

# **PRINCIPLES OF BEHAVIORAL ECONOMICS**

**Prof. Sujata Kar**

**Department of Management Studies**

**IIT Roorkee**

**Week 06**

**Lecture 06**

Hello everyone, this is Lecture 6 of Behavioral Economics. We are going to talk about motivation and hierarchical needs, basically certain theories of motivation and how they are relevant in the field of Behavioral Economics or economics in general. Behavioral Economics focuses on the psychological drivers of economic decisions, as we all understand.

Now, in this module, we explore the concept of motivation and human need hierarchy and its role in economic behavior. So, basically, we will explore the foundations of motivation, a key driver behind human decision-making in economic contexts. By understanding motivation, we can better explain why people make certain choices and how these choices shape markets and policies. So first of all, what is motivation? Motivation refers to the internal process that initiates, directs, and sustains goal-directed behavior.

So I have a goal in front of me, and then how I internally process that would basically help me achieve my goal. Motivation is what drives individuals to take action toward achieving their goals. It can be intrinsic or internal, where actions are driven by personal satisfaction, or it can be extrinsic, where external rewards like money or recognition play a role. Understanding these motivations helps us analyze economic behavior more effectively. So we have two types of motivation.

Intrinsic, which is basically driven by internal rewards or enthusiasm, and the second one is extrinsic motivation, which is driven by external factors, external rewards, for example, money, recognition. So here we show that these are primarily intrinsic factors: passion, interest, curiosity, enjoyment, purpose, fun; and then there are extrinsic factors like money, praise, awards, punishment, grades, rewards, etc. And there are also a few factors which are common to both, for example, academic success,

that could be driven by passion for academics as well as there could be external factors or rewards associated with such success. Similarly, relationships: we maintain relationships

because of our internal gratification or satisfaction. At the same time, relationships could be external also, really maintaining relationships helps us achieve certain social contacts, certain social recognition. And similarly, there could be career success. So again, it shows that there are two types of motivation: intrinsic, which are from within, like autonomy, mastery, purpose; and extrinsic motivation, like those from outside,

for example, compensation, punishment, reward. The importance of motivation in economic behavior. Motivation is central to understanding economic behavior because it drives decisions like spending, saving, and career choices. For example, motivated employees tend to be more productive, while motivated consumers may respond strongly to marketing strategies. However, biases often distort these motivations leading to suboptimal choices in the sense that we always do not

act according to our motivations or maybe what we desire to achieve. We may not be able to achieve that because at times certain decisions are under the influence of some biases which basically retard us or hold us from achieving what we intend to achieve. Motivation shapes economic decisions such as spending and saving habits, career choices and productivity at work. Responses to marketing and advertising. So these are the situations or contexts where we see that our acts reflect our motivation.

Motivated individuals are more likely to engage in behaviors that align with their goals, but biases can distort these behaviors. The study of motivation has deep roots in history. First of all, we have already talked about Adam Smith in his Theory of Moral Sentiments. We mentioned previously that he talked about prudence. He talked about justice.

He highlighted sympathy and virtue as drivers of human behavior. There is this famous psychologist Sigmund Freud, who is primarily known for his psychoanalysis. He explored unconscious motives behind actions. Abraham Maslow, in 1943, proposed the hierarchy of needs theory. And we are going to discuss Maslow's hierarchy of needs theory in detail.

So, the key theories in motivation are primarily four. These theories have shaped our understanding of motivation over time. Maslow's Hierarchy explains motivation as a progression through needs, while McClelland focuses on achievement and power as key drivers. Self-determination theory distinguishes between intrinsic and extrinsic motivation. And Herzberg highlights the role of workplace factors.

So, these are the key theories of motivation. We have Maslow's Hierarchy of Needs, which explains human motivation through five levels of needs. McClelland's Need Theory

focuses on achievement, power, and affiliation as motivators. Self-Determination Theory distinguishes between intrinsic and extrinsic motivation. And Herzberg's Two-Factor Theory differentiates motivators from hygiene factors.

