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Cognitive Bias in Economic Decision Making: The Influence of Herding Behaviour of Consumers on Business and Investment

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Abstract:
Herding behaviour in economic decision-making refers to the tendency of individuals to follow the actions or decisions of a larger group, often disregarding their own independent analysis or judgment. Herd behaviour is a double-edged sword. While it can generate quick wins for businesses, it requires careful planning and consideration to avoid the risks associated with over-dependence on trends and external influences.

Keywords: cognitive biases, economic decision making, herding behaviour, consumer behaviour, influence on business

Introduction

Cognitive biases play a significant role in shaping economic decision-making. These biases occur because human judgment is often influenced by factors that deviate from rationality, leading individuals to make decisions that may not align with optimal economic choices. In economics, cognitive biases can affect everything from consumer behaviour to financial decision-making and market outcomes. Overconfidence leads to excessive risk-taking. Overconfident investors may take on more risk than they can handle, which can lead to market bubbles or individual financial losses.

Some of the key cognitive biases in economic decision-making are the following

- Overconfidence Bias: Overconfidence bias occurs when individuals overestimate their abilities, knowledge, or predictions about the future.
- Loss Aversion: Loss aversion is the tendency for individuals to prefer avoiding losses. People feel the pain of losses more intensely than the pleasure of gains of the same magnitude. Loss aversion can lead to suboptimal decision-making.
- Anchoring Bias: Anchoring bias occurs when individuals rely too heavily on the first piece of information they encounter when making decisions, even if that information is irrelevant. Consumers might base their expectations on an initial price they see, leading them to overvalue or undervalue an item based on this reference point, regardless of its true market value.
- Mental Accounting: Mental accounting refers to the tendency of individuals to treat money differently depending on its source or intended use, rather than considering it as part of a single pool of resources. This bias leads to inefficient decision-making, as people might treat windfall gains differently from regular income, often spending it more freely.

- Confirmation Bias: Confirmation bias is the tendency to search for, interpret, and remember information that confirms one's pre-existing beliefs or hypotheses, while disregarding contradictory evidence. In investment decisions, this bias can lead to poor portfolio choices, as investors seek out information that supports their existing beliefs about a stock or market trend, ignoring information that might suggest they are wrong.
- Framing Effect: The framing effect occurs when the way information is presented influences how it is perceived and decisions are made, even if the underlying information is the same. This can affect consumer choices and investment decisions. For instance, people might opt for a product labelled as "90% fat-free" over one labelled "contains 10% fat," even though both labels describe the same product.
- Herding Behaviour: Herding behaviour is when individuals imitate the actions of others, often leading to irrational decision-making. People tend to follow the crowd, especially in uncertain situations, instead of relying on their own judgment.
- Status Quo Bias: Status quo bias is the preference for the current state of affairs and the resistance to change, even when changing would lead to better outcomes. This bias can lead individuals to make suboptimal financial decisions, such as continuing with outdated investment strategies, insurance plans, or subscriptions, simply because they are familiar or involve less effort than switching.
- Endowment Effect: The endowment effect refers to the tendency to value something more highly simply because it is owned. People often overvalue items they own compared to identical items they don't own. Individuals may demand more money to give up something they own than they would be willing to pay to acquire it.
- Availability Heuristic: The availability heuristic is the tendency to overestimate the likelihood of an event based on how easily examples come to mind, often influenced by recent experiences or media coverage. This can lead to distorted perceptions of risk and opportunity. For instance, after hearing about a market crash or a business failure in the news, investors might overreact and become overly cautious, even though the actual probability of similar events happening may be low.

  Cognitive biases deeply influence economic decision-making, often leading individuals and businesses to make irrational or suboptimal choices. These biases can affect consumer behaviour, investment decisions, pricing strategies, and policy design. Understanding cognitive biases is essential for economists, businesses, and policymakers, as it helps explain why people sometimes make decisions that seem contrary to rational economic theory. Recognizing these biases can also lead to more informed decision-making, both at the individual and institutional levels, and can inform the design of better public policies and business strategies.

