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Present values

THE ECONOMICS OF CHRISTMAS

It's easier to think of economists as the prophets of trading doom than as Santa's little helpers – too busy telling everybody what's happening to productivity, energy demand and like-for-like sales to provide any insights into the annual exchange of goodwill and good-or-ill gifts to family and friends. So Frontier Economics has been scouring the academic literature of behavioural economics for tips to make that last struggle with your present list a little easier...

With so much, for retailers, hanging on their Christmas trade, it's not surprising that economists have been attempting to analyse present-giving for years. Most of the research, however, has a narrow, distinctly Scrooge-like tone to it (maybe too much of it was conducted by analysts soured by their annual quota of socks). So what follows is an attempt to elicit slightly more seasonal cheer – and even a little buyers' guidance – from the available stock of behavioural economics and consumer psychology.



THOUGHT PROFIT AND DEADWEIGHT LOSS

Present buying isn't easy. Ideally, we would give something whose value to the recipient is greater than its cost, having found something original and beautiful that surprises and delights. But the risk is that the value to the recipient is actually lower than the cost: it's just not something he or she wanted. Joel Waldfogel, an academic who has researched this "deadweight loss", estimates that at least 10% and maybe over 30% of the total value of present exchanges is wasted. Of course being given something is nice, but (except for the weird and wonderful offerings from our children) we don't really think "it's the thought that counts".

So as you compile your present list, how should you deal with deadweight risk? Take it as part of the friction costs of Christmas, like traffic queues and indigestion? Or be a bit more disciplined? You could, for example, decide that:

- The less well you know someone, the better it is to let them choose. Of course, if you give cash, you lose the opportunity to deliver value above cost, and take the risk that the recipient spends the money on someone else – but with teenagers (which empirical research suggests are prime recipients of this strategy from grand/godparents) that risk probably isn't very high.
- If you don't want to give cash (research suggests it's socially less acceptable between peers) you can mitigate deadweight risk by giving vouchers. The more imaginative you are (a balloon ride rather than a grocery voucher), the more you may gain in thought profit but also risk deadweight loss. One disadvantage of vouchers over, say, cheques, is that you pay for a voucher when you buy it, for a cheque only when it's cashed. Teenagers are liable to lose either, so if such recipients feature on your present list, you can expect some wastage. With cheques, you can up the face value of your presents in confident expectation that they won't all make it back to your bank.
- You can mitigate deadweight risk by making exchange easy. Some retailers major on this option by offering special "gift receipts" which only reveal the actual cost if you take the present back. Of course, even if you don't include a receipt, you can rest a bit easier if the recipient is a frequent eBay seller.
- You can leave it to the recipient to reduce the loss by recycling. A common, if risky, loss mitigation strategy is to pass on unwanted presents next Christmas. Success with this depends on remembering where that "unusual" ornament came from, and offloading it on to someone who won't be unwrapping presents round the same Christmas tree as the original giver.

BEST BEHAVIOUR

So far, so (relatively) simple. But behavioural economics offers some more sophisticated insights into giving strategies. Here are a few examples:

- **Guilt and indulgence.** Receiving a present that you know cost someone more than he or she can afford can evoke gratitude or annoyance – nobody

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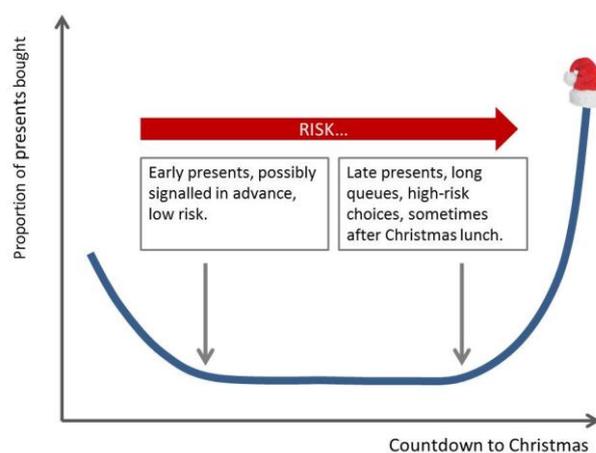
likes to feel beholden. But what if your partner's bought such a present out of your joint account, having sneaked back to buy the beautiful coat for you that you'd decided was just too extravagant? Underwriting a licence to indulgence like that can work really well.

