DP IB Economics: HL

Your notes

2.4 Critique of the Maximizing Behaviour of Consumers & Producers

Contents

Your notes

Rational Consumer Choice

Assumptions of Rational Consumer Choice

- **Free markets** are built on the assumptions of **rational decision making**
- 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** will select the **choice** which presents the **highest benefits (utility)**
- **Rational choice theory** states individuals use logical and sensible reasons to determine the right choice connected to an individual's best self-interest
- Many economic theories assume that **economic agents (individuals, firms and governments)** make decisions that result in maximising their satisfaction
  - E.g. The law of demand which states that as the price falls consumers **will increase their demand** for goods and services
- This traditional economic view is based on the following three assumptions

1. Consumer Rationality

- The assumption that individuals use **rational calculations** to make choices which are within their own best interest, using all the information available to them

2. Utility Maximisation

- Traditional economic theory assumes economic agents **select choices that maximise their utility** to the highest level
  - E.g. If an individual gains greater satisfaction from swimming than going for a run, they will chose to go swimming

3. Perfect Information

- Rational choice theory assumes information is **easily accessible** about all goods and services on the market. It assumes individuals have access to all the information available to make the best decision

Limitations of the Assumptions of Rational Consumer Choice

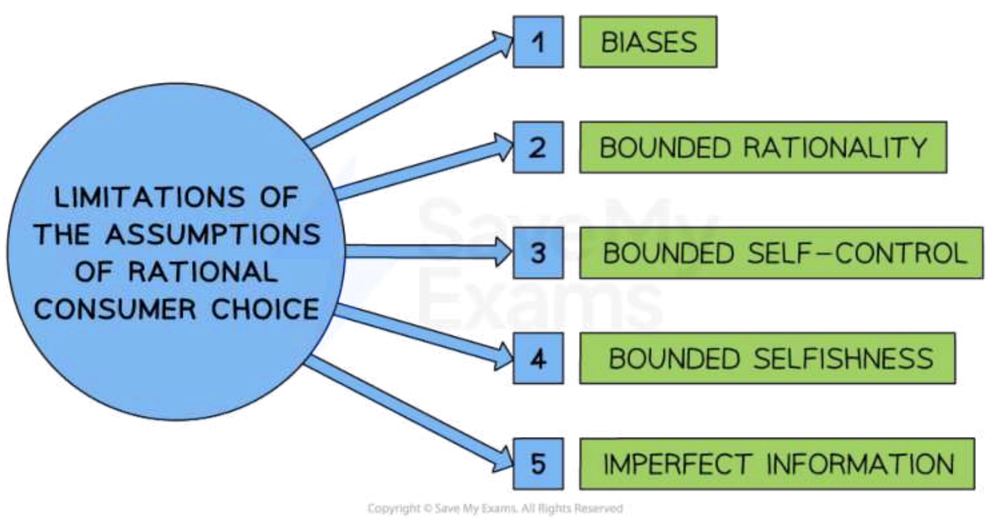
- Behavioural economics **contrasts traditional economics** as it challenge the view that economic agents behave rationally