Herding behaviour of consumers

Herding behaviour in economic decision-making refers to the tendency of individuals to follow the actions or decisions of a larger group, often disregarding their own independent analysis or judgment. This phenomenon can lead people to make decisions based on what others are doing rather than on solid evidence or rational considerations. Herding behaviour is prevalent in many areas of economic life, especially in consumer behaviour. Consumers often look to others for guidance when they are uncertain about a decision. If they see a large number of people buying a product or choosing a particular service, they might believe that it's the right or best choice, even if they don't have enough personal knowledge or evidence to make that judgment. In many situations, individuals are influenced by their friends, family, or colleagues.

Review of Literature

Dr. Mazhar Ali & Dr. Huma Amir (2024) analyse the circumstances under which one is likely to herd. It also explains how the effect of observing others' buying behaviour transmits into herding.

Dr. Natasa Pavlovic-Hock (2022), concludes that consumers may take a shortcut to follow a herd according to which people discount their own information to imitate others. The findings of the study show that consumers use the information from others as cues in making buying decisions, whereby the influence decreases along the buying process and in the post-buying phase, where people no longer seem to follow the herd. Additionally, recommendations of other consumers exert a stronger influence on subject choices than those of experts. Finally, friends seem to influence consumers' choices more than social networks.

Gerben Van Roekel & Martijn Smit (2022) in their model challenge the dominant neoclassical view on clustering. An alternative hypothesis is postulated in which the interaction between herd behaviour and agglomeration externalities is proposed as an explanation for cluster formation.

Research Gap

Herding behaviour of the consumers has significant influence on the business and investment. Investment is dependent on market behaviour. The market behaviour is driven by consumer choices. The influence of herding behaviour on the investment decision making is a hot topic to be studied. Many studies are done on the herd behaviour of consumers. But a few studies are done from the supply side. Hence it is high time to have a study from the supply side.

Statement of the Problem

The herding behaviour influences business decision making both positively and negatively. Positive means influence for the prosperity and wellbeing of the nation. Negative is in the sense that unhealthy and socially undesirable products may rule the market if the herd decides so. Hence it is necessary to analyse whether the herd behaviour of the consumers is good or bad for the nation.

Objectives of the Study

The study has the following objectives

- To understand the reasons behind the herd behaviour of consumers
- To analyse the influence of herd behaviour of consumers on business and investment
- To analyse whether the influence of herd behaviour is positive or negative

Methodology

The study is based on primary and secondary data. Primary data was collected from 100 businesspeople from different parts of Kerala by using a structured questionnaire. Secondary data was collected from different magazines, journals, books and websites.

Significance of the Study

Understanding herding behaviour can be useful for businesses, marketers, and policymakers to predict trends and influence consumer behaviour. The investment decisions can be made based on the herd behaviour. Also, stocks can be maintained to meet the expected demand. However, it can also lead to inefficiencies or bubbles, especially when people are making decisions based on social influence rather than rational choices.

The herd behaviour of the consumers

Herd behaviour in consumers refers to the tendency of individuals to follow the actions of a larger group. It means making decisions based on the collective choices of others rather than on their own independent judgment or research. This behaviour can lead to mass conformity in consumer decisions, affecting purchasing choices, investment behaviours, and opinions.

The primary data required for the study was collected from 100 businesspeople from different parts of Kerala as shown below

Type of business

Type of Business	Number
Textile shops	30
Restaurants	30
Beauty store	30
Tourist Resorts	10

The business mostly influenced by the herd behaviour are clothing, beauty, food and travel. Hence data was collected from them using a structured questionnaire. They all confirmed the influence of herd behaviour in their decision making. The types of influences are listed below

- Social influences: Consumers often look to others for guidance when they are uncertain about a decision. If they see that a product is popular or widely used, they may assume it must be good or desirable. This is common in online reviews, ratings, and testimonials, where seeing many people praise a product can convince others to buy it, even if they had no prior interest.
- Peer influence: In many situations, individuals are influenced by their friends, family, or colleagues. If a certain brand or product becomes a trend within a social circle, others may feel compelled to follow suit to fit in or to avoid being left out.
- Fear of Missing Out: The desire to be part of a successful or exclusive trend can drive consumers to make purchases or engage in behaviours they might not have otherwise considered. When people perceive that others are gaining a benefit (like getting a deal, attending an event, or acquiring a limited-edition product), they may make decisions based on the fear of being left behind or missing out on something important.
- Brand and Product Popularity: Consumers may choose to buy well-known or widely advertised products because they believe these items are high-quality, simply because so many others are buying them.
- Authority Figures or Influencers: The recommendations of celebrities, influencers, or well-known figures can drive mass adoption of products. Consumers often assume that if someone they admire or trust is endorsing something, it must be worth buying. When a celebrity promotes a product, or an influencer showcases a lifestyle, followers or fans often feel a compulsion to adopt the same products or behaviours.

