2.4 Critique of the maximizing behaviour of consumers & producers

Learning objectives

2.4 Critique of the maximizing behaviour of consumers and producers	Depth	Diagrams & calculations

Rational consumer choice (HL only)
• Assumptions—consumer rationality, utility maximization and perfect information
• Behavioural economics—limitations of the assumptions of rational consumer choice
    • Biases—rule of thumb, anchoring and framing, availability
    • Bounded rationality
    • Bounded self-control
    • Bounded selfishness
    • Imperfect information
	AO3	

Learning objectives

2.4 Critique of the maximizing behaviour of consumers and producers	Depth	Diagrams & calculations
Behavioural economics in action (HL only) • Choice architecture—default, restricted, and mandated choices • Nudge theory	AO3	

Business objectives (HL only)
• Profit maximization
• Alternative business objectives
    • Corporate social responsibility
    • Market share
    • Satisficing
    • Growth
	AO3	

Starter: Economic Man vs Humanity: a Puppet Rap Battle

1. Outline the key characteristics of the *Economic Man.*
2. Outline the criticisms of the *Economic Man.*
3. Consider the similarities and differences between yourself and the *Economic Man.*

Rational consumer choice – assumptions

Consumer rationality

Rational choice theory assumes that consumers are driven by self-interests and make choices based on personal preferences.

Utility maximization

Utility refers to the satisfaction consumers derive from consuming a good or service. Rational choice theory assumes that consumers make choices which allow them to maximize utility.

Are consumers always rational?

Rational consumer choice – assumptions

Perfect information

Perfect information refers to when buyers and sellers have complete (total) and instantaneous knowledge about all products available on the market. This may include product prices, product quality, and alternative products.

Rational choice theory assumes that consumers will use this information to make rational decisions.

Perfect information does not exist in the real world.

Behavioural economics

Behavioural economics studies how psychological factors can influence human decision-making and suggests that humans are not always as rational as economic models assume.

Rational consumer choice – limitations

Biases – rule of thumb

A **rule of thumb** is a general piece of advice based on past experiences that helps simplify decision-making processes. Although they can often help consumers make good decisions and save time, they may also be inaccurate and lead to irrational decisions at times.

Examples

- If you are struggling with your computer, a good rule of thumb is to restart the computer.
- A good rule of thumb is to tip the waiter 10 to 15% of the bill (depending on local contexts).
- A good rule of thumb is to not spend more money than your income on a monthly basis.

Rational consumer choice – limitations

Biases – anchoring and framing

Anchoring refers to when consumers use irrelevant pieces of information as benchmarks for their decision-making.

Rational consumer choice – limitations

Class activity – How many jellybeans?

Part 1

Listen carefully to your teacher's instructions.

Part 2:

Watch the following video: [Anchoring Effect: Guessing How Many Jelly Beans Are In A Jar]

Rational consumer choice – limitations

Biases – anchoring and framing

Framing refers to when information or choices are presented in a way which influences the behaviour of consumers. Choices can carry positive or negative connotations which affects the relative attractiveness of the options being presented.

Which is more attractive to you?

‘Buy 1, get 1 free’ or ‘Buy 2 and get 50% off’

Would you rather buy a bottle of hand sanitizer which claims to **kill 99% of germs** or one which claims **only 1% of germs survive**?

Rational consumer choice – limitations

Biases – availability

Availability bias refers to the human tendency to overestimate the likelihood of an event occurring, based on how easily similar situations or examples come to mind. This cognitive bias affects decision-making and could result in irrational choices being made.

For instance, people tend to overestimate the probability of certain events due to frequent media coverage:

- a plane crash
- winning the lottery
- gun violence

Rational consumer choice – limitations

Bounded rationality refers to the idea that consumer rationality is limited due to constraints such as our cognitive abilities, time, and imperfect information. As a result, consumers sacrifice a degree of utility and achieve satisfactory results instead of optimal results.

Rational consumer choice – limitations

Bounded self-control

Bounded self-control refers to the inability of consumers to restrain their emotions, desires, or impulses, which leads to irrational choices being made.