- 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

- 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**



Limitations of the assumptions of rational consumer choice

1. Biases

- 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**

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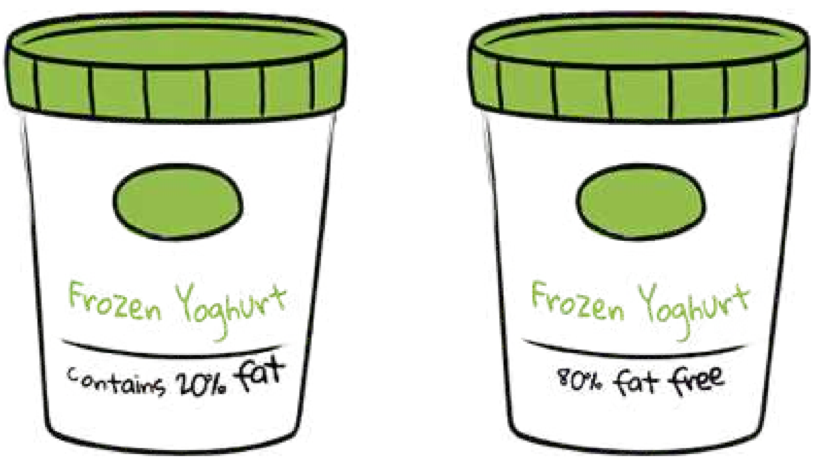
Anchoring and Framing	▪ **Anchoring** bias occurs when individuals **rely too heavily on an initial piece of information** (the "anchor") when making subsequent judgments or decisions ▪ E.g. When buying a used car the seller may initially suggests a price of \$10,000. Even if you know the **market value 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 judgments ▪ The same information can be framed in different ways, leading to different outcomes ▪ E.g consumers are likely to purchase a product that states '80% fat free' than '20% fat' 

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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

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2. 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 infromation 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

3. 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 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 didn't 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

4. Bounded Selfishness

- Behavioural economics challenges the view that economic agents **always act within their own self interest**
- Bounded selfishness recognises that individuals do things for others without a direct reward
  - **Altruism** is the practice of acting selflessly helping others expecting nothing in return
- Examples of bounded selfishness include
  - Donating money to charity
  - Organ donations
  - Voluntary work

5. Imperfect Information

- Rational Choice Theory assumes information is perfectly accessible, however this is incorrect due to factors such as
  - Intellectual property rights e.g. patents, copyrights and trademarks
  - Cost of accessing information
  - The sheer amount of information and options available
- This means people make decisions **based on limited information** meaning they may not make the best choice
- **Asymmetric information** may also lead to decisions based on limited information
  - E.g. When purchasing second hand cars, the seller always has more information than the buyer

Your notes

Your notes

Behavioural Economics in Action

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 veg on their plate
  - Supermarkets placing 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	▪ 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

- When evaluating Choice Architecture, it is useful to consider the advantages and disadvantages

The Advantages and Disadvantages of 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

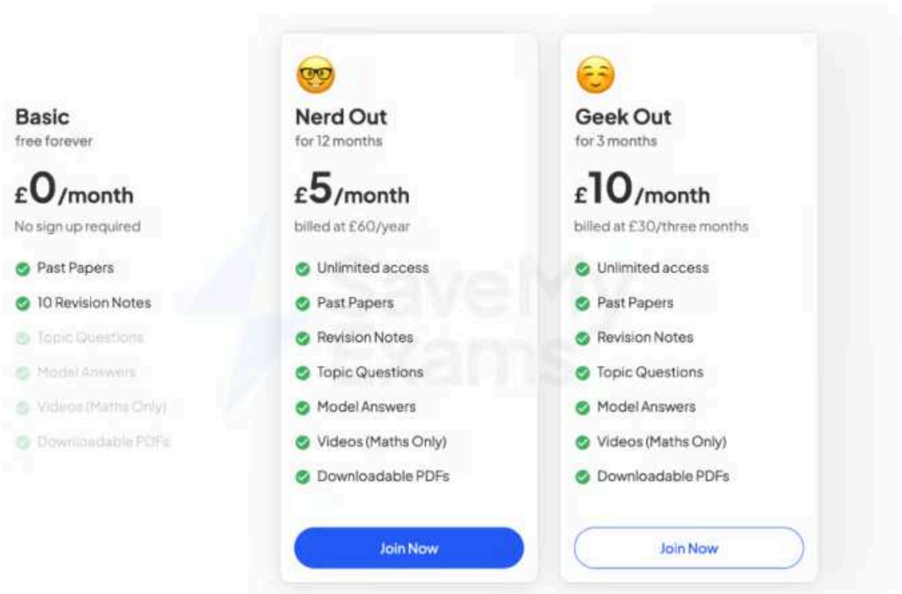
▪ **Improved Outcomes** Effective choice architecture can lead to improved outcomes such as encourage healthier eating habits and combatting issues like obesity	▪ **Potential for Bias** Choice architecture is susceptible to biases inherent in the design process and may be used by companies to increase 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

