AQA A Level Economics

Your notes

2. Individual Economic Decision Making

Contents

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Consumer Behaviour

Rational Economics & Incentives

- Individual economic decision-making is influenced by
  - Rationality
  - Incentives
  - **Marginal utility**
- When analysing markets, a **range of assumptions** are made about the **rationality** of **economic agents** involved in the transactions
- In classical economic theory, the word **'rational'** means that economic agents are able to consider the outcome of their **choices** and **recognise the net benefits** of each one. Rational agents are incentivised to select the choice which presents the **highest benefits**
  - **Consumers** are assumed to act rationally. They do this by **maximising their utility**
  - **Producers** are assumed to act rationally. They do this by **selling goods and services** in a way that **maximises their profits**
  - **Workers** are assumed to act rationally. They do this by **balancing welfare** at work with consideration of both pay and benefits
  - **Governments** are assumed to act rationally. They do this by placing the interests of the people they serve first in order to maximise their welfare
- In many ways, the **assumption of rational decision-making is flawed**. For example, consumers are often more influenced by **emotional purchasing decisions** than a rational computation of net benefits

Examiner Tips and Tricks

In your examinations, the essay questions test your ability to think critically. The command term for these questions are evaluate, justify, assess and to what extent

One way in which you can demonstrate critical thinking is to challenge the underlying assumptions of economic theory. The idea of rational decision making is one such assumption. Do consumers act rationally when they make impulse purchases? Do workers act rationally when they accept terrible working conditions for mediocre pay? Do governments actually maximise public welfare or do they implement policies that mainly benefit their core voter base?

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> Irrationality distorts markets and produces fundamentally different outcomes than what would be achieved if all economic agents acted rationally.

Utility Theory

- **Utility** is the satisfaction gained from consumption
  - **Marginal utility** is the additional utility **(satisfaction)** gained from the consumption of **an additional product**
- The utility gained from consuming the first unit is usually **higher** than the utility gained from **consuming the next unit**
  - For example, a hungry consumer gains **high utility** from eating their **first hamburger**. They are still hungry and purchase a **second hamburger** but gain **less satisfaction** from eating it than they did from the first hamburger
- To calculate **total utility**, the **marginal utility of each unit** consumed is **added together**
  - This means that total utility **keeps increasing** even while marginal utility **is decreasing**
- **The Law of Diminishing Marginal Utility** states that as additional products are consumed, the utility gained from t**he next unit** is lower than the utility gained from the **previous unit**
- **The Law of Diminishing Marginal Utility** helps to explain why the demand curve is **downward sloping**
  - When the first unit is purchased, the **utility is high** and consumers are willing to pay a **high price**
  - When subsequent units are purchased, each one offers **less utility** and the willingness of the consumer to pay the initial price decreases
  - **Lowering the price** makes it a more attractive proposition for the consumer to **keep consuming** additional units
  - This is one reason why **firms offer discounts** such as '50% off the second item'
- A consumer achieves **utility maximisation** when they spend their limited income in such a way that they will achieve the most satisfaction from their money

The Influence of Marginal Analysis on Choices

- A **rational** consumer seeks to maximise satisfaction with their **limited income**
- When **deciding at the margin**, they weigh whether to consume a little more or a little less of something
  - This involves considering the additional happiness or utility gained from each extra unit (**marginal benefit**) and the extra money spent (**marginal cost)**

- Consumers continue to consume until the extra happiness from each unit equals the extra cost, which is making decisions at the margin
- Every choice involves a balance between benefits and costs, taking into account each additional unit consumed
- Thinking at the margin is not exclusive to consumers but is also fundamental for **firms and governments**
- It guides decisions on how to allocate **scarce resources** by evaluating the **marginal benefit** and **marginal cost** of an additional unit
- By comparing the best decisions to their costs, the aim is to achieve **optimal choices**

