Critique of the maximizing behaviour of consumers and producers

RIDLEY COLLEGE

SINCE 1889

Assessment Objectives

	Specific Expectations
AO1	Evaluate the assumptions of consumer rationality, utility maximization and perfect information
AO3	Evaluate the assumptions of consumer rationality, utility maximization and perfect information.
AO3	Discuss the limitations of standard consumer behaviour made by behaviour: anchoring, framing, availability, bounded rationality, bounded self-control, bounded selfishness, imperfect information
AO3	Discuss policies inspired by behavioural economics: choice architecture with respect to default, restricted, mandated choices, and nudge theory.
AO3	Distinguish between various objectives of businesses: profit maximization, CSR, market share, growth, satisficing.

Rational economic decision-making

- Classical economic theories and models are based on an important assumption, that of "rational self interest" or **rational economic decision-making**.
  - Individuals are assumed to act in their best self-interest, trying to maximize the satisfaction they expect to receive from their economic decisions.
    - It is assumed that consumers spend their money on purchases to maximize the satisfaction they get from buying different goods and services.
    - Similarly, it is assumed that firms (or producers) try to maximize the profits they make from their businesses.
    - Workers try to secure the highest possible wage when they get a job.
    - Investors in the stock market try to get the highest possible returns on their investments, and so on.

Rational Consumer Choice

- **Rational consumer choice** in the microeconomic theory of consumer behaviour, consumers make choices about what goods and services to buy based on the following assumptions.

  1. **Consistent tastes and preferences (Rational consumer choice)** – consumers make purchasing decisions according to their tastes and preferences which satisfy three assumptions

     i. **Completeness** – the consumer is able to rank goods according to their preferences. For any $x, y \in X$, either $x \succeq y$ or $y \succeq x$ holds.

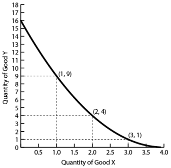
     ii. **Transitivity** – preferences among alternative choices are consistent. For any x, y and $z \in X$, if $x \succeq y$ and $y \succeq z$, then $x \succeq z$.

     iii. **Non-satiation** – the consumer always prefers more of the good to less.

     - If $\succeq$ on X is complete and transitive, it is called a **preference relation**.

Rational Consumer Choice

2. **Perfect Information** – consumers and producers have perfect and instantaneous knowledge of all market prices, their own utility, and own cost functions. There is no uncertainty.
   - When a consumer chooses good A over good B, she possesses all possible information about good A and good B, so that there are no doubts, questions, or uncertainties about the good being chosen.
3. **Utility Maximization** – consumers maximize their utility by buying the combination of goods and services that results in the greatest amount of utility for a given amount of money spent (the consumer's budget or income).



Behavioural Economics

- **Behavioural Economics** is a method of economic analysis that applies psychological insights into human behaviour to explain economic decision-making.
- Behavioural economics criticises consumer rationality and the idea of utility maximization on the following grounds.

  1. **Cognitive Bias** – is a term from psychology that refers to systematic errors in thinking or evaluating. Biases are departures from normal standards of thought or judgements. Biases that affect consumer choices include the following:

     i. **Rules of thumb (Heuristics)** – are simple guidelines based on experience and common sense, simplifying complicated decisions that would have to be based on the complex consideration of every possible choice.

ii. **Anchoring** – involves the use of irrelevant information to make decisions, which often occurs due to its being the first piece of information that consumers happen to come across.

iii. **Framing** – deals with how choices are presented to decision-makers (framed).

iv. **Availability** – refers to information that is most recently available, which people tend to rely on more heavily, though there is no reason to expect that this information is any more reliable than other information that was available at an earlier time.

People remember recent events or information more readily than older events or older information.

Behavioural Economics

- The presence of biases that influence consumer choices has lead to alternative concepts and ideas put forward that may be more accurate descriptions of consumer behaviour.

  1. **Bounded rationality** – is that idea that consumers are rational within limits.

     - People do not have an unlimited capacity to process information and searching fro information needed to maximize utility is itself a costly process.
     - Consumer rationality is limited by consumers' insufficient information, the costliness of obtaining information, and the limitations of the human mind to process large amounts of information.
     - Rather than maximize, consumers **satisfice**, meaning they seek a satisfactory outcome rather than the optimal (or best) one.

Behavioural Economics

2. **Bounded self-control** – refers to the idea that people in reality exercise self-control only within limits.
   - This means they often do not have the self-control that would be required of them to make rational decisions.
   - People may at times each too much, spend too much, save too little or work too little; this is inconsistent with the assumption of rational behaviour.
3. **Imperfect information** – a situation where either the buyer or the seller, or both, are uncertain about the qualities of what is being bought and sold.
   - Classical economics is based on the assumption that consumers have access to all the information needed to make fully informed decisions, regarding prices, products, and product quality.

Nudge Theory

- **Nudge theory** is a concept in behavioural economics, political theory, and behavioural sciences that proposes positive reinforcement and indirect suggestions as ways to influence the behaviour and decision-making of groups or individuals.
  - Examples of nudges and their results include the following:
    - Putting health foods in more visible and accessible positions in stores has been shown to increase sales of such foods.
    - When taxpayers received notifications from tax authorities in white envelopes instead of brown with their names handwritten rather than typed, there was a 16% increase in people paying their tax.
    - In a Danish municipality, the streetlights turn red when solar panels are no longer sufficient to power the light, making residents more aware of their electricity consumption.