Your notes

Nudge Theory

- **Nudge theory i**s 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



Save My Exams Choice Architecture nudges users to select the £5 a month option

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

Your notes

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

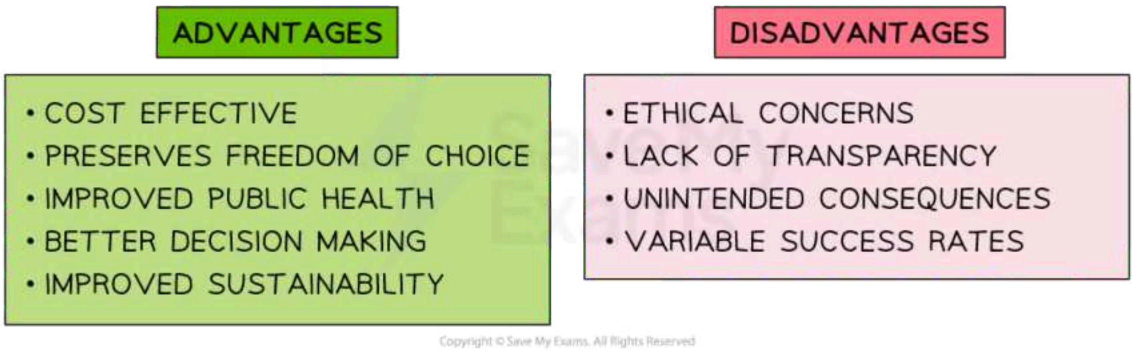
- Dr David Halpern, from the **UK Behavioural Insights team** suggested the following **EAST framework** to nudge decision making
  - **E**asy – Simplify or make it straight forward
  - **A**ttractive – Gain people's attention e.g personalised messages, encourage people not to miss out on opportunities
  - **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**

An Evaluation of Using Nudge to Influence Behaviour

Your notes



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

The Disadvantages

Your notes

- **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/government's using nudge, they may well begin looking for it and **actively work against the nudges** 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

Business Objectives

Your notes

Profit Maximisation

- Most firms have the **rational** business objective of **profit maximisation**
  - Profits benefit shareholders as they receive **dividends** & also increase the underlying share price
    - An increase in the underlying share price increases the **wealth** of the shareholder
- To achieve profit maximisation firms, follow the **profit maximisation rule**
  - When **marginal cost (MC)** = **marginal revenue (MR)** then no additional profit can be extracted by producing another unit of output
  - When MC < MR additional profit can still be extracted by producing an additional unit of output
  - When MC > MR the firm has gone beyond the profit maximisation level of output
    - It is making a marginal loss on each unit produced beyond the point where **MC = MR**

- In reality, firms may find it difficult to produce at the **profit maximisation level of output**
  - They may not know where this level is
  - In the short term they may not adjust their prices if the **marginal cost** changes
    - Marginal costs can change regularly and **regular price changes** would be disruptive to customers
  - In the long-term firms will seek to **adjust prices** to the profit maximisation level of output
  - Firms may be forced to change prices by the c**ompetition regulators in their country** (especially natural monopolies)
    - The profit maximisation level of output often results in **high prices** for consumers
    - Changing prices changes the **marginal revenue**