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Imperfect Information

Asymmetric Information

- One of the **assumptions of free markets** is that there is a perfect flow of information
  - This would include information on pricing, the availability of substitutes, the truthfulness of the product claims, etc
- **Information gaps** exist in nearly all free markets and distort market outcomes, resulting in **market failure**
  - **Perfect information** in the market means that **buyers and sellers** have exactly the same level of information about the good or service. This is called **symmetric information**
  - In many markets, buyers and sellers have different levels of information. This is called **asymmetric information**. For example, there is **asymmetric information** in the used car market: sellers know more about the vehicle than the buyers
- **Asymmetric information** distorts socially optimal prices and quantities in markets, resulting in **over** or **under-provision** of goods or services
  - For example, goods/services with **dangerous side effects** would be sold in lower quantities if buyers were aware of these effects (consider the VW emissions scandal). **Fewer** factors of production should be allocated towards producing these
  - Similarly, goods and services with **extra benefits** would be sold in higher quantities if buyers were aware of them. **More** factors of production should be allocated towards producing these

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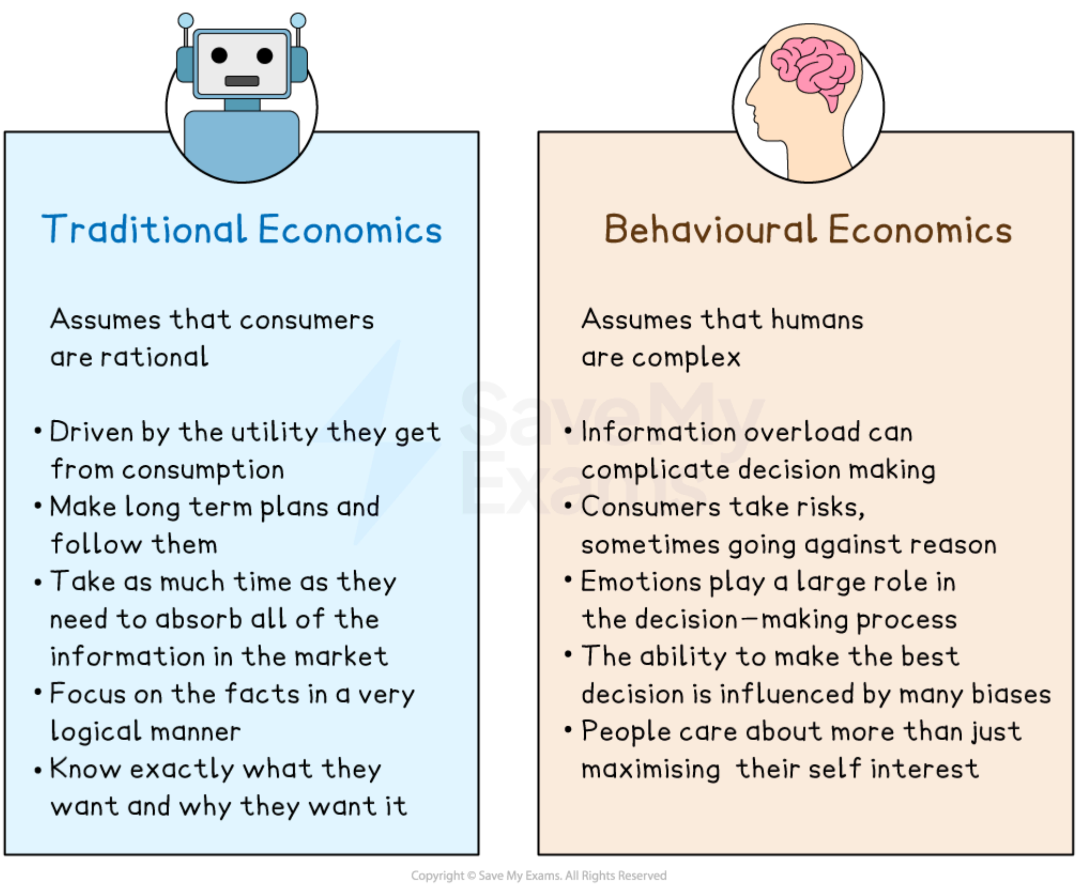
Behavioural Economics

An introduction to Behavioural Economics

- Behavioural economists **question the assumption of traditional economic theory** that individuals are **rational** decision-makers who endeavour to maximise their utility
  - It argues that many economic decisions made by an individual are biassed
- Behavioural economics is a field of study that **combines elements of psychology and economics** to understand **how people make decisions** and behave in economic contexts