Choice Architecture

- **Choice architecture** is the design of particular ways or environments in which people make choices.
  - It is based on the idea that consumers make decisions in a particular context and that the choices of decision-makers are influenced by how options are presented to them.
  - Choice architects are individuals or organizations that arrange the context in which choices are made.
  - Choice architecture offers different kinds of choices that are described below:

  1. **Default choice** – is a choice made by default, which means doing the option that results when one does not do anything.
     - People often make choices by default due to habit or lack of interest in taking a deliberate action, even if doing nothing may not be the best.

Choice Architecture

2. **Restricted choice** – is a choice that is limited by the government or other authority.
   - It is argued that restricting choice is necessary because people have too many choices available to them. and in the absence of more and better information, or due to poor judgement, they often make poor choices.
   - Choice architecture can take advantage of restrictions to encourage people to make choices with socially desirable outcomes.
3. **Mandated choice** – is the choice between alternatives that is made mandatory (compulsory) by the government or other authority.
   - It is a free choice, but it is compulsory to make that free choice.

- Note that default choice, restricted choice and mandated choice are different types of nudges within choice architecture that are intended to work toward influencing people's choices in a direction held to be socially desirable.

Evaluating behavioural economics and economic policy

Potential advantages

- Behavioural economics may be a relatively simple and low-cost way to influence people's behaviour to act in socially desirable ways.
- Successful in a number of area, suggesting that the methods of choice architecture and nudging may have numerous applications.
- Offers consumers and citizens freedom of choice without restricting their choices.
- May overcome weaknesses of the theory of consumer behaviour, which is not always able to explain the inconsistencies and seeming irrationality of actual consumer behaviour.
- Policies are based on principles of psychology, such as framing, many of which have been previously tested over many years.

Evaluating behavioural economics and economic policy

Potential disadvantages

- The body of knowledge being developed is not based on any understanding of human behaviour and is unable to lead to a systematic and unifying theory of how consumers behave with general applicability.
- There may be risks of using psychological principles to manipulate consumers.
- There may be risks that behavioural policies may be used as substitutes for necessary but politically costly economic problems.
- Traditional economic policies may be more effective.
- Choice architecture and nudging may affect people's choices, but these choices may not be a reflection of their true preferences.

Firm business objectives

- **Rational producer behaviour** the basis of standard theory of the firm according to which firms try to maximize profit.
  - Profit maximization involves determining the level of output that the firm should produce to make profit as large as possible.
  - Profit is equal to the total revenue earned by a firm minus the total costs by the firm in the process of producing its output.

$$\text{Profit} = \text{Total Revenue (TR)} - \text{Total Cost (TC)}$$

  - The objective of profit maximization is to make the difference between revenues and costs as large as possible so as to make profit as large as possible.

Alternative Business Objectives

- Profit maximization may not be the overriding objective of firms, as in fact they may have other goals that may be more important.
  - The self-interested behaviour of firms often leads to negative consequences for society.
  - It is often the case that the well-being for firms is not consistent with the well-being for society.

1. **Corporate social responsibility (CSR)** is the practice of some corporations to avoid socially undesirable activities, as well as undertaking socially desirable activities
   - Many firms recognize that the pursuit of self-interest need not necessarily conflict with ethical and environmentally responsible behaviour

Alternative Business Objectives

- A negative image of the firm held by workers and buyers of the product can cut deeply into the firm's revenues and profits by lowering worker productivity and the firm's sales.
- Socially irresponsible firm behaviour may lead to government regulation of the firm intended to minimize the negative consequences of the firm's actions for society.

2. **Market share** refers to the percent of total sales in a market that is earned by a single firm.
   - It may be a goal of some firms to maximize market share, or to make it as large as possible.
   - A high market share means the firm is enjoying large sales of its product or products, and is an indication of the product's popularity among buyers.

Alternative Business Objectives

- A large market share means that it is likely that the firm is achieving economic of scale (falling costs per unit of output as the firm grows) allowing it to increase its profitability.
- In order to increase its market share, the firm may try to lower its prices, or introduce new or innovative products into the market, or use advertising. Each of these strategies may have the effects of lowering profits.

3. **Growth maximization** is one possible goal of firms, involving the objective to make the growth of the firm as high as possible.
    - A growing firm can achieve economies of scale and lower its average costs of production, thus increasing profitability.
    - As a firm grows it can diversify into production of different products and markets and reduce its dependence on a single product or market.
    - A larger firm has greater market power and increased ability to influence prices.

Alternative Business Objectives

- A larger firm reduces its risks because it may be less affected in an economic downturn (a recession) and is less likely to be taken over (bought) by another firm.

4. **Revenue maximization** is focused on increasing sales and maximizing revenues.
   - Sales can be identified and measured more easily over short term than profits, and increased sales targets can be used to motivate employees.
   - Rewards for managers and employees are often linked to increased sales.
   - It is often assumed that revenue from more sales will increase more rapidly than costs, leading to higher profits.
5. **Satisficing** is a goal of firms to achieve satisfactory results, rather than pursue a single maximizing objective, such as to maximize profits or revenues

Alternative Business Objectives

- Modern firms may have numerous objective which may partly overlap or conflict.
- Firms are forced to compromise and reconcile conflicts, rather than pursue optimal results.