Behavioural Economics An introduction

Year 12 Bridging Work for GCSE Economists 2020

2020

Before working through this booklet it would be a good idea to familiarise yourself with some of the issues and concepts you will meet again as you go through this 'bridging work'. This BBC horizon video is a great place to start*

https://www.dailymotion.com/video/x3q4alx

In addition we have provided a copy of the relevant chapter of our Economics A level textbook, that you should refer to to reinforce and extend your understanding of the new concepts introduced below

**This is a nudge by the way*

The Predictions and Assumptions of Conventional Economic Theory

How individuals make decisions matters; individual decision making provides the foundation upon which most traditional economic theories and models have been constructed

Conventional economic theory uses demand and supply to explain how resources are allocated in a market economy. It assumes economic agents interact to determine what is produced, how it is produced and how it is finally distributed between different groups in the economy. The mechanism by which the choices are implemented is a market where the price mechanism coordinates the decisions of economic agents (buyers and sellers) . In this traditional model consumers use their income to purchase the goods and services that give them the most satisfaction (or 'utility) , firms employ factors of production to produce output of goods and services that consumers want . Their objective is to maximise profit. This theoretical framework, where economic agents are 'rational' in the sense they seek only to maximise their own satisfaction by comparing all the cost and benefit of the choices available to them is sometimes referred to as homo economicus and is the view of individual economic decision makers adopted by neo-classical economics

TASK 1

Write in definitions of these key terms. Use the PDF chapter (provided) and on-line sources such as tutor2U, Economics Help and Economics on-line to define and explain the below terms.

Key Term	Definition/Explanation (Max 3 lines)
Economic agent	
Market	
Demand	
Supply	
Equilibrium	
Price Mechanism	
Economic Model	
Homo economicus	
Neo-classical economics	

TASK 2

Now watch the video …… https://www.youtube.com/watch?v=IYO3tOqDISE

In three 300 words answer the following question:

How does the price mechanism ensure that resources are allocated to produce the goods and services consumers want? (You should try and use the terminology in the table above wherever it is relevant)

The Working and Limitations of a Market Economy

https://www.tutor2u.net/economics/reference/economic-systems

'Pure' or complete market economies do not exist 'in the real worlds' but they are useful as an economic model because they allow economists to make judgments about how market orientated a country's economic system is.
Foer example, New Zealand is seen as very market orientated economy as it has a system of private health care (but not as market orientated as, for example, Hong Kong). Sweden and other Scandinavian countries are much less reliant on the price mechanism and a consumers' ability to pay and provide universal education, healthcare, pensions and social protection to all their citizens irrespective of their ability to pay. In countries like Cuba and North Korea mosyt of the conomic activity is undertaken or controlled by the government

https://www.investopedia.com/ask/answers/040915/what-are-some-examples-free-market-economies.asp

The economic system that is adopted or evolves in a country is largely the result of political decisions dating back hundreds of years and market based economies have a number of advantages- they are seen as more efficient, taxes are lower and the private sector takes a much bigger role in employment and production of gods and services. However, all economists agree that under some circumstances markets will fail to achieve an efficient allocation of resources. Some goods and services (which may not always result in higher welfare) can be overconsumed; others (which may be beneficial to human wellbeing) are underconsumed.

https://www.youtube.com/watch?v=QLQjdL7E5pg

https://theconversation.com/the-dark-side-of-free-markets-48862

There are a number of causes or sources of market failure but one of the main causes is information failure, when consumers or firms lack the information to make 'rational' decisions. Conventional economics often proposes taxes, subsidies or regulation to tackle market failures. The aim is to reduce overconsumption (or underconsumption) and restore the market to a social optimum, where equilibrium price and quantity maximise social welfare.
The implications of this information failure have been extensively explored by behavioural economists who propose supplementary or even alternative policies, aimed mainly at addressing information 'gaps' that underpins many of the market failures.

https://www.theguardian.com/society/2019/sep/05/tax-on-snacks-would-have-huge-impact-on-obesity-say-experts

TASK 3

Using a diagram evaluate how an indirect tax will help reduce overconsumption of sugary snacks

You should make sure your diagram illustrates how an indirect tax affect the market, the amount of the tax per unit of output and the government revenue the tax would raise, and that your written explanation refers to all of these. Make sure you use economic terminology. Try not to write in 'your own words'

You then need to go on to review your work from GCSE on the potential limitations of using a tax to limit the consumption of demerit goods or goods that result in negative externalities.

Behavioural economics

Traditionally, most economic models have assumed that economic agents attempt to maximise their expected individual rewards. Behavioural economists dispute this assumption because they believe it is too narrow a view of human behaviour. Consequently, they also question many of the predictions of models that are based on this assumption.