Video: How Marshmallows Predict Your Success

Other examples:

- Overconsumption of unhealthy food or other demerit goods e.g., cigarettes, alcohol, and drugs
- Overspending and insufficient saving for retirement

Rational consumer choice – limitations

Bounded selfishness - Rational choice theory assumes that consumers are driven by self-interests and aim to maximize personal welfare. However, people often display altruism and are willing to lose some degree of personal benefit to help others.

Rational consumer choice – limitations

Imperfect information – Buyer and sellers often do not have complete and instantaneous knowledge of relevant information in the real world. Economic agents must use the limited information that they have to make the best possible decisions.

Real world example

Article: The behavioural economics of an A$1,800 iPhone

1. Using examples, explain how consumers may not always be rational.

2. With reference to the concept of anchoring, explain how Apple influences consumer behaviour.

3. Explain how the concept of imperfect information is highlighted in the article.

Behavioural economics in action – choice architecture

Choice architecture refers to the way in which choices are presented to influence consumer behaviour. The three categories of choice architecture are: default, restricted, and mandated choices.

Choice architecture

Choice architecture – default choices

Default choices are the preset courses of action that will take effect if consumers do not specify or pursue other options.

Examples:

Source 1: [When an opt-out system nudges people to stay in]

Source 2: [Using Healthy Defaults to Improve Nutritional Choices]

Source 3: [Pensions policy shows the power of defaults]

With reference to the above sources, outline why the default choices in each source are desirable.

Choice architecture

Choice architecture – restricted choices

Restricting the number of choices that are available to consumers may force them to make more rational decisions.

Article: McDonald's Removes Unhealthy Foods from Happy Meal

1. Which items will be removed from the menu?
2. Which items will be added to the menu?
3. How will restricting choices affect consumers?

Choice architecture

Choice architecture – mandated choices

A **mandated choice** refers to when consumers are required, by law, to decide whether they wish to participate in a particular action.

For example, people are given a form after obtaining their driver's license and must decide whether they would like to donate their organs in the event of death.

Nudge theory

Nudge theory is an aspect of choice architecture which aims to influence consumer behaviour and steer consumers towards desirable actions without restricting their freedom to choose.

Nudge theory

Nudges are often very simple and inexpensive, yet highly effective. However, while nudges can help citizens and consumers make more rational decisions, businesses and policymakers may use them to manipulate decision-making for their own benefit.

Examples:

Using behavioral science research to train pilots to save fuel

How The British Government Got More Citizens To Pay Their Taxes On Time

Real world example – case study

Podcast: [Nudging Grocery Shoppers Toward Healthy Food]

1. How did Romny Mini Market use choice architecture to influence its consumers?

2. Explain the patterns of behaviour the typical consumer displays when shopping at a supermarket.

Real world example – case study

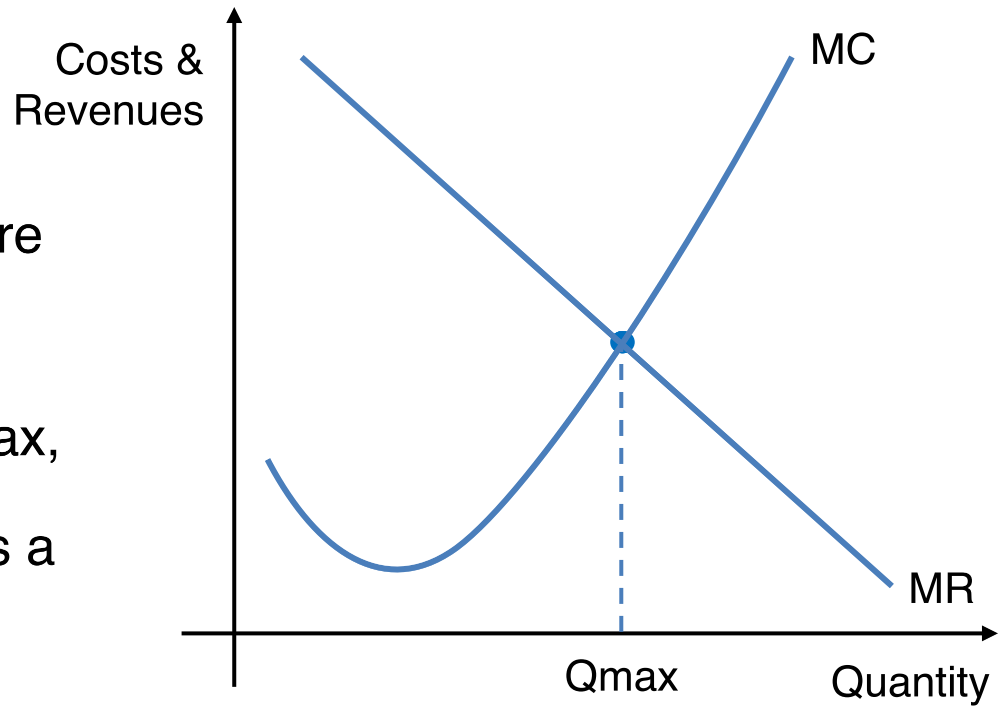
Podcast: [Behavioural Economists On Why Some People Resist Wearing Masks]