In behavioral economics, understanding motivation allows us to design better policies and strategies. For instance, nudges can encourage savings or sustainable practices by aligning with intrinsic motivations or leveraging extrinsic rewards like tax benefits. Let us consider some examples. Consumer behavior. In the field of consumer behavior, we can try to understand why people buy luxury goods or save for retirement.

In terms of workplace productivity, the role of intrinsic versus extrinsic rewards can explain how work-based productivity varies. Nudges that motivate sustainable behaviors can be utilized by public policy, and there are many examples. We will discuss them at length while examining nudges. Now, talking about hierarchically ordered needs in behavioral economics, we will focus on Maslow's theory. Abraham Maslow, an American psychologist, introduced his hierarchy of needs in 1943. This five-tier model arranges human needs from the most basic to the most complex, providing a framework for understanding human motivation.

The pyramid structure is often depicted; so basically, Maslow's hierarchy is often depicted as a pyramid. At the base are physiological needs, followed by safety, love and belonging, esteem, and finally self-actualization at the top. The structure suggests that lower-level needs must be largely satisfied before higher needs become significant motivators. So we have already mentioned the five levels from bottom to top: physiological, safety, love and belonging, esteem, and self-actualization. So this is how it looks. We begin from the lowest—we begin from the bottom, the base—and then going up, we have physiological, safety, love and belonging, esteem, and self-actualization.

So what are they actually? First of all, talking about physiological needs. So at the very least, we don't want to be hungry, thirsty, exhausted, freezing, overheating, sick, or in pain. So, first of all, we need to fulfill our physiological needs. That is why this is the very basic. This is at the bottom.

Then comes safety. If we feel okay when our basic physiological needs are met, then we look for safety. We need to feel safe then. We need to feel confident. We can avoid pain. I mean safety from not only outside factors but also internal factors like pain, hunger, and other dangers for the immediate future. That is safety.

Coming to the third kind of need, which is basically love and belonging, that has a certain social aspect. So once we feel safe, then our social needs for love and belonging come into play. We feel secure when we are part of a tribe. We can trust, and basically, we do not need to worry about rejection or affiliation. So our alienation, and that is why love and belonging come into play.

Then the fourth tier is self-esteem. Once we are secure in our social needs, our primal desires for status and self-esteem come into play. We want to feel not only part of the group but also an admired and respected individual or a respected part of the group. And then the final one is self-actualization. Now our core needs are met.

When our core needs are met, we are ready to pursue our deepest desire for self-actualization, to become the most complete and authentic version of ourselves. With the fundamentals taken care of, we are free to act as we choose, aligned with our values and higher purposes. Now, again, I will talk very briefly about these needs. First of all, psychological needs. These are basically the basic biological requirements for human survival.

This includes air, food, water, shelter, sleep, clothing, just to mention a few. Economic implications. Basically, here we demand essential goods and services. How is it related to our economic behavior? Consumer spending on necessities.

We purchase goods which are basically necessities under this need. Price elasticity of demand for essential goods. We know that these elasticities are actually—the elasticities are basically inelastic. The prices are inelastic. These goods often, or I would say rather, the demand is inelastic with respect to price.

These goods often have inelastic demand, meaning people will buy them regardless of price changes. This concept is crucial in poverty alleviation and development economics, and as a result, it has an impact on poverty and development economics. Now, talking about safety needs. Security, stability, and freedom from fear are part of safety needs. This includes personal security, financial security, and health and well-being as well.

Because of this need, we demand insurance, savings products, healthcare facilities, and so on. In terms of economic behavior, we tend toward risk aversion in financial decisions. We need secure jobs. Our job preferences depend on how secure they are, along with how much they pay, of course. Markets for safety products and services exist because of safety needs.