Behavioural economics is starting to have a profound impact on government economic policy. In the UK, the Behavioural Insights Team uses lessons learned from behavioural economics to help the government design more effective policies, and, hopefully, improve social welfare and efficiency.

https://www.tutor2u.net/economics/blog/behavioural-economics-a-very-short-introduction

Consumer behaviour

the notion of 'rational economic decision making' relies on the concept of homo economicus. Students should appreciate that many economic theories assume that economic agents, e.g consumers, workers, firms and their shareholders, act rationally attempting to maximise their own narrow self-interest.(Homo economicus is sometimes associated with the work of the 18th century economist Adam Smith who wrote 'The Wealth of Nations') A rational decision making is 'when individuals compare the costs and benefits of possible decisions and choose the one which maximises their personal net benefit'. It is usually, often implicitly, assumed that the individual has perfect information and can calculate and weigh up the consequences of each available choice.

Imperfect information

good quality information is essential if markets are to operate efficiently. The competitive market model assumes that economic agents have perfect information about, for example: products, product prices and factor prices. In the absence of good quality information, free markets are likely to misallocate resources and price signals will be misleading. This means that imperfect information is a potential source of market failure and that the pervasiveness of imperfect information casts doubt on models that are based on the assumption that economic agents make rational decisions. However, providing more and better information doesn't necessarily result in rational, or even better, decision making. This is because there are many reasons why people's decisions may be biased. They may be overly optimistic, they may generalise from a few examples, they may put too high (or low) a value of the opinions of experts

Aspects of behavioural economic theory

Behavioural economists incorporate ideas from psychology and other disciplines to enhance their understanding of economic decision making. They reject the view that economic agents are fully 'rational' decision-makers and highlight the importance of psychological biases and social and emotional factors. Psychologists and behavioural economists have identified a large number of other cognitive biases that can affect people's behaviour. These are just a few.

1. https://theintactone.com/2019/06/19/mpob-u1-topic-8-bounded-rationality/

Bounded rationality means that people's ability to make rational decisions is severely restricted.

Three main reasons are often identified:

- the human mind has limited ability to process and evaluate information
- the information available is invariably incomplete and often unreliable
- the time available in which to make decisions is limited

Therefore, even if economic agents intend to make rational choices they usually end up 'satisficing', accepting a satisfactory outcome rather than searching for an optimal solution. Bounded rationality often leads to economic agents using **heuristics** (rules of thumb) to help them make decisions. Attempting to calculate and evaluate all possible outcomes often takes 'too much effort' and is too complicated. As a result, people adopt these rules of thumb but they frequently lead to systematic, and often predictable, biases.

2. https://www.youtube.com/watch?v=W3SQp9qnnu4

The assumption that people have complete self-control is a basic tenet of standard economics and is incorporated in the concept of homo economicus. This contrasts with view of behavioural economists that individuals have bounded (or limited) self-control. People often say that they would, for example, like to: lose weight, give up smoking, drink less alcohol or save more, but frequently lack the self-control to act in a manner that they claim is in their own best interest. Many people are well aware of the consequences of **bounded self-control** and may adopt strategies to help them exert better control over their decision making, for example, by joining organisations such as Weight Watchers. Behavioural economists believe that recognising that people have bounded self-control can lead to the development of approaches that help improve social welfare. For example, the recently introduced Workplace Pension Scheme automatically enrols workers in the scheme but allows people to opt out if they wish. The take-up of such schemes is far greater than if people were required to opt in.

Behavioural economists have identified a large number of **cognitive biases** that affect people's decision making. Biases in decision making often result from people adopting mental shortcuts, or rules of thumb, which allow them to solve problems quickly. These rules of thumb enable people to function without always stopping to think about their next course of action. Decisions that are made in this way are associated with what Kahneman has called 'System 1' or 'thinking fast' which is instinctive and emotional. Rules of thumb often serve us well, but they can also result in poor decisions which could have been improved if more 'effort' had been devoted to considering the alternatives available. Kahneman's 'System 2', or 'thinking slow', is deliberate and logical but requires more effort and is often avoided, particularly for routine decisions.

i. https://www.coglode.com/gem/anchoring-bias
Anchoring is an example of a predictable bias in individual decision making. It is the tendency to rely too much on a single piece of information, frequently the first piece of information, when making decisions. For example, the first price that is quoted for a product influences what people think is reasonable to pay for such a product. Similarly, charities, when asking for a donation, may offer some suggestions, eg £10, £15, £20 or other; the purpose of such suggestions is to influence the individual's decision. For example, most people don't want to appear mean and might choose to donate £10 whereas without the anchor they might have given a smaller amount.

ii. https://www.verywellmind.com/availability-heuristic-2794824
The **availability bias** is when people make judgements about the probability of events by how easy it is to recall examples of such events. However, the recent occurrence of a particular event, and its consequences, is not necessarily a good guide to the underlying probability of such events occurring in the future. For example, after a very severe winter people are likely to overestimate the likelihood of future disruption and its costs. As a result, there may be a clamour to spend large amounts of money on snow-clearing equipment that isn't really justified when long-term weather patterns are taken into account.

iii. **A social norm** is a belief that is held by the group or groups of people with whom we associate about how we should behave in a given situation. Much of our behaviour is influenced by other people's behaviour, particularly those we respect and/or 'hang around with'. Standard economic theory tends to ignore the influence of other people and often assumes that our preferences (or 'tastes') are fixed and determined independently of other economic agents. Behavioural economists believe that if we want to have a long-term effect on people's behaviour, it is probably best to try to modify their social norms. For example, getting people to accept that driving after consuming alcohol is socially unacceptable is likely to more effective than just imposing large fines on offenders. In practice, behavioural approaches are likely combined with legal sanctions and other more traditional approaches.

iv. Although standard economic theory does not preclude **altruism,** it emphasises that the primary motive for, and influence on, people's behaviour is self-interest.