- Scarcity and Urgency: When consumers are aware that a product is limited in supply or available for a short period, they might rush to purchase, following the herd mentality. This is often seen in flash sales and limited time offers.

Social media and herd behaviour

The businesspeople are aware of the influence of social media on the herd behaviour of consumers. Social media serves as a platform where people are constantly exposed to others' opinions, behaviours, and trends. The visibility of collective actions, opinions, and purchasing decisions on social media can significantly amplify herding behaviour. Social media platforms like Instagram, TikTok, Twitter, and YouTube are ideal for creating viral trends. Influencers on social media, especially those with millions of followers, hold significant power over consumer decisions. When an influencer promotes a product, their followers may feel compelled to buy it, often without doing their own independent research, simply because they trust the influencer's judgment.

Social media amplifies the concept of social proof, where people make decisions based on what others are doing. When consumers see many of their peers posting about a product, liking it, or commenting on it positively, they may believe it’s a good or trendy choice and decide to purchase it, often just to fit in. Hashtags and social media challenges can lead to herd behaviour by creating a sense of community or movement around a specific product, idea, or activity. As more people participate in a hashtag or challenge, others join in to feel part of the community, often purchasing the same items or engaging in the same behaviours.

Social media platforms contribute to the desire for status and a specific social identity. Consumers may buy products to project a certain image or align themselves with a specific group, especially if those products are heavily promoted or associated with status symbols on social media. Social media can easily foster a bandwagon effect, where people adopt certain behaviours, preferences, or products because they observe others doing the same. As trends quickly spread, consumers may feel pressure to continuously buy new products to keep up with ever-changing trends, leading to overconsumption.

Positive influence of herding behaviour on business

Herding behaviour, while often seen as a force that leads to irrational or impulsive decisions, can have a positive impact on businesses when channelled correctly. By understanding and harnessing this behaviour, businessmen can create environments and marketing strategies that encourage consumers to follow the crowd in ways that benefit the brand. When herding behaviour fosters the sense of being part of a community, it can help businesses build long-term customer loyalty. Herding behaviour often leads to a word-of-mouth effect. This organic promotion is incredibly valuable, as consumers tend to trust recommendations from friends, family, or even strangers on social media more than traditional advertising. Products, like food items, tourist destinations and resorts or beauty and fashion trends, often spread through social media as people post photos of their purchases. This generates free promotion and expands the customer base without the company needing to invest heavily in advertising. Herding behaviour can elevate the perceived value or prestige of a brand, especially when it is associated with status or social identity. When people see that a certain product is popular, they might want to adopt it to signal affiliation with a specific social group or lifestyle. For businesses that offer platforms or social networks herding behaviour can significantly enhance the value of the platform as more users join and interact. The more people use the platform, the more attractive it becomes to new users, creating a network effect that drives growth. When a product becomes a social media trend, it significantly increases brand visibility. The more people participate in the trend, whether by using the product or engaging with the campaign, the more exposure the brand gets, which can lead to wider recognition and greater sales.

Herding behaviour can be a major asset for businesses, especially when used strategically. By creating an environment where social proof, scarcity, influencer endorsements, and community building are central to the customer experience, businesses can harness the power of collective action to drive sales, increase brand loyalty, and improve visibility. When businesses align themselves with the natural tendency of consumers to follow the crowd, they can see significant positive outcomes, from increased demand to stronger customer engagement.

Negative influence of herding behaviour on business

While herding behaviour can offer several benefits to businesses, it can also have negative effects if not managed properly. When consumers make decisions based solely on the actions or choices of others, it can lead to issues that harm a business's long-term reputation, customer satisfaction, and financial stability. Herding behaviour often leads to impulsive purchases, which can result in customers buying products or services they don't actually need or want. After the initial excitement fades, customers may regret their purchase, leading to returns, complaints, and negative reviews. Businesses that depend too heavily on trends or viral moments to drive sales may experience volatile and unsustainable demand. Once the trend fades, sales can drop, leaving businesses with excess inventory or even leading to financial losses if they fail to adjust their strategy. Brands that create products solely based on social media trends, such as certain fashion items, may find that when the trend dies down, consumers lose interest, leaving the business with unsold stock and the need to heavily discount or clear inventory.

