AQA Economics A-level
Microeconomics

Topic 2: Individual Economic Decision Marketing

2.3 Aspects of behavioural economic theory

Notes

Bounded rationality and bounded self-control

- Individuals are rational decision makers who endeavour to maximise their utility.

- **The Administrative Man:**

- Herbert Simon recognised the limitations of the decision making model, so he devised the **bounded rationality model,** which is also known as the administrative man theory.
- The assumptions of this model are:
  - The first alternative that is satisfactory is selected
  - The decision maker recognises that they perceive the world as simple
  - The decision maker recognises the need to be comfortable making decisions without considering every alternative
  - Decisions could be made by heuristics.

- Bounded self-control assumes consumers are able to exercise self-control.
- However, consumers are unable to exercise self-control with some decisions. The law of diminishing marginal utility suggests that every extra unit consumed provides a smaller benefit to the consumer. Yet, if the example of food is taken, some consumers will still eat more than gives them optimal benefit.
- Another example could use the short term and long term view. Consumers know that it will benefit them in the long run if they save for their pension, but this will limit their spending in the short run. Spending less in the short run instils fear in the consumer, even if they are aware that unless they save, they will not be able to consume as much in the long run. With the long run view, consumers feel as though they 'could always start saving tomorrow'. It is this procrastination which leads to consumers making irrational decisions by not having self-control.

Biases in decision making: rules of thumb, anchoring, availability and social norms

- Consumers do not always act rationally. Acting rationally means making a decision that results in the most optimal level of utility or benefit for the consumer.

- The rational consumer is *Homo Economicus*, who is a utility maximiser and makes rational decisions.

- Heuristics simplify the decision making process to come to a reasonable decision. They are shortcuts to avoid taking too long to make the decision, and they avoid the problem of having imperfect information or limited time.
- For example, the consumer might use common sense or intuition. They might consider how it is cheaper to buy goods in the sale. They might have pre-decided criteria, or a rule-of-thumb, and only buy the good if it is in a sale. This could lead to irrational decisions being made.

- **Social norms**
- Assume there are two restaurants; one is empty whilst the other has a long queue. Consumers are more likely to queue for their food than go straight into the other restaurant. The behaviour of other people affects how the consumer acts.
- Other people's behaviour creates a bias within the consumer. This social pressure encourages consumers to do things they would not otherwise do, or that they know could be harmful. Consumers become unwilling to change, even if it is of benefit to them, if it goes against the norms of their society.

- **Anchoring**
- This is a type of bias created by the human tendency to rely on the first piece of information they are given.
- This first piece of information causes consumers to be biased towards it when subsequent information is given.
- For example, if a car's original price is high, but it is on sale for a lower price, consumers will be inclined to think this is reasonable, even if the lower price is more than the car's value.

- **Availability**
- This is a form of bias towards events that were recent, personal or memorable. This is because they are overestimated and cause emotional responses.
- For example, consumers are likely to think plane accidents are much more likely to occur, if they have been involved in one or know someone else who has. Even though they are very rare, they overestimate the probability. This then influences how the consumer behaves.
- This type of bias is spread across populations by reporting them in the news and media.

The importance of altruism and perceptions of fairness

- Altruism is the act of being selfless and considerate towards other people.
- The Ultimatum Game is used to describe altruism. There are two players: a proposer and a responder. The proposer has to offer the responder a portion of the sum of money they are given. The proposer can choose how much to offer. The responder can either accept or decline the offer. If the responder accepts the offer, the sum of money is divided. If the responder declines the offer, both players receive nothing.
- Proposers do not just offer the minimum amount. Usually, it is in the range of 40%-50% of the total. Responders usually accept offers above 25%.
- This highlights the perception of fairness. Proposers and responders do not aim to get as much money as possible, but they aim to distribute the money according to what is considered fair.
- Responders choose to accept nothing rather than be treated unfairly (with offers below 25%). This essentially 'punishes' the proposer for treated them unfairly by offering a small amount. Proposers might try and be fair, but they also try to offer an amount which will be accepted by the responder.