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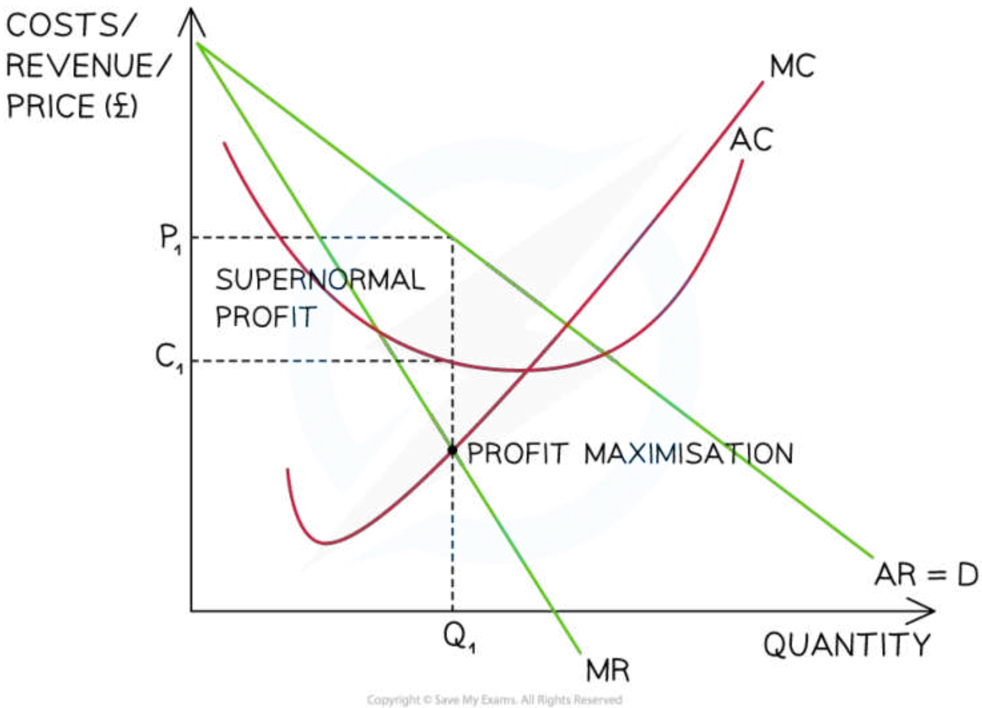


The profit maximisation level of output occurs at Q_1 where MC = MR resulting in a market price of P_1

Diagram Analysis

- This firm has **market power** as the MR and **average revenue (AR)** curve are downward sloping
- At the profit maximisation level of output (MC = MR)
  - The selling price is P_1
  - The average cost is C_1
  - The **supernormal profit** = $(P_1 - C_1) \times Q_1$

Examiner Tips and Tricks

Profit maximisation is all about the quantity of output.

To determine the level of profit:

Your notes

1. identify where MC = MR and then **extend the dotted line upwards** to the point where it hits the AR curve - this is your selling price
2. Where this line crosses the **average cost curve (AC)** represents the cost per unit at this level of output
3. The profit is the difference between the selling price and the average cost

Evaluating Profit Maximisation as a Business Objective

- Apart from the very significant advantages that are offered by pursuing profit maximisation, there are some distinct disadvantages too

The Advantages & Disadvantages of Pursuing Profit Maximisation

Advantages	Disadvantages
▪ **Financial Stability and Growth** Maximising profits allows businesses to accumulate capital, **reinvest in growth opportunities**, and withstand economic uncertainties	▪ **Ethical and Social Concerns** Focussing on profit maximisation can result in actions that disregard the well-being of employees, communities, and the environment (negative externalities)
▪ **Shareholder Value Creation** By focusing on profit maximisation, companies can enhance shareholder value, attract new investors and **maintain their competitiveness** in the market ▪ **Resource Allocation Efficiency** Businesses are incentivised to allocate resources efficiently which can **lead to improved productivity** and cost control	▪ **Risk of Neglecting Non-Financial Metrics** Important factors like employee satisfaction, customer loyalty, product quality, and environmental sustainability may be neglected if they are not directly tied to immediate profit generation ▪ **Short term profits versus long term value creation** Extracting the highest level of short term profits will often **detract from future value creation through** research or innovation