1. What sort of issues have behavioural economists helped America with?
2. What concepts are illustrated in this podcast?

Business objectives

Business objectives – profit maximization

Classical economics assumes that rational producers aim to **maximize profit.**



Profit maximization occurs at the level of output where **marginal costs (MC) = marginal revenue (MR).**

- If a firm produces at a level of output beyond Qmax, its **MC will exceed its MR**. Therefore, the firm incurs a greater cost than revenue for each additional unit of output and should not increase production.

Business objectives – profit maximization

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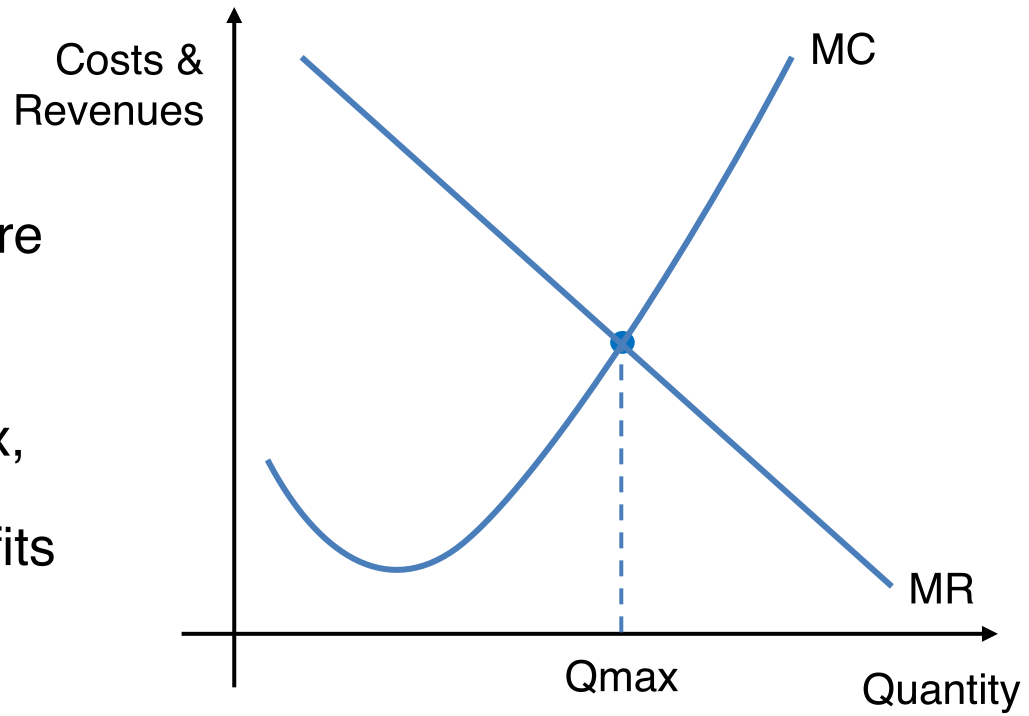
Profit maximization occurs at the level of output where **marginal costs (MC) = marginal revenue (MR).**

- If a firm produces at a level of output below Qmax, its **MR will exceed its MC**. Therefore, the firm benefits from greater revenue than costs for each additional unit of output and should continue production.



