other-Focused Sentiments

Emotion	Example Scenario
Contempt	You see a colleague consistently taking credit for others' work.
Anger	Someone cuts in line at the grocery store, provoking your anger.
Disgust	Witnessing someone cheat on a test in front of the class.
Schadenfreude	You secretly feel pleasure when a rival who was arrogant fails a task.

Biases and blunders

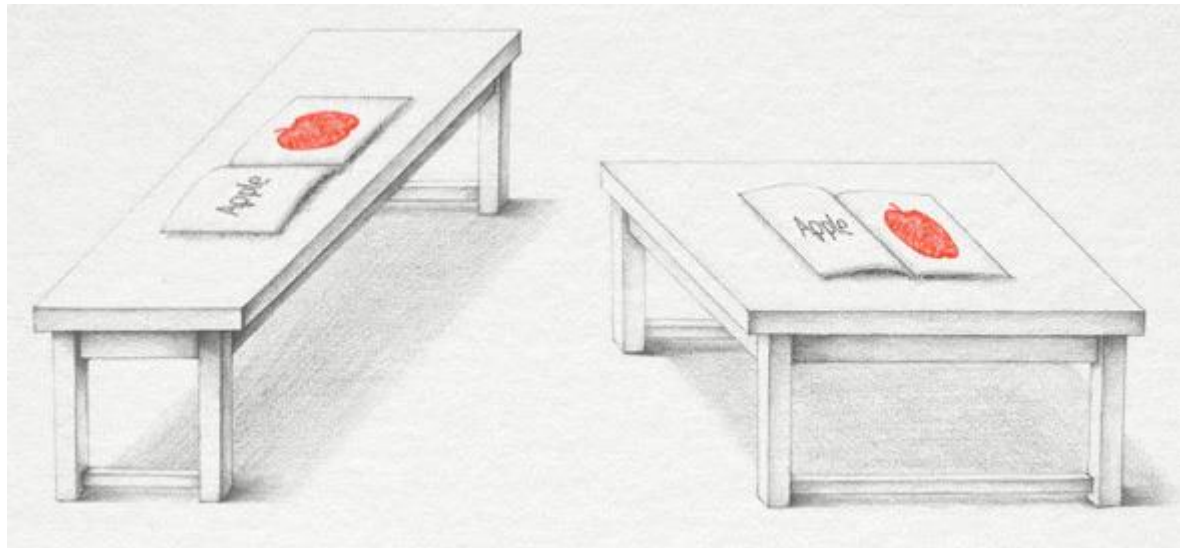


Suppose that you are thinking about which one would work better as a coffee table in your living room.

What would you say are the dimensions of the two tables? Take a guess at the ratio of the length to the width of each.

Do you think that the table on the left is much longer and narrower than the one on the right.

Biases and blunders



Biases and blunders

How do people think?

There are systematic biases in our thinking. Two kinds of thinking, one that is intuitive and automatic, and another that is reflective and rational.

The Automatic System is rapid and is or feels instinctive, and it does not involve what we usually associate with the word thinking. The Reflective System is more deliberate and self-conscious.

Tversky and Kahneman (1974), identified three heuristics, or rules of thumb—anchoring, availability, and representativeness—and the biases that are associated with each.

Two cognitive systems

<i>Automatic System</i>	<i>Reflective System</i>
Uncontrolled	Controlled
Effortless	Effortful
Associative	Deductive
Fast	Slow
Unconscious	Self-aware
Skilled	Rule-following

Choice architecture

Choice architecture refers to the design of environments in which people make decisions, specifically how the way choices are presented can influence decision-making. It involves structuring options in a way that encourages people to make certain choices, without restricting their freedom to choose. The idea is based on behavioral science, which suggests that the way choices are framed, organized, or made more accessible can nudge people toward more beneficial or desired behaviors.

If you indirectly influence the choices other people make, you are a choice architect. And since the choices you are influencing are going to be made by Humans, you will want your architecture to reflect a good understanding of how humans behave.

Basic principles of good (and bad) choice architecture:

- Defaults: Padding the Path of Least Resistance
- Expect Error: well-designed system expects its users to err and is as forgiving as possible
- Give Feedback: Well-designed systems tell people when they are doing well and when they are making mistakes
- Understanding “Mappings”: From Choice to Welfare: map and hence select options that will make them better off.
- Structure Complex Choices: adopt different strategies for making choices depending on the size and complexity of the available options
- Incentives

Choice architecture

Scenario: A university cafeteria wants students to eat healthier without restricting their freedom of choice.

Choice Architecture:

- **Defaults:** Place fruits, salads, and water at eye level; unhealthy snacks are less prominent.
- **Expect Error:** Cafeteria design forgives errors and guides students toward healthy options by labelling each food with nutrition info.
- **Feedback:** Digital display shows calories saved or nutrients consumed when a healthy meal is chosen
- **Understanding mapping:** Label meals with nutritional benefits (e.g., “High in protein, supports energy”). So, students understand how their choice affects their well-being.
- **Structure complex choices:** Organize meals into categories (e.g., “Low-calorie,” “Protein-rich,” “Vegetarian”). Simplifies decision-making, especially when options are numerous.
- **Incentives:** Offer a discount or loyalty points for choosing healthy meals

How the Incentive Works:

- Students are nudged toward healthier options because they gain rewards or discounts
- The reward increases the perceived value of choosing healthy foods
- Healthy eating becomes easier, more attractive, and more habitual

