

# *Behavioral Economics Series*

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## An Introduction to Behavioral Economics

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## Abstract

People behave in all kinds of ways, often in ways that either don't seem to make sense, or don't seem to be in their long-term best interest. And the question is how do we align those things?

The standard solution is to give people information and say if people knew what the right thing is, they would do it. But we know that's not the case: Financial euphoria, Texting and Driving, Overeating, Overspending, you name it...

What I want to present to you here today is a framework of how to understand some of the barriers that people have for performing in the way that it is in their long-term best interest.

Once we understand those barriers, we can build a mechanism. We can say, much like if we're building a bridge, we need to understand the terrain and what's going on. We can't just tell people go over the air – we need to understand exactly what's missing, and the same thing goes for changing Human Behavior.

**KEYWORDS:** behavioral economics, decision analysis, behavioral finance, placebo effect, power of price, expectation effect, overconfidence, relativity, loss aversion, anchoring.

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\*I thank Dan Ariely and the Center for Advanced Hindsight for their support and helpful comments.

I want to thank Dr. Stephen E. Armah for inviting me to give this talk at AELS today and to all of you for showing up.

Many of you are probably wondering, what is the significance of the subject at hand? Just in the little time that I have observed the capital market, I have experienced the fall and rise of Apple, the obliteration of Lotus, the dotcom crash, the MCI-Worldcom collapse, the sundown of Sun Microsystems, the rise of Amazon and Google, boom to gloom in Dubai, the financial crisis of 2008, let's not forget Greece, to name a few...

I always thought of myself as better looking than average. I thought I was a better driver than average until I had to think back at the three road tests I failed before finally getting my driver's license. Did you know that per Progressive Insurance, ninety-three percent of people think they are above average drivers? How many here are above average drivers?

You know, people behave in all kinds of ways, often in ways that either don't seem to make sense, or don't seem to be in their long-term best interest. And the question is how do we align those things?

The standard solution is to give people information and say if people knew what the right thing is, they would do it. But we know that's not the case: Financial euphoria, Texting and Driving, Overeating, Overspending, you name it...

What I want to present to you here today is a framework of how to understand some of the barriers that people have for performing in the way that it is in their long-term best interest.

Once we understand those barriers, we can build a mechanism. We can say, much like if we're building a bridge, we need to understand the terrain and what's going on. We can't just tell people go over the air – we need to understand exactly what's missing, and the same thing goes for changing Human Behavior.

### **What is behavioral economics?**

"In standard economics, we make assumptions about how people behave: people are rational; they compute everything; they always work in their best self-interest. Starting from that perspective, you make conclusions about how people would behave and how institutions should be built and so on.

In behavioral economics, we have no assumptions about how people behave. Instead, we put people in different situations and observe how they behave. We often find that they don't behave as you would expect, and they don't behave rationally." (Faith & Leadership, 2010)

Earlier this year at the Berkshire Hathaway Annual Meeting, Charlie Munger (Vice Chairman) in the Q&A says: "I think we have one other advantage, a lot of other people are trying to be brilliant and we're just trying to stay rational... and... It's a big advantage!"

If there's one thing that I'd like you to take from this talk is that being rational takes conscious effort.

"Since biases are inherently unintentional and unconscious, attempts to deter people from its influence are doomed to failure." (Lowenstein & Bazerman, 2001).

Let's start putting this framework together:

**Placebo Effect and The Power of Price** (Ariely, When Expectations Override our Senses: Dan Ariely at TEDxTunali, 2013)

The very first experiment I'd like to begin with is one that a very attractive rep from Veladone – RX (a hypothetical company) tries to recruit students at a university campus. The participants are asked to help the company determine the potency of this pain killer drug for a little fee that the hypothetical drug company is willing to pay. In the worksheet, the participants are given, it clearly states if the participants will be taking the full priced (expensive \$2.50/pill) version of the drug or the discounted version (cheap 10 cents/pill), also on the worksheet is clearly stated the country of origin of the pill - either US or China.

Does a discounted 10-cent pain killer work as well as the fully priced \$2.50 pill? Participants were twice as likely to stand the pain with the more expensive placebo than the discounted placebo. Yes, both pills were placebo filled with vitamin C.