Growth

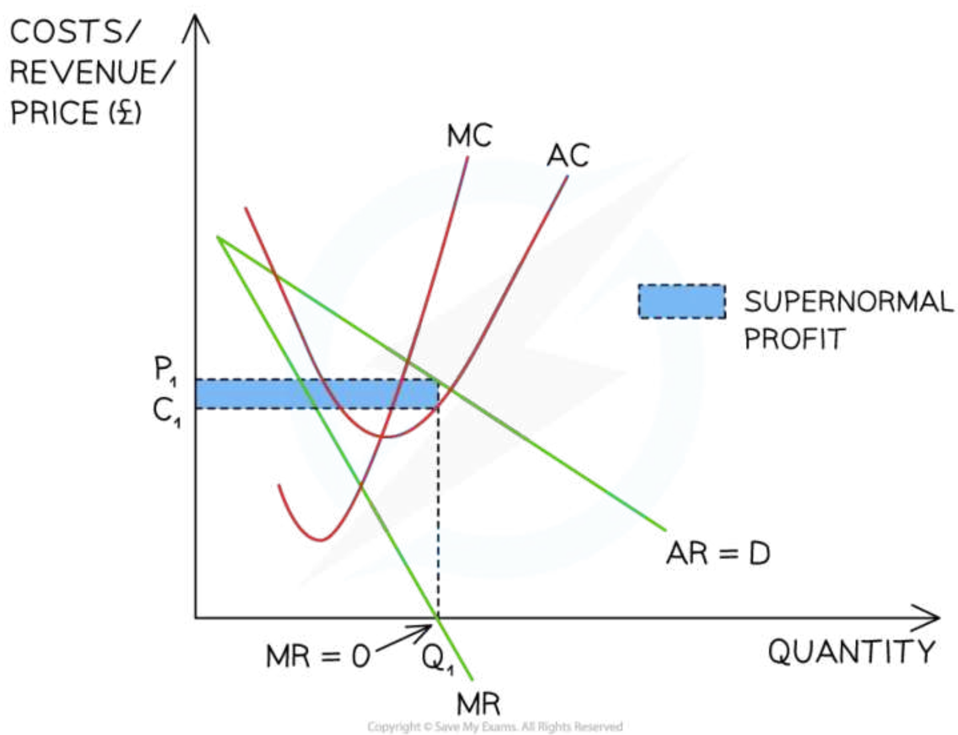
- Some firms have the business objective of growth
- Firms with a growth objective often focus on increasing their **sales revenue** or **market share**

- Firms will also maximise revenue in order to increase output & benefit from **economies of scale**
  - A growing firm is less likely to fail

1. Revenue Maximisation as a Sign of Growth

- Firms aim to **maximise revenue** in order to increase output & benefit from **economies of scale**
  - In the short-term firms may use this strategy to **eliminate the competition** as the price is lower than when focussing on profit maximisation

- To achieve revenue maximisation firms produce up to the **level of output where MR = 0**
  - When MR > 0, producing another unit of output will **increase total revenue**



The revenue maximisation level of output occurs at Q1 where MR = 0 resulting in a market price of P1

Diagram Analysis

- This firm has **market power** as the MR and **average revenue (AR)** curve are downward sloping
- At the revenue maximisation level of output **(MR = 0)**