Diagram: Traditional Versus Behavioural Economics



Behavioural economics contrasts traditional economics as it challenge the view that economic agents behave rationally

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- Behavioural economics recognises that human decision-making is influenced by **cognitive biases**, emotions, social, and other psychological factors that can **lead to deviations from rational behaviour**
- The assumptions **of traditional economics** regarding decision-making **do not hold**
- The following limitations mean individuals are **unlikely to always make rational decisions**
  - Bounded rationality
  - Bounded self-control
  - Biases

Bounded Rationality & Self Control

Bounded Rationality Theory

- This theory argues that people make decisions **without gathering all the necessary information** to make a rational decision within a given time period
  - Individuals may not understand the technical jargon linked to selecting insurance or pensions
- The theory assumes **rational decision-making is limited** because of
  - An individual's thinking capacity
  - Availability of information
  - Lack of time available to gather all of the information and make a judgement
- **Too much choice** can also cause people to make irrational decisions
  - E.g. When making choices about purchasing particular products in the supermarket, there may be too much choice, making it difficult to make a decision

Bounded Self-Control

- The theory of bounded self-control suggests that individuals have a limited capacity to regulate their behaviour and make decisions in the face of **conflicting desires or impulses**
  - It recognises that self-control is not an unlimited resource that can be exercised endlessly without consequences
- Humans are **social beings influenced by family**, friends, and social settings. This often results in **decision-making which conforms to social norms** but does not result in the maximisation of

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consumer utility

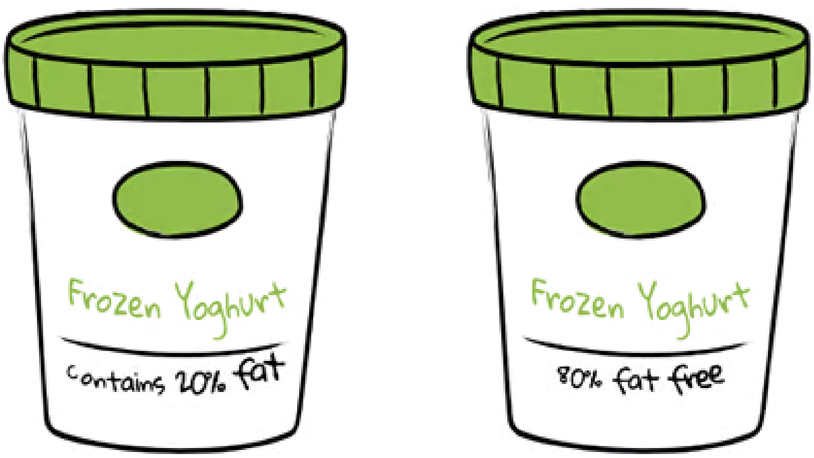
- Bounded self-control leads to decision-**making based on emotions**, which may not yield the best outcome
  - E.g People may indulge in impulsive spending, purchasing goods they did not originally intend to buy
- Businesses use marketing to capitalise **on the lack of bounded self-control** of individuals when appealing to their target audience to maximise sales
  - E.g. Supermarkets place a **range of items at the checkout register** to encourage impulse purchases

The Influence of Biases on Decision Making

- Biases influence **how we process information** when making decisions and these influence the process of rational decision-making
  - Examples of bias include common sense, intuition, emotions and personal and social norms

Types of Bias

Type of Bias	Explanation
Rule of thumb	▪ This is when individuals make choices based on their **default choice** based on experience ▪ E.g. Individuals may also order the same pizza anytime they order from Pizza Hut, However, the best choice may be to buy the new tasty option, which is available at 50% discount
Anchoring and framing	▪ Anchoring bias occurs when individuals rely too heavily on an initial piece of information (the "anchor") when making subsequent judgements or decisions ▪ E.g. When buying a used car, the seller may initially suggest a price of $10,000. Even if you know the market value is lower, the anchor of $10,000 might still influence your perception and as a result, the consumer ends up paying a higher price than intended ▪ Framing refers to how the presentation or wording of information can significantly influence people's choices or judgements