- **Status quo bias.** People tend to do the same things repeatedly, and behavioural economics teaches us that they tend to overstate the personal costs of doing something different. Repeated present-giving can work well, of course – the family all get to rely on their bottles of single malt from Uncle Ian. And giving everyone the same present saves the giver a lot of time and effort, which can be economically translated into a higher spend. But there's a lot to be said for going wild, too. Giving people presents they wouldn't choose themselves is a high-risk strategy, but it can be remarkably successful overall. You'll never know if Granny likes belting out Lady Gaga on a karaoke machine unless you buy her one.
- **Experience value.** Research into happiness suggests that experiences are often valued more highly than physical gifts, and learning experiences can be the most highly valued. Lessons with a top chef? Spend a day as a zoo-keeper? That'll be remembered long after the reindeer sweater has shrunk.
- **Optimism bias.** It doesn't take much behavioural science to recognise this trait in present-giving: the musical instruments for children who are longing to give up violin lessons, the health club membership unused after January. To be avoided. At least bath oil is meant to be poured down the drain.

TWELVE INTO ONE DOESN'T GO

So how much of this have you already got right this year? Research tells us that women tend to plan and buy their presents earlier than men and that parents tend to buy earlier than those without children. Married, middle-aged, men are the worst planners. The chart below illustrates something everyone except such men seems to know: buying early can reduce both congestion costs and risks.

The sleigh curve Christmas risk relationship



Present values

So why do the laggards wait? Late shoppers often claim they simply misjudged how much time it would take to compile their present lists, but it's hard to square that with the repeat nature of Christmas. More likely explanations provided by behavioural economics are that late shoppers fail to remember how poor some of their choices were last year (the so-called rosy retrospection effect) or simply loathe shopping and suffer from the "ostrich effect". Not, of course, to be confused with the turkey effect that comes only days – or even hours – later...

GAMES CHRISTMAS PEOPLE PLAY

Game theory, one of the great advances in economics over the past 30 years, also offers some tips for a successful Christmas. Watch out for:

- **Signalling.** Game theory has helped us explore the ways in which human interactions send signals that may or may not be intended. Watch out for this on your present list. A "Best Mum in the World" mug usually goes down well (assuming it's not your only present...); a diet book just won't.
- **Sequencing.** Extreme information asymmetries cause problems, even at Christmas. New couples, faced by their first go at a simultaneous giving "game", rather than the sequencing allowed by birthday present-giving, struggle with the risk of appearing (relatively) mean or flash on Christmas morning. You can of course try to cheat by finding out what your partner's spent, but there may be other risks with that strategy. A fall-back option is to buy two presents and keep one back – but that's not risk-free either.
- **Reciprocity.** Christmas card-sending used to work almost entirely on the reciprocity model. Careful people made lists of the people who sent them cards last year in order to send to them this year. But e-mail Christmas messages don't work like that, since it's easier just to flood your database. However, it's questionable whether those messages telling people you've decided not to send cards this year in order to save the rainforest have quite the same impact as a handwritten card. The trend at home seems to be towards sending a message that is, at least, worth opening - and better still, worth reading.

Like - we hope - this bulletin. A Happy Christmas, giving and receiving, and a peaceful and prosperous New Year to our friends, clients and collaborators from all of us at Frontier Economics.

CONTACT	Simon Gaysford simon.gaysford@frontier-economics.com
	Philip Maggs philip.maggs@frontier-economics.com
	Frontier Economics Ltd
	FRONTIER ECONOMICS EUROPE BRUSSELS COLOGNE LONDON MADRID
	www.frontier-economics.com