Behavioural economic theory recognises that people have a conscience and often choose to ‘do the right thing’. We have a sense of fairness and are not only influenced by how we are affected; we also take into account the impact of our actions on others. Offering financial rewards can sometimes have unexpected effects, contradicting predictions that are based on the assumption of self-seeking behaviour. For example, some studies have shown that when payments are made for donations of blood, the supply of willing donors falls; introducing the market can crowd out altruism as a motive for making such donations. The desire to act fairly can also persuade firms to pay above the ruling market, or minimum wage to their employees. The established relationships and obligations between the employer and employee can also influence the wage paid. The payment of what is perceived to be a fair wage can affect motivation and productivity.

TASK 4

Key Term	Definition/Explanation (Max 3 lines)
Cognitive bias	
Bounded rationality	
Heuristic/’Rule of thumb’	
Bounded self control	
Anchoring	
Availability Bias	
Social Norm	
Altruism	

Behavioural economics and economic policy

https://theconversation.com/obesity-is-a-market-failure-and-personal-responsibility-will-not-solve-it-alone-101038

1. https://www.youtube.com/watch?v=4rKRvQFo_B4
   Framing is the tendency for people to be influenced by the context in which the choice is presented when making a decision. How choices are framed, including the words used, affects the choices people make. For example, advertising the cost of gym membership at £25 per week is probably more palatable to most people than £1,300 per year. Retiring on 70% of your income seems much more 'doable' than living on 30% less money,

2. https://www.economicshelp.org/blog/glossary/choice-architecture/
   Choice architecture is about how choices can be influenced by the way in which the various options are presented to the decision-maker. Governments can use choice architecture in an attempt to achieve what they perceive to be a more socially desirable outcome. For example, countries that require people to opt out of organ donations generally have a much higher proportion of the population willing to donate than countries who ask people to opt in. As with the Workplace Pension Scheme, opting in is the default choice. A variation of default choice is mandated choice; this is where people are required by law to make a decision. For example, when people apply for important national documents, such as a passport or driving licence, they could be required to choose whether or not they are willing to donate their organs when they die. The way in which the options are categorised and presented to the decision-maker can also be used to influence people's choices. For example, in the case of pensions, offering people a vast number of options can result a low take-up rate and inappropriate decisions being made. More information doesn't always lead to the best outcomes, restricted choice may be better.

3. https://theconversation.com/when-it-comes-to-sugary-drinks-people-prefer-a-nudge-to-a-tax-58617 and https://www.bbc.co.uk/sounds/play/b01rg1hb (podcast)
   A **nudge** is a means of changing people's behaviour in a predictable manner without removing their freedom of choice. The use of nudges is part of the choice architecture. Banning junk food in school canteens is **not** a nudge but placing healthy food in easy reach and making junk food less accessible is an example of a nudge. The use of nudges can be seen as an alternative to passing laws and banning certain activities. Thaler and Sunstein have labelled the use of nudges as 'libertarian paternalism'. Nudges attempt to influence people's decisions, and thereby increase social welfare, without coercion. Two of the most influential behavioural economists, Thaler and Sunstein argue that since people are unlikely to have complete information, unlimited cognitive ability and unrestrained will power, they will inevitably make sub-optimal choices and so using nudges can improve people's well-being.

TASK 5

Now revisit your answer to the question on tax (Task 3). Are there alternative 'nudge' based solutions to the problem of overconsumption of sugary drinks?

But………

Behavioural economics is not without its critics who argue that the use of nudges and choice architecture assert that they are manipulative and interfere with an individual's freedom to choose.

https://www.tutor2u.net/economics/reference/evaluating-behavioural-nudges

https://www.economicsonline.co.uk/Behavioural_economics/Criticisms_of_behavioural_economics.html

TASK 6

List the key criticisms of behavioural economics

In summary, behavioural economists don’t deny that rational considerations play a part in people’s decision making, but they believe that traditional models provide an incomplete account of the factors that influence the choices people make. Behavioural economic analysis extends the traditional model to provide a better, more realistic explanation of human decision making. You first year of A Level Microeconomic will explore this conventional model of economic decision making in much more detail, as it is the core of economic theory, but we hope you have enjoyed looking at some alternate views of how economic agents, especially consumers , may be much less rational than neo-classical economics (or even they) realise

ASSESSMENT FOR A LEVEL ECONOMICS ENTRY

Your assessment in economics will be based on the content of this booklet and the other materials that it refers you to. You also need to revisit and revise your GCSE work on the role of markets, demand and supply (including price elasticity of demand and price elasticity of supply) and the limitations of markets (for further detail, please revisit the relevant sections on your GCSE specification)