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Irrational Buying

Applying Behavioral Economics to the Art Market

Visitors look at Andy Warhol, *The Last Supper (1986)* and Jeff Koons, *Amore* (1988) shown in the "Pictures People" in Munich (2017). Photo credit: Alexander Heinl/dpa/Alamy Live News

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Earlier this month one of the leading economic theorists on irrational behavior, Professor Richard Thaler, was awarded a Nobel Prize. The assumption that people behave rationally underlies most economic theory, but Thaler's research in the field of behavioral economics has focused instead on how and when people behave irrationally. Many of his theories can be applied to the art market.

Anchoring and adjustment

Anchoring is a priming effect in which judgment is influenced by initial exposure to either a specific number or to the particular order in which questions are asked. For example, if people taking part in a survey are asked whether Paul Cézanne was more than 90 years old when he died, they are likely to guess that he led a longer life than if the question had referred to his death aged 40.

The effects of anchoring are seen at auction with estimates. Potential bidders will start with the estimates as a reference point and adjust around them. If the estimates are too high, potential bidders frequently refrain from bidding. This is despite the fact that they don't know where the reserve is set: the work could sell below the low estimate if the reserve is set for less than that amount. Conversely, an estimate that seems too low can cause potential bidders to question whether there are issues with the work, even if other red flags are not apparent.

Perception of fairness

The perceived fairness of an action influences people's opinions of it. In his 2015 book *Misbehaving: The Making of Behavioral Economics (2015),* Thaler gives an example of a retailer raising the price of a much in-demand Cabbage Patch doll one week before Christmas. When surveyed, 74% of people called that action unfair. But when they were told the proceeds would be donated to a charity, only 21% of people thought it unfair.

Cabbage Patch Dolls. Photo Credit: Photo by Nils Jorgensen/Rex/Shutterstock

Rationally, buyers at auction should not be influenced by whether the proceeds of a sale of a work will be donated to benefit a good cause (which is separate from a charity auction, in which buyers might receive a tax advantage): they should only consider the maximum amount they are willing or able to pay. Yet auction houses include this information because it is assumed that the perception of fairness might influence buyers' behavior and encourage them to pay higher prices.

Framing concept

In his bestselling book *Nudge: Improving Decisions About Health, Wealth and Happiness* (2008), co-authored by Cass R. Sunstein, Thaler describes how the words a doctor chooses to describe a patient's treatment options impact how appealing a patient finds those courses of action. If the doctor frames the outcome of an operation by saying that, "of the 100 patients who have had this operation, 90 are alive after five years", the patient will typically be more interested in having it than if he or she is told that, "of the 100 patients who have had the operation, 10 are dead after five years".

Galleries understand the importance of framing in how they state the asking prices for works of art. Active participants in the primary or secondary market expect they will receive a discount of around 10% to 20% on the asking price. Even though a gallery may have expected to net this lower price from the beginning of negotiations, it will frame the price higher so the buyer feels like they are getting a good deal.

Availability

Economist Richard H. Thaler. Photo credit: Keith Morris News/Alamy Stock Photo

People assess risk on the basis of what information readily comes to mind. For example, because homicides are more often reported on than suicides, it is commonly believed (wrongly) that more people are murdered than kill themselves.

We see this principle playing out in the art market. News outlets often include quotes from prominent market participants. These tend to be repeated until a consensus is formed. Our expectations become distorted because it is easier to recall soundbites and headlines than it is to undertake the more arduous exercise of analyzing results and historical trends by artist, work, category and overall market over a sustained period.

For example, much was written in 2016 about the looming specter of market collapse that ultimately proved to be exaggeration. If two paintings by Jean-Michel Basquiat fail to sell at auction, the tendency is to proclaim the Basquiat market dead, rather than looking at the specific reasons those specific works didn't sell.

Endowment effect

People can make poor economic decisions because they value things more highly when they own them. In one of Thaler's best-known experiments, he gave half of his students a mug. He then asked them how much they would be willing to sell the mug for, and the other half of the group how much they would be willing to pay. The potential buyers were only willing to pay half the amount the mug owners expected. Simply put, the expectations of the sellers were higher than they should have been. This relates to the theory of loss aversion: people experience losses more strongly than corresponding gains.

In the art market there is often a discrepancy between what a buyer is willing to pay for a work of art and the price for which the owner is willing to sell it. This is most common in the private market, where prices are negotiated among a small group of potential buyers and a seller. Because people value losses more greatly (which may mean a financial loss on the original purchase price, or the psychological loss of no longer owning the work) sellers might be more inclined to keep an object than lower their expectations of its value.

The fear of buying a lemon

The information asymmetry problem relating to the purchase of a "lemon"—a dud or damaged object—is associated with the theories of another Nobel Prize-winning economist, George Akerlof, whose field differs from Thaler's but, for the purposes of this article, let's explore the concept.

Research shows that, because buyers of used cars aren't always sure whether they're buying a good car or a lemon, they are unwilling to pay the full price, which in turn makes sellers of good cars less likely to sell.

Pieter Claesz. *Still Life of Lemons and Olives, Pewter Plates, a Roemer and a Façon-de-Venise Wine Glass on a Ledge* (1629). Courtesy Sotheby's Digital Images

Let's look at the fear of purchasing a "lemon" work of art at auction. Potential buyers tend to be influenced by how many other people are interested in a specific lot. We often see that many are reluctant to bid against the reserve—they want to wait to see who jumps first.

This pattern of behavior was widely reported following the failed sale of Francis Bacon's *Study of Red Pope* (1962) at Christie's in October 2017 or the light bidding on EdvardMunch's *Girls on the Bridge* (1902), which sold for $54.5m at Sotheby's in November 2016.

But, it is clearly irrational. When several people bid on a lot it pushes the price up. When there is only one bidder, the work sells for less. While one assumes that the possibility of paying less is better for the potential buyer, some bidders are deterred by a quiet salesroom, fearing that other people know something they do not—that the work is, in fact, a lemon when it actually is not.

Consensus is increasingly important to some buyers in today's shifting market, in which prices for some works are skyrocketing and for others steady or slumping. Buyers who are more concerned with getting it "right" than following their own personal or eclectic taste are more prone to equate lack of other bidders with lack of value.