### **Expectation Effect**

The Muddy Charles is one of two pubs at MIT. Here the researchers approached students at the pub and offered samples of beers and offered a FREE full glass of the choice the participant

liked better. There were two samples, MIT Brew and a commercial beer. In the blind test, most participants chose the MIT Brew over the commercial beer (usually a Budweiser or Sam Adams). When told that the beer they are enjoying is laced with balsamic vinegar (2 drops per ounce of beer), participants were surprised that they enjoyed the MIT Brew more than the commercial brew.

In other experiments when the participants were told beforehand that the MIT Brew is beer laced with balsamic vinegar, they wrinkled their noses and chose the commercial brew.

What do these experiments tell us? These experiments tell us that our expectations change our decisions. The way we anticipate something changes the way we perceive it and experience it. Our brain works to influence our perception. Our preconceived notions color the world around us.

### Relativity

We do not evaluate things in absolute terms. Size May Influence Intake – In the Bottomless Soup Bowl (Wansink, Painter, & North, 2005) experiment, restaurant guests enjoying delicious hot soup used visual cues to monitor how much they're consuming. The self-refilling soup bowls contraption could increase intake but not the perception of intake although on average the participants consumed 73% more.

Economist Pricing Page – Here the students in a classroom were offered a subscription to the Online version of the "The Economist" for \$59 or Print-Only subscription at \$125 or the Print & Web subscription (Combo Deal) for \$125. The Print-Only subscription is similar option but inferior option obviously, 84% of participants went for the \$125 Print & Web (Combo Deal) option, and ONLY 16% went for the cheaper Online subscription. None of the participants took the Print-Only option (0%). The introduction of the inferior choice - although useless since no one chose it - was enormous in how it affected the participants' behavior.

Another set of students in a classroom were offered a subscription to the Online version of the "The Economist" for \$59 or the Print & Web subscription for \$125. In this scenario, 68% of the participants chose the less expensive Online version and 32% chose the more expensive Print & Web.

When given the choice between a surgery with a 10% mortality rate or a 90% success rate, people are more likely to choose the success rate.

### Loss Aversion

- Endowment Effect (Carmon & Ariely, 2000) –

A group of participants in an experiment were given a mug and the rest of the participants were not. Those that had mugs required approximately twice as much as the buyers were willing to pay. The gap between selling and buying is a manifestation of loss aversion.

Participants in an experiment were asked to bid on a box. Half of them had assembled this plain black box, the other half were handed the box already assembled. On average those who had built the box were willing to pay 62.5% more for it (Norton, Mochon, & Ariely, 2011).

- Ikea Effect –

In the 1950s American housewives were initially resistant to instant cake mixes that attempted to make baking cakes very easy, making their labor and skill seem undervalued. Manufacturers had to change the recipe to require adding at least the egg, "infusing the task with labor appeared to be a crucial ingredient."

Arbitrary Coherence & Anchoring (Ariely, Predictably Irrational, 2008) Researchers Drazen Prelec, George Loewenstein, and Dan Ariely held up some random items in a classroom. A cordless trackball, a cordless keyboard and mouse, a design book, box of Belgian chocolates, and a bottle of wine. The researchers described each item in detail to the students. The students were handed a printout with the list of these items. Students were asked to write their last two digits of their SSN at the top of the paper. Then students were then asked to write these last two digits of their SSN as if it were a price next to each item. The students were asked to bid for each of the items. When asked if the last two digits of their SSN had influenced their bid by any chance, they replied: No Way!

Social security numbers were the anchor in this experiment only because Dan requested them. He could have just as well asked for the current temperature or any other number. Any question, in fact, would have created the anchor. Does that seem rational? Of course, not. Here's a summary of the results:

- Last two digits of SSN 80 to 99 bid the highest
- Last two digits of SSN 1 to 20 bid the lowest
- Top 20% avg. \$56
- Bottom 20% avg. \$16
- A difference of 216% to 346%

### Overconfidence

There's this comedy radio show "Prairie Home Companion" by Garrison Keillor on NPR in the US that talks about this apocryphal town called, Lake Wobegon. There's a segment called "News from Lake Wobegon" that always made me laugh after the host gives the news. It goes like this: "That's the news from Lake Wobegon, where all the women are strong, all the men are good-looking, and all the children are above average."

