2.3 Rational choice, behavioural economics and business objectives

Name: _____ Class: _____ Date: _____ **Total: 26 marks**

KEY WORDS rational consumer choice • bounded rationality • anchoring • default choice • nudge • satisficing

Objective

Build the skills to answer exam questions on **rational consumer choice**, its limits from **behavioural economics**, **nudges**, and the objectives of firms.

You must be able to:

- outline the assumptions of rational consumer choice
- explain bounded rationality, self-control and selfishness, and common biases
- explain choice architecture and nudges, with examples
- compare profit maximization with other business objectives

1 Key knowledge and worked examples

■ Rational choice and behavioural economics

Rational consumer choice assumes that consumers have **consistent preferences**, **perfect information**, and always choose to **maximize utility** (satisfaction). Firms are assumed to **maximize profit**.

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Behavioural economics uses psychology to show where real people differ:

idea	meaning	example
bounded rationality	limited time and information, so people make "good enough" choices	choosing a phone plan after reading two offers
bounded self-control	people find it hard to stick to plans	planning to save but spending the money
bounded selfishness	people care about others and fairness	giving to charity, tipping
rule of thumb (heuristic)	a mental shortcut	always buying the same brand
anchoring	relying too much on the first number seen	"was $200, now $120"
framing	the way a choice is presented changes it	"90% fat-free" vs "10% fat"
availability	judging risk by examples that come to mind easily	fearing flying after a crash in the news

Choice architecture is the way choices are presented. **Nudges** change behaviour without banning options or changing prices much:

- **default choice:** an option that applies unless people opt out (automatic enrolment in a pension; organ donation opt-out);
- **restricted choice:** fewer options so the choice is easier;
- **mandated choice:** people must make a decision (e.g. state yes or no to organ donation when renewing a licence).

Firms also use behavioural ideas (free trials that roll into payments, "limited time" offers, product placement).

Business objectives: firms may not only maximize profit. Alternatives: **corporate social responsibility** (CSR: ethical and environmental aims), **market share** (lower prices to grow), **satisficing** (making "enough" profit to keep shareholders happy while pursuing other aims), **revenue** or **growth** maximization.

Answer shapes: name the bias or nudge → apply it to the case → evaluate (does it work, is it ethical, is it enough?).

2 Practice

2.1 State **two** assumptions of rational consumer choice. [2]

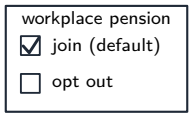


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2.2 Explain what is meant by **bounded self-control**, with an example. [2]



2.3 A government changes workplace pensions so that workers are enrolled automatically and must opt out if they do not want to save. Explain why this is likely to increase saving. [4]



2.4 An online shop lists a jacket as "Was $250 – now $150". Explain how this uses anchoring, and how it could lead to a choice that is not rational. [3]



2.5 A family-owned company accepts lower profits so that it can pay suppliers fairly and cut its emissions. Explain **two** objectives other than profit maximization that it may be following. [3]



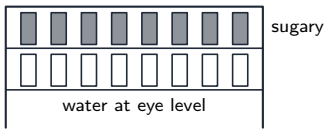
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3 Exam-style questions

3.1 A government wants to reduce the consumption of sugary drinks by young people.

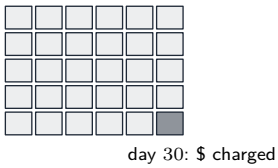
(a) Define **choice architecture**. [2]

(b) Evaluate the use of nudges to reduce the consumption of sugary drinks. [6]



3.2 A streaming service offers a free 30-day trial that turns into a paid monthly plan unless the customer cancels.

Explain how the firm uses behavioural economics, and why a government might regulate this practice. [4]



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Solutions

Marking: **M1** a correct method, **A1** the correct answer, **B1** an independent mark.

Each answer shows the steps, then the **result**.

2.1

any two: consistent preferences; perfect information; consumers aim to maximize utility

2.2

people have limited self-discipline, so they do not always act on plans that are in their long-run interest; e.g. planning to go to the gym but not going / overeating / not saving

2.3

this is a default choice (nudge); people often stay with the default because of inertia / bounded rationality: deciding takes time and effort; bounded self-control means people would otherwise delay joining; workers can still opt out, so freedom of choice remains while the saving rate rises

2.4

the first price ($250) acts as an anchor / reference point; the $150 price then looks like a bargain, compared with the anchor; the buyer may pay more than the jacket is worth to them, or buy something they do not need: not utility-maximizing

2.5

corporate social responsibility: acting ethically towards suppliers, workers and the environment; satisficing: making enough profit to satisfy owners while following other aims; CSR may also build reputation and customer loyalty, raising long-run profit / market share

3.1

(a) the way in which choices are presented to people; which affects the decisions they make

(b) examples: water as the default drink in school meals, healthy drinks at eye level, smaller cups, warning labels; they use bounded rationality: people take the easiest option; low cost to government, and freedom of choice remains; limits: effects may be small or short-lived; strong habits and advertising remain; critics see nudges as manipulation / paternalism; judgement: useful as part of a mix with a sugar tax and education, but probably not enough on their own

3.2

default choice: the paid plan applies unless the customer acts; bounded self-control and inertia mean many forget or delay cancelling; so the firm earns revenue from people who would not have chosen to pay; governments may require reminders or easy cancellation to protect consumers, because the choice is not fully informed