Exercise walk-through

2.3

Rational choice, behavioural economics and business objectives

International Baccalaureate · IB Diploma · Economics · SL

Elasticity

- **Income elasticity of demand** (YED) $= \%\Delta Q_d \div \%\Delta$income: positive for normal goods, above 1 for luxuries, negative for inferior goods. Firms use YED to predict sales over the business cycle.
- As incomes grow, spending moves away from goods with low YED, such as basic food, towards services with high YED, so the primary sector shrinks as a share of the economy.

$$PED = \frac{\%\Delta Q_d}{\%\Delta P}$$

Data-response practice (Paper 2 style) (2)

- (d) Using a diagram, explain the effect of the planned **maximum price** on the rice market in Country R. [4]
- (e) Using information from the text and your knowledge of economics, evaluate the use of a maximum price to protect consumers in Country R from higher rice prices. [15]
- **The case for.** Demand is very inelastic ($PED = -0.16$), so the price rise from 0.80 dollars to 1.00 dollars mostly raises spending, not saving. Poor households spend a large share of their income on rice and are hit hardest. A cap at 0.85 dollars lowers the price for everyone who can still buy rice, and it costs the government almost nothing to announce.

Key terms (2)

- **Price elasticity of demand**: the responsiveness of quantity demanded to a change in price.
- **Incidence**: how the burden of a tax is shared between consumers and producers.
- **Maximum price**: a legal upper limit on price, set below equilibrium.
- **Nudge**: a change to how a choice is presented that changes behaviour without removing options.

Exercises 2.1·2.2

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



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



Exercises 2.1·2.2

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



2.1

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

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



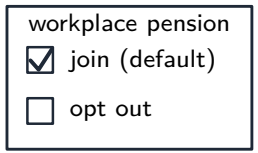
2.2

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

exercises.lol exercises.com.cn

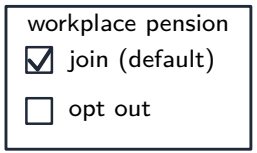
Exercise 2.3

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]



Exercise 2.3

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]



2.3

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

Exercise 3.1 (a)

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

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

Exercise 3.1 (a)

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

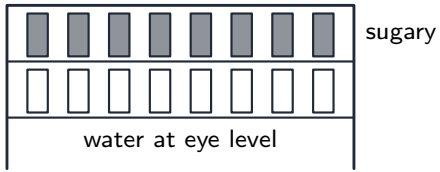
(a) Define **choice architecture**. [2]

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

Exercise 3.1 (b)

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

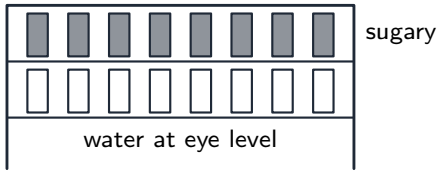
(b) Evaluate the use of nudges to reduce the consumption of sugary drinks. [6]



Exercise 3.1 (b)

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

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



(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