	▪ The same information can be framed in different ways, leading to different outcomes ▪ E.g Consumers are more likely to purchase a product that states '80% fat free' than '20% fat' 

Availability bias	▪ Occurs when people rely on immediate examples or information that comes to mind easily when making judgments or decisions
	  ▪ It leads individuals to overestimate the likelihood or importance of events or situations based on how readily available they are in their memory
	▪ Availability bias is influenced by **personal experiences**, vividness of the information, media exposure, and emotional impact
	  ▪ E.g. People use alternative modes of transport when there is a plane crash, even though the probability of a crash happening is very low

Social norms	▪ These are the **informal rules** that govern behaviour in groups and societies
	  ▪ E.g Consumers buy expensive goods to display wealth or social status rather than for practical reasons
	  ▪ The perception is that owning luxury goods equates to success and status

The Influence of Altruism & Perception on Rational Choice

- **Traditional economics** assumes that people always act in their own self interest
  - Yet many charitable economic decisions have **no economic benefit** for the decision-maker
  - Altruism and perception can be major drivers in the non-rational decision-making process
- Altruism is the idea that behaviour **benefits a group** at the expense of the person performing it
  - E.g. Giving charitable donations or volunteering
- This explains why individuals make decisions that do not always align with maximising their own personal benefits and is in contrast to what **rational** self-interest theory would suggest
- Altruistic decision-making can be influenced by
  - The pressure to conform to **social norms**
    - E.g Following ethical and conscious shopping trends may **nudge** consumers towards sustainable options
- The **perception of fairness** and what individuals and societies deem to be right or wrong
  - Individuals may be more concerned with **more equitable outcomes** for society than their own self-interest
  - E.g Some people buy the *Big Issue* even though they never read it, as they choose to support the individuals selling the *Big Issue*

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Using Behavioural Economics

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Choice Architecture

- **Choice architecture refers to the intentional design of how choices are presented so as to to influence decision making**
  - E.g. Salad bar placement at the beginning of buffets to encourage people to put fruit and vegetables on their plate
  - Supermarkets place more profitable products at eye level on the shelves
- **Choice architecture aims to simplify the decision making process**
  - E.g. Restaurants present information about food options in a particular format to **encourage individuals to make a particular choice** - often bundling items together
  - E.g. Tesco replaced confectionary usually found at the checkout till with **healthier options** so as to encourage people to make better food choices

Types of Choice Architecture

Type of Choice	How does it work?

Default choice	▪ Occurs when an individual is **automatically signed up to a particular choice**
	▪ This reduces choice as it means **a decision is already made** even if no action has been taken
	▪ Research has shown that **individuals rarely change from the default choice**
	  ▪ E.g. Driver licence agencies select 'organ donation' as the default choice when offering driver's new licences
	  ▪ When **signing up for an online service**, the default choice for receiving promotional emails may be set to "opt-in,"

Restricted choice	▪ It occurs when the choices available to individuals are **limited,** which helps individuals make **more rational decisions** ▪ E.g. In a cafeteria, if unhealthy food options like sugary drinks are removed and replaced with healthier choices like water, consumers will be more likely to purchase them
Mandated choices	▪ Mandated choices require individuals to make a specific decision or take a particular action **by imposing a requirement or obligation** ▪ Mandated choices can be used to **ensure compliance with regulations** or societal norms, making it necessary for individuals to make certain decisions ▪ E.g. Some countries **mandate car insurance,** which requires all vehicle owners to make an active decision to choose and purchase car insurance rather than leaving it as an optional choice

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An Evaluation of Choice Architecture

- Choice Architecture is a powerful tool which can be used both for the benefit of firms and society, but it can also be abused

Evaluating Choice Architecture

Advantages	Disadvantages
▪ **Influences behaviour** Choice architecture can be used to nudge individuals towards making choices that are in their best interest or align with desired outcomes	▪ **Manipulation** It can be seen as a form of manipulation as it attempts to influence people's decisions without their explicit consent, which may infringe on the principle of free choice
▪ **Simplifies decision-making** Well-designed choice architecture can simplify complex decisions by providing clear and understandable options	▪ **Ethical concerns** Individuals may not be aware that their choices are being influenced, or they may not fully understand the consequences of their decisions due to the way choices are presented
▪ **Improved outcomes**	▪ **Potential for bias**