"What would I eliminate if I had a magic wand? Overconfidence" (Kahneman, 2015)

"Write down 10 traits [such as 'investment skill' or 'ability to make good stock picks'], then ask yourself how you rate compared to your co-workers. If you rate yourself above average on all of them, plead guilty," he says. [Book NUDGE]

When individuals are assessing quantities about which they know very little, they are too confident of their knowledge (Alpert and Raiffa, 1982).

Zeckhauser, in his article Investing in the Unknown and Unknowable, clearly explains what to do with this exercise (see Appendix A). "For each of the unknown quantities, such as the area of Finland, you are asked to provide your median estimate, then your 25th and 75th percentile estimates (i.e., it is one quarter likely the true value will be more extreme than either of the two), and then your 1st and 99th percentiles, what are referred to as surprise points. In theory, an individual should have estimates outside her surprise points about 2% of the time."

In fact, even if warned about overconfidence, individuals are surprised about 35% of the time. Quite simply, individuals think they know much more about unknowable quantities than they do. And I also failed with flying colors – I was overconfident.

Step 1: Estimate the Median

Step 2: Estimate the ¼ likely more extreme than either of the two

Step 3: Estimate Surprise points – about 2% of the time

He continues: "If you are overconfident of your knowledge, you will fall prey to poor investments in the UU world. Indeed, they are green plants in the elaborate ecosystem of finance where there are few lions, like Bill Miller and Warren Buffett; many gazelles, like you and me; and vast acres of grass ultimately nourishing us all."

### Hyperbolic Discounting

Would you prefer half a box of chocolate today versus a big box of chocolate in a week? Most people take half a box of chocolate today. When asked would you take half a box of chocolate in year versus a full box of chocolate in a year plus a week? Most people say we'll take the full box of chocolate in a year and week. In the future, we're smarter, wiser, healthier, and happier.

- We overemphasize the present over the long term. The Basic Human Dilemma (Ariely, Predictably Irrational, 2008)

- o Should we diet now? Not good for now, but good for the future
- o Should we exercise now? Not fun now, but good for the future.
- o Should we save now? Not fun now, but good for the future.
- o Should we check our text message while driving? Good for now, and very, very bad for the immediate future.

- Present events are weighted more heavily than future ones. In the personal example of Dan Ariely, he had contracted Hepatitis-C. There was a new drug – Interferon – that had the chance of curing this disease. He had to inject himself 3 times a week. It had miserable side effects. To overcome the heavily weighted uncomfortable side-effects and to preserve his liver in the future. Dan rewarded himself with a movie immediately after he injected himself. He could save his liver not because he loved his liver more than anyone else, but by intervening against his present self to save his future self.

To amplify existing benefits, we can use our behavioral tools like social proof and loss aversion to enable us to behave in the best interest of future selves.

Path of Least Resistance

Organ Donations & Defaults

DMV forms designers inadvertently affect our behavior. Countries with a check box to opt-in for organ donation, end up with less participation since we do not check the box and automatically end up not participating.

Countries with opt-out check boxes get the opposite results. Here participants do not check the box and automatically enroll into the organ donation program.

Ego Depletion (Ariely, Understanding Ego Depletion, 2012)

Would you be more likely to eat half a pizza at the end of a hectic work week, or on a Monday after a restful weekend? We tend to give in to temptations if part of our brain responsible for thinking is exhausted. [Baba Shiv]

### Pricing

#### Decoy Effect or the Asymmetric Dominance Effect

Would you prefer a paid vacation in Rome or a paid vacation in Paris? Based on your preference for culture and language, you would choose your favorite vacation spot and what you'd enjoy most.

But experiments show that we are influenced in our decision-making if a third option was presented that is like one of the options but clearly inferior. So, if I added paid vacation in Rome but without coffee, the Rome with coffee looks better in comparison. Most participants end up choosing Rome and forgetting about the Paris choice.