The third category is love and belonging needs. This includes social needs, relationships, and a sense of connection—for example, friendships, intimate relationships, and family. Because of this need, we have social goods, communication services, and social media. So, love and belonging needs significantly impact consumer behavior as well, influencing choices like gift-giving. They also explain the effectiveness of social proof in marketing and the rise of community-based economic models.

The fourth one is esteem needs. That includes respect, self-esteem, status, and recognition. For example, the feeling of prestige and the feeling of accomplishment are part of esteem needs. Because of esteem needs, we buy luxury goods, goods that symbolize status, and invest in professional development. So, esteem needs explain economic phenomena like conspicuous consumption, where people buy expensive items to display wealth and status.

They also influence brand loyalty, premium pricing strategies, and investments in education and skills. And finally, we have self-actualization needs. Through this, one tries to achieve one's full potential—the desire to reach one's full potential. Examples include creativity, problem-solving, acceptance of facts, and because of that, institutions or markets for the personal growth industry and experiential purchases do exist. Self-actualization needs have given rise to the experience economy, where consumers value unique experiences over material possessions.

For example, when we visit a luxury resort and pay, say, 20,000 rupees for a night, what we basically pay for is the experience there. They also tend to offer us experiences that are not commonly or casually available. And as a result, these kinds of experiences create memories. So these are part of the experience economy. This level also drives demand for self-improvement products and services and often motivates entrepreneurship and innovation.

It is important to note that Maslow's five-stage model has been expanded to include cognitive and aesthetic needs and later transcendence needs as well. So now we have this eight-stage need hierarchy, which after belonging and love needs includes esteem needs, cognitive needs, and aesthetic needs. Then we have the usual self-actualization followed by transcendence. Now we talk about the additional needs that are introduced. So cognitive needs include knowledge and understanding, curiosity, exploration, the need for meaning, and predictability.

Cognitive needs drive our pursuit of knowledge and understanding. For instance, if students desire to understand complex mathematical theories, a traveler's curiosity about

diverse cultures, or an individual's quest for life's deeper meanings all exemplify these needs. Meeting these needs facilitates personal growth, comprehension, and a deeper understanding of life and its complexities. So there we have cognitive needs.

Now talking about aesthetic needs, appreciation and the search for beauty, balance, form, etc., are included in aesthetic needs. Fulfilling these needs leads to a deeper sense of satisfaction and harmony in life as individuals seek environments and experiences that are pleasing and resonant with their sense of beauty. This involves the appreciation and pursuit of art, music, nature, and other forms of aesthetic expression. Fulfilling these needs isn't just about physical beauty but also the emotional and psychological satisfaction derived from experiencing order and elegance. Then we have the final one, which is transcendence needs.

A person is motivated by values that transcend beyond the personal self. Beyond self-actualization, they represent the human desire to connect with a higher reality, purpose, or the universe. So that is, in a sense, what transcendence needs are. This level emphasizes altruism, spiritual connection, and helping others achieve their potential. Individuals seek experiences that move beyond personal concerns, aiming to achieve a deep sense of unity, understanding, and belonging within the vast expanse of existence.

Examples of transcendence needs include mystical experiences, certain experiences with nature, aesthetic experiences, and sexual experiences. Service to others, the pursuit of science, religious faith, etc. Now we talk about criticisms of Maslow's theory. Despite its popularity, Maslow's theory faces several criticisms. These include a lack of empirical evidence, cultural bias toward Western values, the assumption of a rigid hierarchy, and oversimplification of complex human needs.

Modern interpretations of Maslow's theory acknowledge that progression through needs isn't always linear. Individuals may pursue multiple needs simultaneously and prioritize them differently. Current research often integrates Maslow's insights with other motivational theories. In this context, we talk about Alderfer's ERG theory. In 1969, Clayton Alderfer proposed the ERG theory as a simplification and extension of Maslow's hierarchy.