Effective choice architecture can lead to improved outcomes such as encourage healthier eating habits and combatting issues like obesity	Choice architecture is susceptible to biases inherent in the design process and may be used by companies to increase profits
▪ **Enhance decision quality** By structuring choices carefully, it can provide guidance, reduce biases, and increase the likelihood of individuals making choices they would consider to be better	▪ **Unintended consequences** Changes in the presentation of choices can have unforeseen effects and the outcomes may not align with the original goals

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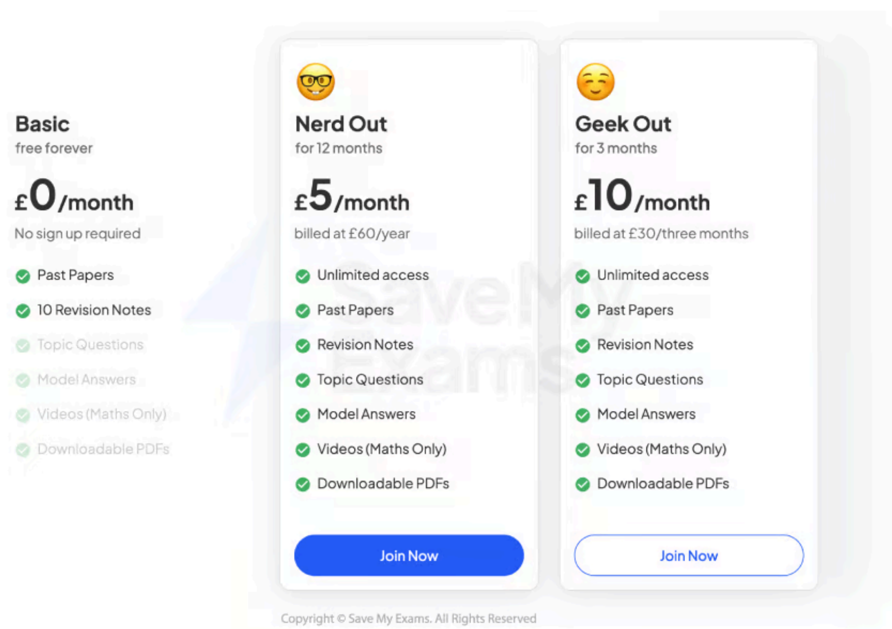
Nudge Theory

- **Nudge theory is the practice of influencing choices that economic agents make, using small prompts to influence their behaviour**
- Richard Thaler coined the phrase 'nudge theory' and argued that firms should **use nudges in a responsible way** to guide and influence decision-making

Examples of nudges

Diagram: Nudge Theory at SME



Save My Exams choice architecture nudges users to select the £5 a month option

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- The choice architecture above 'nudges' individuals towards selecting the monthly plan above the other plans available

Diagram: London Underground

Source: Transport for London

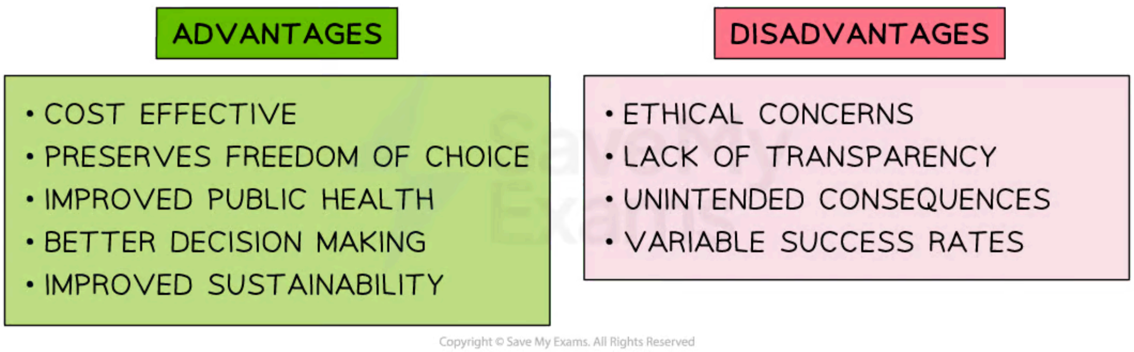
- The **baby on board badge** is supplied by Transport for London to expectant mothers to wear when using public transport
  - Other commuters should see the badge and **accommodate for the expectant mother** by giving their seat to her
- Dr David Halpern, from the **UK Behavioural Insights team** suggested the following **EAST framework** to nudge decision making
  - **E**asy: Simplify or make it straight forward
  - **A**ttractive: Gain people's attention, e.g through personalised messages, encourage people not to miss out on opportunities
  - **S**ocial: Individuals are influenced by what other people do rather than rules and regulations
  - **T**imely: identify when people are most responsive