#### Incentives

##### Intrinsic vs Extrinsic Motivation

Tangible rewards can trump monetary rewards. Students asked to arrange books at a library were more productive if they were given a \$7 thermos than those that were given \$7 cash.

Offering people \$7 to donate blood decreases blood donation.

##### Goal Gradient Effect

A 12-space coffee card pre-stamped twice will be completed faster than a 10-space coffee card with no stamps.

#### Emotions

##### Hot state vs. cold state

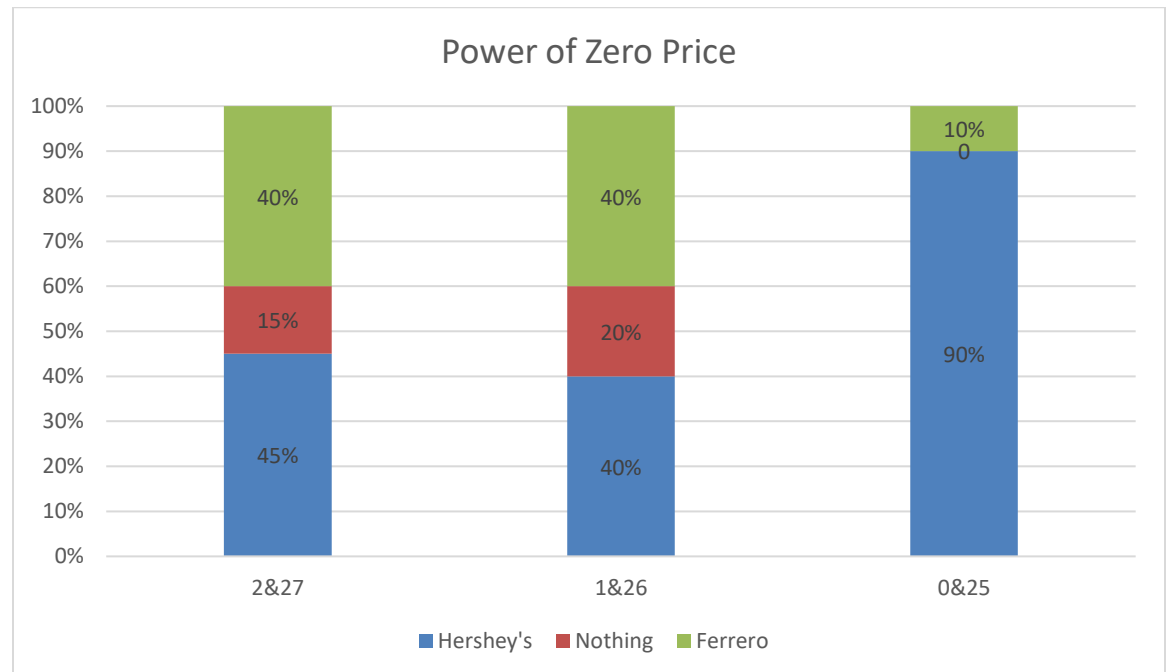
##### Gift giving & happiness

##### Free things make us happy - Zero as a special price

When people are faced with a choice between two products, one of which is free, they over-react to the free product as if zero price meant not only a low cost of buying the product, but also its increased valuation.

In the following set of experiments (Shampan'er & Ariely), participants were offered the following choices:

- 1 – Ferrero Rocher for 27 cents or Hershey's Kiss for 2 cents.
- 2 – Ferrero Rocher for 26 cents or Hershey's Kiss for 1 cent.
- 3 – Ferrero Rocher for 25 cents or Hershey's Kiss for 0 cent (FREE).



**CASE STUDY****UNITED EXPRESS FLIGHT 3411***Fly the friendly skies*

On April 9<sup>th</sup> 2017, Dr. David Dao and 3 other passengers are chosen to exit an overbooked flight.

**David Dao Point of View****Expectations Effect**

So you're on the flight with your wife, you've been given a boarding pass. You think to yourself: "I'm definitely flying!"

**Market Norms vs. Social Norm**

You're sitting in your seat. You hear an announcement offering any volunteer passenger a \$400 voucher to give up their seats. (United Airlines: Doctor dragged off Flight 3411 speaks out after the incident: 'Everything is injured', 2017)

They're talking cash, this is no longer a social norm transaction. This is a market transaction.... but no one came forward. You hear another announcement offering \$800 in compensation. Next comes the \$1000 offer.