Herding behaviour often requires businesses to constantly innovate or update their products to maintain interest and engagement. This pressure to innovate can be exhausting and costly, leading to burnout within the company, resource strain, and even poor product launches if the focus is solely on keeping up with trends. Businesses that rely too much on herding behaviour may focus too much on short-term gains and neglect long-term customer relationships and sustainable growth. While these tactics can boost sales temporarily, they may fail to establish deep customer loyalty or provide lasting value, which is essential for long-term business success.

Herding behaviour can sometimes lead to the promotion of unsustainable or unethical products that are fashionable at the moment but ultimately harm the environment or society. If consumers rush to buy items based on trends without considering the ethical or environmental implications, businesses might face backlash. The fast fashion industry is a prime example of businesses capitalizing on consumer herding behaviour. Brands that mass-produce cheap, trendy clothing can create a sense of urgency, leading to overconsumption and environmental degradation. As awareness of environmental issues grows, companies that rely on this model may face criticism, boycotts, or legal challenges.

In some cases, businesses may intentionally manipulate herding behaviour, may be by using influencers to push products or by creating artificial scarcity to create a sense of urgency or demand. If consumers feel manipulated or deceived, this can result in loss of trust and long-term damage to the brand's reputation. If a company is found to have intentionally created fake reviews, inflated product popularity, or manipulated social media trends, consumers may feel deceived. This can lead to boycotts, legal action, and lasting damage to the brand's credibility.

When herding behaviour drives too many consumers toward a specific product or service, businesses may end up in fierce price wars with competitors, eroding profit margins. In efforts to attract attention, businesses might lower prices significantly, which can lead to unsustainable pricing strategies and potential losses. When a product or service becomes widely popular due to herd behaviour, it can lead to market saturation, where too many businesses enter the market with similar offerings. This creates intense competition.

While herding behaviour can drive short-term sales and visibility, businesses need to be aware of its potential negative effects. Over-reliance on trends, impulsive buying, ethical dilemmas, and the pressure to constantly innovate can harm a brand's reputation, cause financial instability, and result in unsatisfied customers. For businesses, the key to avoiding these pitfalls is to balance trend-driven strategies with long-term value creation, focusing on authenticity, sustainability, and consumer satisfaction. Managing the risks of herding behaviour requires careful planning and an understanding of how it interacts with consumer psychology and market dynamics.

Conclusion

Herd behaviour is a powerful psychological phenomenon that significantly influences consumer decision-making and, by extension, the success of businesses. It refers to the tendency of individuals to align their actions or choices with those of a larger group, often following trends, adopting popular products, or emulating social behaviours without independent evaluation. While this behaviour can be beneficial to businesses by driving sales, fostering brand loyalty, and increasing visibility, it can also have negative consequences if not carefully managed.

On the positive side, businesses can leverage herd behaviour to boost brand visibility, create viral marketing campaigns, enhance social proof, and even foster a sense of community around their products. This can lead to rapid sales growth, brand loyalty, and an increased customer base. By tapping into the fear of missing out, social validation, and influencer marketing, companies can create compelling narratives that encourage consumers to follow the crowd.

However, on the negative side, unchecked herd behaviour can lead to impulsive purchasing, product dissatisfaction, ethical concerns, market bubbles, and brand dilution. Relying too heavily on trends or short-term gains can result in unsustainable business practices, poor customer retention, and reputational damage. The pressure to constantly innovate and meet the expectations of a rapidly shifting market can cause businesses to lose focus on their long-term strategy and authentic brand identity.

To navigate the complexities of herd behaviour, businesses must strike a balance between capitalizing on short-term trends and maintaining a strong, authentic, and sustainable long-term strategy. Understanding the motivations behind herd behaviour and its potential pitfalls is crucial for ensuring that its influence remains a positive force in driving customer engagement and business success.

Ultimately, herd behaviour is a double-edged sword. While it can generate quick wins for businesses, it requires careful planning and consideration to avoid the risks associated with over-dependence on trends and external influences. By maintaining ethical practices, focusing on customer value, and staying true to their brand identity, businesses can harness herd behaviour in a way that benefits both their bottom line and their relationship with consumers.

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