Business objectives – alternative business objectives

Corporate social responsibility (CSR) refers to business activities involving ethical and environmental factors which may benefit internal and external stakeholders.

Business objectives – alternative business objectives

Corporate social responsibility (CSR)

Many business activities have negative effects on society and the environment. For example, activities in the manufacturing sector may cause the depletion of natural resources and pollution.

Companies are becoming increasingly aware of the need to engage in sustainable practices and have transitioned to using renewable energy sources and minimizing waste.

Business objectives – alternative business objectives

Corporate social responsibility (CSR)

Big companies such as Nestlé , H&M, Nike, and Primark have been accused of using child labour. While some of them may be unaware of such unethical practices in their supply chains, other companies may knowingly employ child labour to benefit from lower costs of production.

On the other hand, employees at Patagonia are paid fairly and enjoy good benefits. They receive health care, subsidized childcare, enjoy flexible work schedules, and paid time off for environmental internships.

Real world example – research activity

Corporate social responsibility (CSR)

How has Starbucks practiced CSR?

Task: In groups of 2 or 3, visit [Starbucks Social Impact] and select **one** of the four categories to create a **presentation or poster** which addresses the following question:

Using examples, explain how Starbucks have demonstrated CSR in relation to the area you have selected.

Real world example

Source: [The Reputation of 100 Major Brands in the U.S.]

Identify the CSR activities which have contributed to Patagonia and Pfizer’s rankings.

Business objectives – alternative business objectives

Market share

Market share refers to a firm's percentage of an industry's total sales revenue.

$$\text{Market share} = \frac{\text{Individual firm's sales revenuve}}{\text{Industry's sales revenue}}$$

Some of the reasons why firms may aim to increases their market share:

- Lower average costs due to economies of scale
- Easier to attract investors and to raise funds for investments
- Improved brand recognition, stronger customer base, and improved brand loyalty

Real world example – research activity

Market share

Task: Select an industry of your choice and identify the top 3-5 companies by market share.

For example, the top 5 companies in the pharmaceutical industry worldwide based on prescription drug market share in 2019 are: Roche, Novartis, Pfizer, Merck & Co., and Johnson & Johnson.

Real world example – data analysis

Market share

Source: Internet Browser Market Share (1996–2019)

Data Analysis Questions

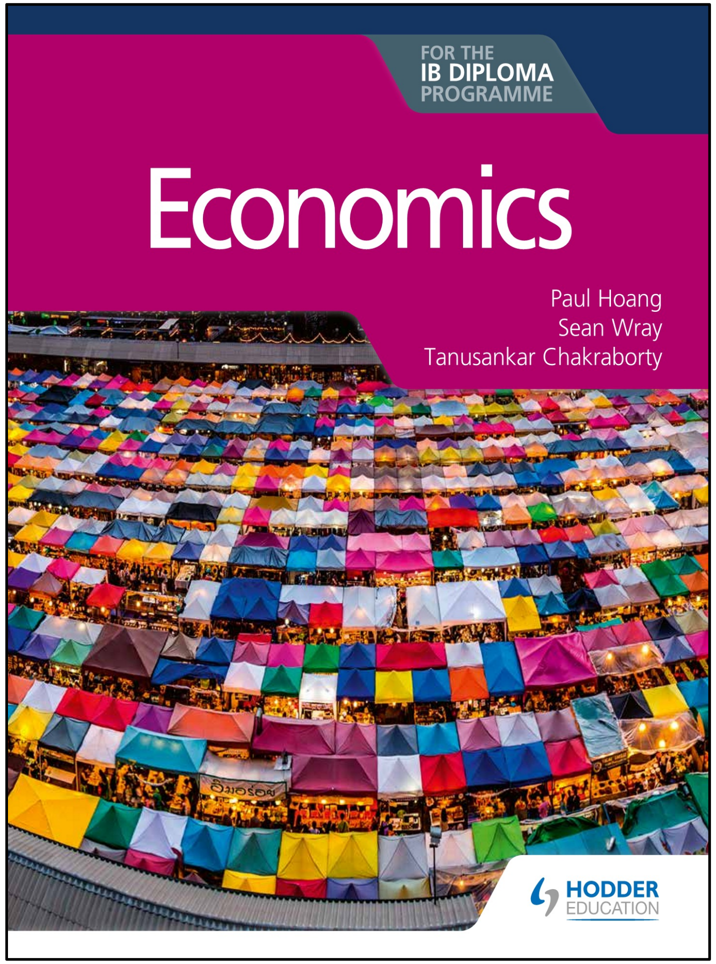
1. What do you notice from the data?
2. What questions do you wonder about the data?
3. Research information that may help you answer your questions from Q2.
4. What conclusions can you make from Q1, Q2, and Q3?