**Herding Effect**

Again, no one came forward. We are lemmings in our behavior. No one volunteered so I'm also not volunteering. United decided to "randomly" select 4 passengers

**Endowment Effect**

This is not just a seat. This is MY seat! I love MY seat! You've been picked to abandon your seat. It's a window seat by the way.

**Relativity**

We do not evaluate things in absolute terms, we look at things as they relate to other things. Everyone is seated and traveling, but I must exit the aircraft. Why?

**Hot State vs. Cool State**

You become scared. You are no longer in a cool state. You move to a hot state. You are no longer Dr Dao, you are Mr. Hyde.

Emotions are high, hormones are pumping, breathing fast, heart beating. They start to drag you by force. You are now using your full reptilian brain.

**Loss Aversion**

Security officers surround you. You're fighting for survival. "They'll kill me, I want to go home." Your nose is broken, you've lost your two front teeth, and you're suffering a concussion

**UNITED EXPRESS FLIGHT 3411***Fly the friendly skies*

On April 9<sup>th</sup> 2017, three city aviation department officers are asked to handle a “disruptive and belligerent,” passenger that has been chosen to exit an overbooked flight.

## Officers Point of View

### **Authority Figure**

So you’re one of three officers, you’ve been called to handle this “disruptive and belligerent” passenger.

### **Reciprocation**

The airline calls for your assistance, tells you the passenger is not cooperating. You must do something. You have a relationship with the airlines. They are in uniform like you. You probably even know them on first name basis. You try to help the flight attendants.

### **Tunneling**

You’re the only one that can save the day. You’ll do whatever it takes. You’re also in a hot state. You forget that you’re in an aircraft and surrounded by onlookers.

## CEO Point of View

### **Overconfidence and Denial**

I apologize for having to re-accommodate these customers. No mention of the bloody face and the broken nose, and traumatized passengers.

You send an internal letter blaming the passenger.

You take two days to issue an apology.

Two months ago, you won “Communicator of the Year 2017” from PRWeek.

## Passengers Point of View

### **Social Proof**

So you’re overlooking what’s going on. A fellow passenger is being verbally abused by flight attendants, then physically attacked by authority figures (officers), obviously bleeding, violently yanked from the seat and dragged off the plane. You think to yourself: “No one is doing anything. There’s nothing to do.”



Oscar Munoz internal letter, April 10 2017 (Levin, 2017):

Dear Team,

Like you, I was upset to see and hear about what happened last night aboard United Express Flight 3411 headed from Chicago to Louisville. While the facts and circumstances are still evolving, especially with respect to why this customer defied Chicago Aviation Security Officers the way he did, to give you a clearer picture of what transpired, I've included below a recap from the preliminary reports filed by our employees.

As you will read, this situation was unfortunately compounded when one of the passengers we politely asked to deplane refused and it became necessary to contact Chicago Aviation Security Officers to help. Our employees followed established procedures for dealing with situations like this. While I deeply regret this situation arose, I also emphatically stand behind all of you, and I want to commend you for continuing to go above and beyond to ensure we fly right.

I do, however, believe there are lessons we can learn from this experience, and we are taking a close look at the circumstances surrounding this incident. Treating our customers and each other with respect and dignity is at the core of who we are, and we must always remember this no matter how challenging the situation.

Oscar

- On Sunday, April 9, after United Express Flight 3411 was fully boarded, United's gate agents were approached by crewmembers that were told they needed to board the flight.

- We sought volunteers and then followed our involuntary denial of boarding process (including offering up to \$1,000 in compensation) and when we approached one of these passengers to explain apologetically that he was being denied boarding, he raised his voice and refused to comply with crew member instructions.

- He was approached a few more times after that in order to gain his compliance to come off the aircraft, and each time he refused and became more and more disruptive and belligerent.

