Royal Russell

A Level Economics

Summer Bridging Work

<u>Are Consumers Rational?</u>

Economists make simplifying assumptions to help make sense of the complex world in which we live. One such assumption of 'traditional' economics is that consumers behave rationally. To economists, rational behaviour means that consumers always seek to maximise their utility. This means consumers want to derive as much satisfaction and enjoyment as possible from the money they spend. And yet in the real world, we often see that this is not the case. For example, consumers may stick with the same mobile phone company for years, even though there are better deals available from other providers. A new branch of economics called 'behavioural economics' tries to explain why consumers might behave irrationally and make decisions that don't maximise their utility. Possible reasons include the following.

1. Consideration of the influence of other people's behaviour

One key behavioural bias observed in individuals is *herding behaviour*. According to Thaler and Sunstein, 'We are greatly influenced by *consumption norms* within the relevant group.' For example, if we see our friends drinking alcohol, we are more likely to do so, too. Even housing market booms can be caused by this effect: some people start investing in houses so others think this is a good idea, too. We seem to be particularly *influenced by what other people do* when making our consumption decisions.

2. The importance of habitual behaviour

The *'status quo' bias* is the tendency which individuals have of just sticking with their current situation. We observe this in the weekly shop of most families at the supermarket, and in the tendency to stay with the same bank even though others may be offering a higher interest rate. This is often linked to individuals wanting to 'play safe', not wanting to risk a change which might make them worse off (*loss aversion*). This bias can cause consumers to lose out on possible utility gains (and also links with the default option mentioned later).

3. Consumer weakness at computation

Humans are particularly bad at mathematical computation. For example, we find it really hard to understand probabilities and to make forecasts about how we will feel in the future.
In Richard Layard's book *Happiness: Lessons from a new science*, he states that people tend to *exaggerate small probabilities* into their thinking. This is often observed in how individuals react to 'health scare' stories in the media. Articles on how we triple our chance of getting some horrible illness can overly swing consumers into avoiding certain foods. The purchase of super foods may also soar despite the fact that its effect on reducing our real risk of a disease may be mathematically almost negligible.

Layard also points out that individuals find it *hard to forecast future feelings*. Individuals always think their purchasing decision, eg whether to buy a new car, will give them happiness for a longer time than it does in reality. 'If only I had the latest iPhone …'

Products which have an *addictive element* also cause particular problems for individuals. They have a tendency to underestimate the future problems of trying to stop once they start and instead overly base their decision to buy cigarettes on the immediate gratification they receive. Individuals also have an *unrealistic optimism*, despite statistical data, and so 'overestimate their personal immunity from harm' (source: *Nudge*).

Amos Tversky and Daniel Kahneman (1974) studied how humans go about making judgements. They observed three heuristics (mental short cuts) which individuals tend to use to help them *when uncertainty exists* and *where assessing the probabilities involved would be too complex*. They help consumers make quick and often useful decisions. Let's look at some examples from the perspective of a consumer.

• Should I spend money on an upgraded and more secure front door? What is the likelihood that I might be burgled if not? The *availability heuristic* says that people, as a mental short cut, tend to base their assessment of risk on immediate examples which spring to mind. If I have recently watched a programme on the negative impact of being burgled, I am likely to over base my judgement on this and think my chances of being burgled are actually higher than they are. Therefore 'availability bias' is at work, which will influence my consumption decision.

• Should I buy a bread maker? A famous example from Dan Ariely involves a retail business based in San Francisco. They originally offered one type of bread maker to the market priced at $275. There were virtually zero sales. They then launched a $400 bread maker on the market which was bigger but otherwise had the same features. The original, smaller bread maker's sales doubled! The *anchoring heuristic* shows a human tendency to make decisions by comparing with a nearby reference point. The first bread maker had no reference point so consumers were left muddled about its value and whether they wanted it. Once the $400 bread maker became a reference point (an anchor), consumers then decided the cheaper option was an attractive proposition, despite the fact that it was being viewed by the same consumers with supposedly their own preferences and was the same bread maker. We rely too much on the first piece of information (the anchor) which is presented to us. It is clear that the anchor itself can lead to very different consumption decisions.

In Thaler and Sunstein's book *Nudge*, when *issues are complex*, making it hard for individuals to assess the full costs and benefits of a consumption decision, individuals tend to just go with the *'default' option*, ie the choice that has effectively been chosen for them. For example, if you take out a magazine subscription, unless you actively cancel the subscription it will automatically be renewed. People tend to let their subscriptions carry on without engaging in an active rational assessment as to whether the magazine will generate sufficient utility for another year. This affects consumption patterns and intelligent firms can exploit this tendency!

<u>Short-answer questions</u>

1. Most people pick a retirement savings plan and then forget about it, despite opportunities to make a higher return by switching their investments over time. This demonstrates that:

A consumers are rational.
B consumers have a tendency to stick with the 'status quo'.
C consumers will always behave in such a way to maximise their utility.
D the costs of switching are always greater than the benefits.

2. Which statement is true?

A Other people's behaviour has no influence over an individual's consumption decision.
B A rational consumer never aims to maximise utility.
C Behavioural economics makes the assumption that consumers are rational.
D There are many reasons why consumers may not behave rationally.

3. It is difficult for consumers to make a fully informed consumption decision because ...

A consumers have perfect information to help them make choices.
B it is always easy to compare the prices of goods and services.
C they are strong at computation skills.
D information is not always perfect and available to consumers.

4. There are currently over 12.7 million mobile phone deals being offered within the UK with a range of options, such as pay as you go or a monthly contract, the handset included, and the number of minutes and texts included in the contract.

a) Explain why this makes it difficult for a consumer to make a rational decision.

b) Many individuals will stick with their current deal over time, despite other deals being offered which would increase their utility. Give two distinct reasons why this behaviour is often observed.

5. Explain why it is particularly hard in the second-hand car market for consumers to decide which car to buy.

6. To what extent was your decision to study Economics a rational one?

7. Explain why a reduction in the price of a good should cause its sales to rise. (Use your knowledge of both traditional economics and behavioural economics.)

ESSAY: 'The most effective way for the government to stop people smoking is to put up taxes on cigarettes.' With reference to the information provided and your own knowledge, to what extent do you agree with this statement?

Advice for writing the essay:

Two sides of A4 will be quite sufficient.

Here is a possible approach.

1: Explain how higher taxes (excise duties) on cigarettes **would** be successful in reducing smoking. Clue: How would the tax affect the price of cigarettes? Research tobacco taxes in the UK.

2: Explain some possible arguments why higher taxes on cigarettes **would not** be successful in reducing smoking. Use some of the behavioural arguments in the above article. You could also look up the meaning of *inelastic demand* which is relevant here.

3: Write an overall conclusion explaining whether you agree or disagree with the statement and why. You need to **justify** your opinion.

This link contains useful information for your essay, and you can also do your own research.

https://www.ukessays.com/essays/economics/the-effects-of-high-taxes-on-tobacco-economics-essay.php

Other useful websites for A level economics are:

https://www.economicshelp.org/

https://www.tutor2u.net/

https://www.economicsonline.co.uk/

https://studywise.co.uk/a-level-revision/economics/

https://www.s-cool.co.uk/a-level/economics