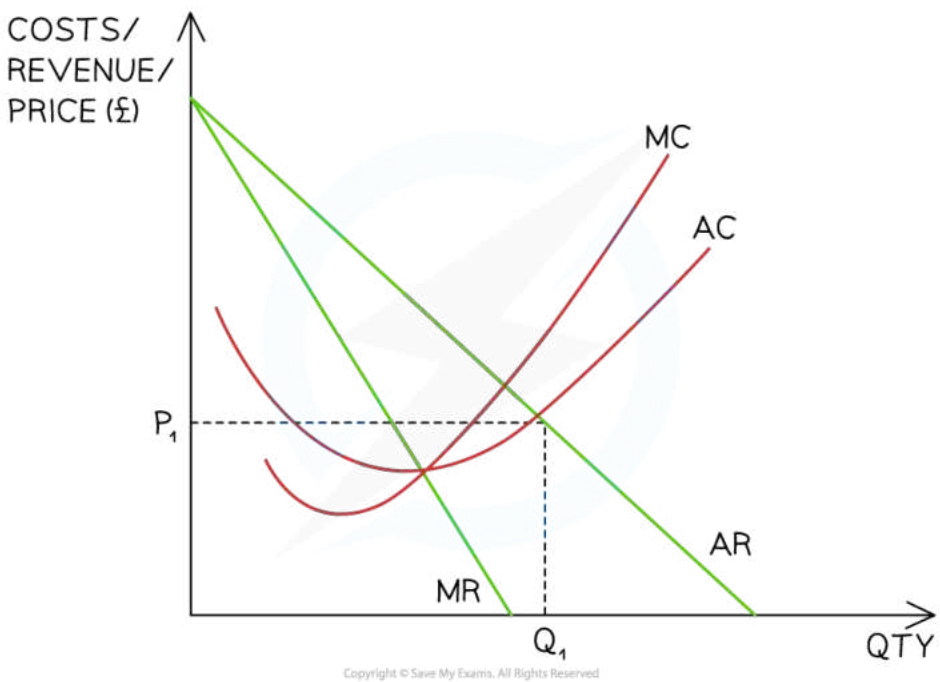
Your notes

Your notes

- The selling price is P_1
- The average cost is C_1
- The **supernormal profit** = $(P_1 - C_1) \times Q_1$
- The supernormal profit is less than when the firm follows the **profit maximisation rule**

2. Market Share as a sign of Growth

- Some firms have the business objective of **sales maximisation which further lowers prices** and has the potential to **increases market share**
  - Sales maximisation occurs at the level of output where **AC = AR (normal profit/breakeven)**
  - In the short-term firms may use this strategy to clear stock during a sale **or increase market share**
    - Firms sell remaining stock without making a **loss per unit**



The sales maximisation level of output occurs at Q_1 where AC = AR resulting in a market price of P_1

Diagram Analysis

- This firm has **market power** as the MR and **average revenue (AR)** curve are downward sloping
- At the sales maximisation level of output **(AC = AR)**

- The selling price is P_1
- The average cost is also at P_1
- The firm is breaking even (normal profit)

Your notes

Examiner Tips and Tricks

Although sales and revenue maximisation are not in the syllabus per se, due to the fat they can form part of the growth objective, it would be useful to understand them. Revenue maximisation was also examined in the May 2023 session.

Evaluating Growth as a Corporate Objective

- Companies need to carefully assess the trade-offs and consider a **balanced approach to growth**, taking into account risk management, organisational capabilities, and long-term sustainability of any growth actions

The Advantages & Disadvantages of Pursuing Growth

Advantages	Disadvantages
▪ **Increased market share** and competitive advantage ▪ Growth is often associated with **improved financial performance** and increased shareholder value ▪ Pursuing growth **stimulates innovation** and attracts top talent ▪ Growth also **creates opportunities for employees** to take on new roles and responsibilities, fostering a dynamic and engaging work environment	▪ Growth comes with **inherent risks and complexities**. Expanding into new markets, integrating acquisitions, or scaling operations can strain resources, disrupt existing processes, and expose the company to new challenges ▪ Rapid growth can **strain organisational resources**, systems, and structures e.g the ability to offer effective customer service ▪ Pursuing growth opportunities can **lead to a loss of focus** if companies diversify into unrelated markets or industries, diluting their expertise and stretching their resources