An Evaluation of Nudge Theory

- Consumer nudges are designed to **guide people towards certain decisions or actions** while still allowing them to have freedom of choice

- These interventions are typically based on behavioural economics principles and aim to nudge individuals towards decisions that are considered beneficial for themselves and society as a whole
- Consumer nudges should be designed with **transparency**, respect for individual autonomy, and clear societal benefits in mind
  - **Ethical considerations** should be taken into account to ensure that interventions are **not manipulative or coercive**

Diagram: Evaluating Nudge theory



The advantages and disadvantages of using nudge to influence behaviour

The advantages

- **Cost effective**
  - Relatively low-cost compared to other marketing measures
- **Preserves freedom of choice**
  - Steers individuals towards certain choices while still allowing them to retain their freedom of choice
- **Improved public health**
  - Nudges can be used effectively to encourage healthier behaviours such as exercising, eating nutritious food, or quitting smoking
- **Better decision making**
  - Helps individuals make better decisions by simplifying complex information, providing reminders, or structuring choices
- **Environmental sustainability**
  - By influencing individual choices in a subtle way, firms/governments can contribute to broader environmental goals without imposing strict regulations

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The disadvantages

- **Ethical concerns**
  - Some critics argue that **nudges can be manipulative**, as they rely on influencing behaviour without individuals being fully aware of the intervention
  - This raises ethical concerns about **autonomy, consent, and the potential for abuse** by governments
- **Lack of transparency**
  - Nudges often operate behind the scenes, making it **difficult for individuals to understand or question the influences** shaping their choices
- **Unintended consequences**
  - As citizens become used to firms and government's use of nudges, they may well begin looking for it and **actively work against them,** e.g. In the UK, more people now look for automatic inclusion in organ donor databases and quickly select the non-default option
- **Variable success rates**
  - Nudges may not be equally effective for all individuals due to differences in cognitive biases, cultural backgrounds, or personal circumstances

Examples of UK Government Nudge Theory in Action

- Nudge theory helps governments and other agencies shape economic decision-making
- Examples of UK government nudge theory in action include
  - Workplace pension schemes
  - Health checks
  - Labels on food packaging

Evaluating the UK Governments Use of Nudge

Nudge	Description	Cost	Benefits to Consumers	Benefits to Society

Workplace pension schemes	▪ Employers enrol eligible workers automatically into pension schemes unless they choose to **opt-out**	▪ **Administrative** costs for employers to implement the scheme	▪ Encourages retirement savings among workers ▪ Ensures **financial security** in old age	▪ Reduces reliance on state pensions ▪ Reduces future financial strain on government **welfare systems**
Health checks	▪ Preventive health checks offered for those aged 40-74	▪ Cost of funding the **healthcare professionals** who carry out the tests	▪ Early detection of diseases that can be treated ▪ Nudges to patients to manage own healthcare and wellbeing	▪ Reduced future **health care costs** ▪ A healthier and more **productive society**
Labels on food packaging	▪ Traffic light labelling on food packaging to indicate nutrient value	▪ Cost of designing and printing labels	▪ Improved **health** of individuals as they can make more informed choices about food	▪ Improved **public health** of society ▪ Reduced long term cost of health care

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