**Economics Bridging Unit - Part 2 – Introduction to A-level**

Answer all questions. Your hand-written responses must be handed in to me in the first week back in September.

**Section 1**

Classical economic theory assumes that economic agents (individual people or firms) behave rationally to maximise their satisfaction, (or ‘utility’ as it’s sometimes called). This rational economic agent, known as ‘homo economicus’, will never make a decision that leaves him / her worse off.

1. Research ‘homo economicus’ and give a more detailed definition. Try to use the following terms in your definition: self-interested, minimise costs, maximise benefits, optimal.

**Section 2**

Most of us wouldn’t struggle to compile an extensive list of examples where people (economic agents) don’t act in their own self-interest:

|  |  |
| --- | --- |
| * consuming excessive units of alcohol | * saving too little for old age |
| * smoking | * dropping litter |
| * taking illicit drugs | * using a mobile phone whilst driving |
| * unsafe sexual practices | * missing medical or dental appointments |
| * taking too little exercise | * tweeting offensive messages |
| * over-eating | * not buying insurance before travelling abroad |
| * degrading the environment | * refusing inoculation |
| * not studying in ILC lessons | * applying too little sunscreen in summer |
| * under eating | * over exercising |

Ralph Keeney (a researcher at Duke University) explored the impact of poor decision-making in the USA. Using mortality data from the Center for Disease Control, Keeney estimated that about half of all deaths among 15-64 year olds in the United States are caused or aided by bad personal decisions, particularly those relating to smoking, not exercising, criminality, drug and alcohol use, and unsafe sexual behavior.

Behavioural theory attempts to combine psychology and economics to explain why economic agents make irrational choices i.e. choices that leave them worse off.

If economists are aware of the types of decision-making errors we humans make they can suggest more effective policy solutions to social and economic problems.

Behavioural theory suggests various reasons why economic agents make irrational decisions:

* Our decisions are strongly influenced by context. Even the way choices are presented to us influence our behaviour.
* Our behaviour varies across time and space
* Our behaviour is subject to **cognitive biases** (things we believe are the case even though they might not be)
* Our behaviour is heavily influenced by emotion
* Our behaviour is subject to social influence
* Our decision-making ability is less than perfect (it is **constrained**)

**Questions 2 – 4: Bounded rationality**

**Throughout the economic course your ability to apply economic theory to an issue is key. The skill of application requires lots of practice starting with question 4.**

1. Herbert A. Simon suggested that humans try to make rational decisions but are prevented from doing so for three main reasons. List the reasons and state why they lead to poor decision making.
2. Given the difficulties of making rational decisions, Herbert claimed that humans “satisfice” rather than “optimise”. Explain what this means.
3. Some students in Year 12 opt to change subjects in the first few weeks of the sixth form. Explain how the theory of bounded rationality might lead to the decision to study the “wrong” subject.

**Questions 5 – 6: Feedback and bounded rationality**

Feedback - [information](https://dictionary.cambridge.org/dictionary/english/information) about something that can [tell](https://dictionary.cambridge.org/dictionary/english/tell) us if it is [successful](https://dictionary.cambridge.org/dictionary/english/successful), unsuccessful, [liked](https://dictionary.cambridge.org/dictionary/english/like) or disliked.

Theory suggests that feedback is an essential tool in helping us make optimal choices. If we experience the consequences of decisions we take, we are more likely to avoid repeating sub-optimal behaviour (and more likely to repeat optimal behaviour). Someone drinks too much and suffers a hangover. This feedback makes it less likely the person will over-consume alcohol again, (at least in the short term).

In situations where feedback doesn’t exist the amount of information available reduces. With less information we are likely to make poorer decisions.

The environment is an excellent example. If you decide to reduce your impact on the environment the benefits are unlikely to be immediate. Turning vegetarian, buying fewer goods and services, switching to renewable sources of energy, recycling more, flying less (or not at all), and ditching the car are all likely to do some good. Unfortunately, in the absence of feedback you will be unsure whether your lifestyle changes are making a difference; nothing noticeable will happen in the short term. This lack of feedback could be partly responsible for the environmentally irresponsible way in which humans behave.

1. **Apply** the concepts of **feedback** and **bounded rationality** to teenage children deciding to take up smoking.
2. Assess whether campaigns that highlight the long-term health impacts of smoking will deter young smokers? What else could be tried?

**Questions 7 – 11: Bounded self-control**

**In the economics course linking theories is an important skill called ‘analysis’. Question 8 asks you to use this difficult skill.**

Classical economic theory suggest that rational economic agents will consume a product if the benefit is greater than the price paid. It isn’t rational for someone to pay £5.00 for a product that gives them £1.00 of satisfaction.

Bounded self-control seeks to explain why an economic agent might continue to consume a product despite the satisfaction falling below the price paid: they don’t possess the self-control (willpower) to stop consuming even when it makes sense to do so.

As an example, overweight people may realize that they need to improve their health through more exercise and a better diet. For the future, they vow to forego all short-term temptations in exchange for the greater long-term reward of improved health. However, after their next meal they cannot resist having chocolate cake for dessert: they focus on the instant pleasure the chocolate cake can provide. After eating the cake, they may once again intend to follow a diet in the future: they believe that next time they will want to, (and be able to), turn down the cake. Although these people really want to follow the regimen necessary for better health, the immediate reward outweighs the future benefits of healthier eating. Their preference for healthy eating simply does not hold up **in the heat of the moment** when the satisfaction of eating the cake is greater than the future health benefits of not eating it.

1. What is meant by the term ‘*present bias’*.
2. Explain the link between bounded self-control and the present bias.
3. In a famous 1996 paper behavioural economics expert George Lowenstein explained how *visceral states* can profoundly affect decision making in ways that are not in people’s long-term interests. Strong emotional responses (“hot states”) create *present bias* leading to sub-optimal behaviour. Give an example where such emotional responses (hot states) lead to poor decision-making.
4. Using the theory of bounded self-control and present bias, explain why some economic agents don’t save enough for retirement, (another application question).
5. Give three policy options which seek to overcome this problem.