ERG stands for existence, relatedness, and growth. The components of ERG theory are, thus, existence, which includes physical and physiological needs, relatedness includes social and external needs, external esteem needs, and growth includes internal esteem and

self-actualization needs. So, as you can see, ERG theory condenses Maslow's five levels into three. Existence covers physiological and safety needs.

Relatedness encompasses social needs and external esteem, while growth includes internal esteem and self-actualization. So, if we compare ERG theory with Maslow's hierarchy, then we can say that in the case of ERG, there is no strict hierarchy. It allows for the simultaneous activation of different needs. There is also a concept like the frustration-regression principle. We will talk about it. But another aspect is that it is more flexible across cultures.

So, it is not only confined to Western value systems. Now, talking about the frustration-regression principle, we say that, unlike Maslow's strict hierarchy, ERG theory allows for the simultaneous pursuit of different needs. It introduces the frustration-regression principle, where unmet higher needs can increase the desire for lower needs. So basically, when someone is frustrated for not being able to achieve higher needs or fulfill higher needs,

then they revert to fulfilling the lower needs. So that's why we go for regression. The flexibility makes it more applicable across diverse cultures. Motivation and decision-making in behavioral economics. So needs actually lead to choices.

How needs influence economic choices is basically crucial to our understanding. Needs shape economic choices by creating demand hierarchies. For instance, physiological needs drive bulk buying of essentials, while esteem needs fuel luxury purchases. Let's explore how these hierarchies operate. Talking about need-driven economic decisions, first of all, when we look at basic needs, we can see that grocery shopping during inflation,

for example, Walmart sales surge is an example of fulfilling basic needs. Social needs include spending on weddings or events. The global wedding industry is valued at \$160 billion. Esteem needs include luxury car purchases. For example, BMW sales may go up by 12% in emerging markets.

Now, let us consider the case of the luxury goods market, where we fulfill the role of esteem needs. There is something called Veblen goods. This is named after an American economist, Thorstein Veblen, who observed that there are certain commodities for which the law of demand is violated. The law of demand states that as price increases, quantity demanded decreases, or when price decreases, quantity demanded increases. What he observed for luxury goods is that when the price increases for certain commodities,

we observe that when price increases, quantity demanded increases, and when price decreases, quantity demanded decreases. This is because there are certain commodities. For example, vintage paintings, items, or antique goods—goods that are being auctioned. So, the higher the prices, by purchasing those commodities or products, the buyers actually think of attaining higher social status. As a result, they tend to buy more of those products, which defies the law of demand. 73% of luxury buyers cite 'status' as the key motivator.

So, what is the behavioral insight? Scarcity plus exclusivity. In the sense, commodities which are not easily available. Certain paintings by famous painters, or maybe painters who have already died, or sculptors who have died, Their creations are, of course, scarce and also exclusive. So that increases the perceived value.

The luxury goods market thrives on esteem needs. Brands like Rolex use scarcity and exclusivity to create irrational demand. 73% of buyers prioritize status over utility, defying traditional price-demand laws. Let us consider another case study: Coca-Cola's 'Share a Coke' campaign. The strategy was to personalize the Coke bottles.

It was introduced in 2011 in Australia, where popular names were printed on Coke bottles. That led to emotional connections and resulted in a 7% sales increase in a declining market. The behavioral insight is that social belonging plus self-esteem led to viral success. In 2025, they reintroduced this concept, which became effective on April 1st across 120 countries, where the Coca-Cola mobile app and on-pack QR codes provide a gateway to the 'Share a Coke' digital hub, where fans can customize Coca-Cola packaging with additional names and access the 'Share a Coke Memory Maker'

—an interactive digital experience to create personalized videos with their own content and memes to share with friends. These are strategies where you exploit certain needs, such as social needs, to increase the sales of your product. So, in summary, motivation blends cognitive goals and emotional triggers. Whether designing policies or ads, aligning with these drivers—like Coca-Cola did—can transform economic outcomes.

With this, I conclude this lecture. These are the references. Thank you.