- Our agents were left with no choice but to call Chicago Aviation Security Officers to assist in removing the customer from the flight. He repeatedly declined to leave. Chicago Aviation Security Officers were unable to gain his cooperation and physically removed him from the flight as he continued to resist - running back onto the aircraft in defiance of both our crew and security officials.

## APPENDIX A

### Assessing Quantities\*

1. Democratic votes in Montana, 2004 Presidential election
2. Length of Congo River (in miles)
3. Number of subscribers to *Field and Stream*
4. Area of Finland (in square miles)
5. Birth rate in France per 1,000 population
6. Population of Cambodia
7. Revenues of Wal-Mart Stores (largest in U.S.), 2003
8. Annual Percent Yields on 30-Year Treasury Bonds in 1981  
(This year had the highest rate over the 1980-1998 period.)
9. Number of physicians in the United States, 2002
10. Number of electoral votes going to Republican presidential candidate in 2008 (out of 538)
11. Value of Dow Jones Average on December 31, 2006 (on 6/30/06 closed at 11,150)
12. Value of the NASDAQ on December 31, 2006 (on 6/30/06 closed at 2,172)

	1 <sup>st</sup> %ile	25 <sup>th</sup> %ile	50 <sup>th</sup> %ile	75 <sup>th</sup> %ile	99 <sup>th</sup> %ile
Democratic votes MT 2004 Pres. election					
Congo River (length in miles)					
<i>Field &amp; Stream</i> (number of subscribers)					
Finland (area in square miles)					
Birth Rate of France (per thousand)					
Population of Cambodia					
Revenues of Wal-Mart Stores, 2003					
% Yields on 30-Year Bonds, 1981					
Number of Physicians in U.S., 2002					
# electoral college votes, Republican presidential candidate in 2008					
Dow Jones Average 12/31/06 (on 6/30/06 closed at 11,150)					
Value of NASDAQ 12/31/06 (on 6/30/06 closed at 2,172)					

\* Question 1, <http://www.uselectionatlas.org/RESULTS/state.php?f=0&year=2004&fips=30>. Questions 2-6, *1995 Information Please Almanac*. Question 8, *1999 Wall Street Journal Almanac*. Questions 7 & 9, *World Almanac 2005*.

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- Daniel Kahneman: ‘What would I eliminate if I had a magic wand? Overconfidence’  
<https://www.psychologicalscience.org/news/daniel-kahneman-what-would-i-eliminate-if-i-had-a-magic-wand-overconfidence.html>
- Judgment under Uncertainty: Heuristics and Bias  
[http://psiexp.ss.uci.edu/research/teaching/Tversky\\_Kahneman\\_1974.pdf](http://psiexp.ss.uci.edu/research/teaching/Tversky_Kahneman_1974.pdf)  
<https://www.behavioraleconomics.com/mini-encyclopedia-of-be/anchoring-heuristic/>
- Buy 18 Snickers bars for your freezer”), but also purchase quantity limits (e.g. “limit of 12 per person”) or ‘expansion anchors’ (e.g. “101 uses!”) can increase purchase quantities

<https://www.behavioraleconomics.com/introduction-to-be/>

present events are weighted more heavily than future ones

<https://www.youtube.com/watch?v=dPQj547KXPE&list=PLC583D9595105220E>

upside of rationality

<http://onlinelibrary.wiley.com/doi/10.1002/bdm.501/epdf>

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RECOMMENDED READING

Predictably Irrational Dan Ariely  
Upside of Irrationality Dan Ariely  
Why Smart People Make Big Money Mistakes Belsky and Gilovich  
Simpler Cass Sunstein  
The Invisible Gorilla CHRISTOPHER CHABRIS and DANIEL SIMONS  
Payoff Dan Ariely  
Stumbling On Happiness Dan Gilbert  
Thinking Fast and Slow Daniel Kahneman  
Drive Daniel Pink  
Decisive Heath Brothers  
Happy Money Michael Norton  
Nudge Richard Thaler and Cass Sunstein  
Pre-suasion Robert Cialdini  
The Darwin Economy Robert H. Frank  
Willpower: Rediscovering the Greatest Human Strength Roy Baumeister  
Scarcity Sendhil Mullainathan  
Redirect Timothy Wilson  
The Why Axis Uri Gneezy