Over to you…

Hoang, Wray, & Chakraborty (2020)

Economics for the IB Diploma Programme

- Page 88
- Paper 2 and 3 Exam Practice Question 6.1
- [2 marks]



Business objectives – alternative business objectives

Satisficing

This refers to firms aiming to achieve satisfactory results in multiple areas instead of optimal results in one particular area.

For example, instead of maximizing profits, a firm may aim to make enough profits to pursue other objectives such as enhancing CSR or maximizing revenue.

In groups of 2 or 3, discuss the business objectives which you consider the most important.

Business objectives – alternative business objectives

Growth

The growth of a firm can be measured by indicators such as the number of employees, market share, value of assets, revenues, and profits.

Some of the reasons why firms may want to grow:

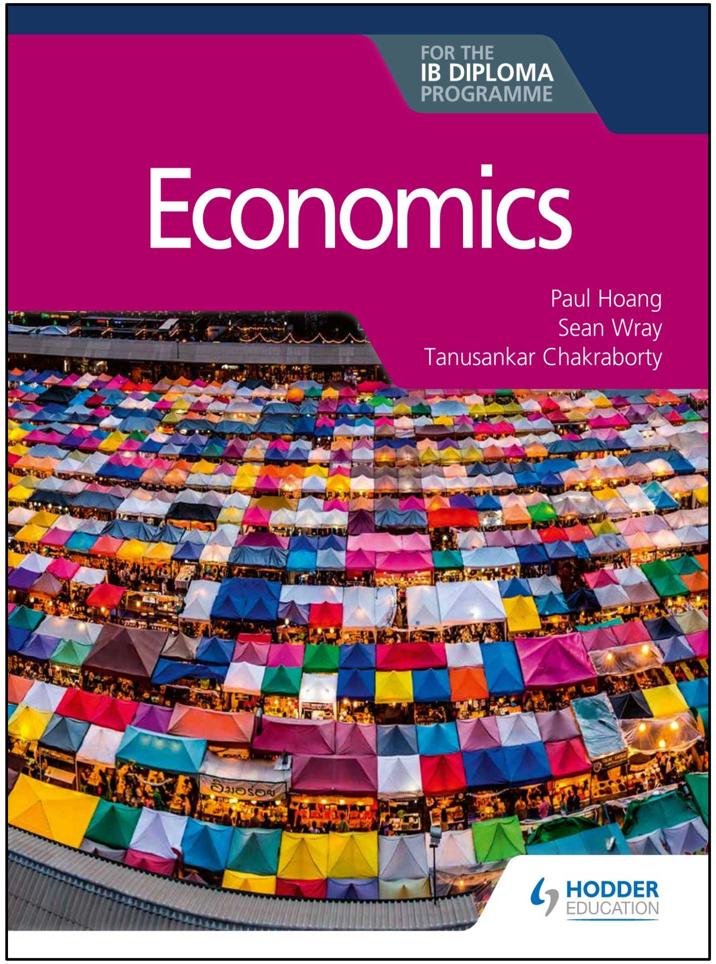
- Lower average costs due to economies of scale
- Easier to attract investors and to raise funds for investments
- Improved brand recognition, stronger customer base, and improved brand loyalty
- Greater revenue streams and lower dependency on a single product through diversification.

Over to you…

Hoang, Wray, & Chakraborty (2020)

Economics for the IB Diploma Programme

- Page 91
- Paper 1 Exam Practice Question 6.2
- [25 marks]



Test your knowledge on this unit: [Kahoot!]