Satisficing

Your notes

- Satisficing refers to the pursuit of **satisfactory or acceptable outcomes** rather than profit maximisation
  - It is a decision-making approach where businesses aim to **meet a minimum threshold or standard of performance** rather than striving for the absolute best outcome

- Small firms may satisfice around the **desires of the business owner** (sole trader) to have more well-being in their life

- Many large firms often end up satisficing as a result of the **principal agent problem**
  - Rationally, managers know **shareholders want to profit maximise**
  - However, **managers want to maximise sales** or revenue so as to increase their wages
  - Managers (who control the business) settle for a level of output somewhere **between profit and sales** maximisation
    - This increases their wages and **reduces potential conflict** with shareholders

Evaluating Satisficing as a Corporate Objective

- Balancing the advantages and disadvantages of satisficing is essential, and companies may **adopt a combination of satisficing and profit or growth strategies** to achieve the best possible outcomes

The Advantages & Disadvantages of Pursuing Satisficing

Advantages	Disadvantages

▪ Offers internal stakeholders (owners, management and employees) the opportunity to develop **a healthy work-life balance** - or to focus on other goals they consider to be important ▪ It **reduces decision-making costs** and speeds up the decision making process as less extensive and time-consuming research is required as compared to seeking **optimal solutions** that maximise profit	▪ There is the **potential for mediocrity** or suboptimal results. Companies may miss out on opportunities to achieve better results and improve their competitiveness ▪ Satisficing may **discourage the pursuit** of innovative and creative solutions ▪ By focusing on satisfactory outcomes, companies risk **falling short of higher expectations**, which can lead to customer dissatisfaction, employee disengagement, or **investor skepticism**

Your notes

Corporate Social Responsibility (CSR)

- Corporate social responsibility involved **conducting business activity in an ethical way** and **balancing the interests of shareholders with those of the wider community**

Examples of Corporate Socially Responsible Activities

Socially Responsible Activity	Example
Sustainable sourcing of raw materials and components	▪ High street retailer **H&M** has a goal of using only recycled or sustainably sourced materials by 2030 ▪ It also publishes a **list of the majority of their supplier's** information which is updated regularly, allowing stakeholders to verify and hold the company responsible for their suppliers' conduct
Responsible marketing	▪ **Marks and Spencer** ensures that it never actively directs any marketing communications to **children** under the age of 12 and does not directly advertise any **products high in fat, sugar or salt** to children under the age of eighteen
Protecting the environment	▪ Cafe chain **Prêt à Manger** offers discounts to customers who bring their own coffee cup, reducing the number of single-use plastic containers it dispenses

Responsible customer service	▪ **John Lewis**'s famous 'Never Knowingly Undersold' slogan refers to the company's commitment to **checking competitor prices** regularly to ensure that the price its customers pay is the lowest available in the local area at that time

Your notes

- It is now common practice for large companies to publish annual **Corporate Responsibility Reports** which provide an audit of the steps being taken to meet their commitments to a range of stakeholders alongside annual financial reports
- **Extra costs** are involved in operating in a socially responsible way and these costs must be passed on to consumers

The Advantages of CSR Objectives

- CSR can **enhance** the business image and reputation
- CSR is attractive to many **stakeholders**
- CSR can be very profitable as it **adds value** for many stakeholders
- CSR may improve employee motivation and productivity
- CSR can help to **recruit strong candidates** for jobs advertised
- CSR may help to solve social problems e.g. resource depletion

The Disadvantages of CSR Objectives

- CSR goals can involve **significant financial and resource commitments** which can divert funds and attention away from other business priorities
- CSR goals means facing **increased expectations from stakeholders**, including customers, employees, investors, and the general public
- Defining and **measuring the impact of CSR initiatives can be challenging** as it may be difficult to establish clear metrics and demonstrate tangible results
- Adopting CSR goals **without genuine commitment** and meaningful action can lead to accusations of **greenwashing** or **socialwashing**