



ECONOMICS

Bridging Work - Rational or Irrational Consumers?

This work is designed to support the understanding of Rational decision making and Alternative views of consumer behaviour:

- a) The reasons why consumers may not behave rationally:
 - consideration of the influence of other people's behaviour
 - the importance of habitual behaviour
 - consumer weakness at computation.

Are consumers rational?

As Jodi Beggs has put it in her article *What Is Behavioral Economics?*, traditional economic theory has assumed that consumers are 'perfectly rational, patient, computationally proficient little economic robots that know objectively what makes them happy and make choices that maximise this happiness'. To do this we would have to end up with a consumption bundle where the satisfaction obtained from consuming the last unit of a particular type of good per pound spent is equal to the satisfaction we are getting on the last unit consumed of other product types per pound spent! Otherwise, we could shift our spending between products to give us more utility! Moreover, do we even know what will make us happy?

Are consumers, when they go shopping, rationally making these spending decisions? Although we probably all hope we are maximising our happiness, and perhaps convince ourselves that we are, it is apparent that what drives much consumer behaviour is altogether far removed from the traditional economic view of the consumer. Behavioural economics is a relatively new field in economics that is attempting to model how consumers *really* make decisions.

Introduction to behavioural economics

Psychologists believe that the brain processes two types of thinking. One way we process information is automatic and intuitive (the automatic system); the other way is through reflective and rational thought (the reflective system). As Richard Thaler and Cass Sunstein put it in their book *Nudge*, 'One way to think about all this is that the Automatic System is your gut reaction and the Reflective System is your conscious thought.' The decisions we make involve both systems interacting together.

Because our time is precious, (we cannot spend hours analysing all our spending decisions) and information is often too complex to make analytical assessments of the costs and benefits of our decisions, we tend to rely on rules of thumb (heuristics or short cuts) to help us make choices on what to consume. Behavioural economists believe that these rules of thumb provide a clue as to why consumers in practice often seem to make systematic, biased decisions which seem to contradict the model of the consumer as rational.

Behavioural economists have also identified a range of consumer behavior that suggests that we are subject to psychological biases when we make decisions about what to consume. Behavioural biases *do* suggest that consumers are irrational.

The reasons why consumers may not behave rationally

1. Consideration of the influence of other people's behaviour

One key behavioural bias observed in individuals is *herding behaviour*. According to Thaler and Sunstein, 'We are greatly influenced by *consumption norms* within the relevant group.' For example, if we see our friends drinking alcohol, we are more likely to do so, too. Even housing market booms can be caused by this effect: some people start investing in houses so others think this is a good idea, too. We seem to be particularly *influenced by what other people do* when making our consumption decisions.

2. The importance of habitual behaviour

The '*status quo*' bias is the tendency, which individuals have of just sticking with their current situation. We observe this in the weekly shop of most families at the supermarket, and in the tendency to stay with the same bank even though others may be offering a higher interest rate. This is often linked to individuals wanting to 'play safe', not wanting to risk a change which might make them worse off (*loss aversion*). This bias can cause consumers to lose out on possible utility gains (and also links with the default option mentioned later).

3. Consumer weakness at computation

Humans are particularly bad at mathematical computation. For example, we find it hard to understand probabilities and to make forecasts about how we will feel in the future.

In Richard Layard's book *Happiness: Lessons from a new science*, he states that people tend to *exaggerate small probabilities* into their thinking. This is often observed in how individuals react to 'health scare' stories in the media. Articles on how we triple our chance of getting some horrible illness can overly swing consumers into avoiding certain foods. The purchase of super foods may also soar despite the fact that its effect on reducing our real risk of a disease may be mathematically almost negligible.

Layard also points out that individuals find it *hard to forecast future feelings*. Individuals always think their purchasing decision, e.g. whether to buy a new car, will give them happiness for a longer time than it does in reality. 'If only I had the latest iPhone ...'

Products that have an addictive element also cause particular problems for individuals. They have a tendency to underestimate the future problems of trying to stop once they start and instead overly base their decision to buy cigarettes on the immediate gratification they receive. Individuals also have an *unrealistic optimism*, despite statistical data, and so 'overestimate their personal immunity from harm' (source: *Nudge*).

Amos Tversky and Daniel Kahneman (1974) studied how humans go about making judgements. They observed three heuristics (mental short cuts) which individuals tend to use to help them *when uncertainty exists* and *where assessing the probabilities involved would be too complex*. They help consumers make quick and often useful decisions. Let's look at some examples from the perspective of a consumer.

- Should I spend money on an upgraded and more secure front door? What is the likelihood that I might be burgled if not? The *availability heuristic* says that people, as a mental short cut, tend to base their assessment of risk on immediate examples which spring to mind. If I have recently watched a programme on the negative impact of being burgled, I am likely to over base my judgement on this and think my chances of being burgled are actually higher than they are. Therefore 'availability bias' is at work, which will influence my consumption decision.

- Should I buy a bread maker? A famous example from Dan Ariely involves a retail business based in San Francisco. They originally offered one type of bread maker to the market priced at \$275. There were virtually zero sales. They then launched a \$400 bread maker on the market that was bigger but otherwise had the same features. The original, smaller bread maker's sales doubled! The *anchoring heuristic* shows a human tendency to make decisions by comparing with a nearby reference point. The first breadmaker had no reference point so consumers were left muddled about its value and whether they wanted it. Once the \$400 bread maker became a reference point (an anchor), consumers then decided the cheaper option was an attractive proposition, despite the fact that it was being viewed by the same consumers with supposedly their own preferences and was the same bread maker. We rely too much on the first piece of information (the anchor) which is presented to us. It is clear that the anchor itself can lead to very different consumption decisions.

In Thaler and Sunstein's book *Nudge*, when *issues are complex*, making it hard for individuals to assess the full costs and benefits of a consumption decision, individuals tend to just go with the '*default option*', ie the choice that has effectively been chosen for them. For example, if you take out a magazine subscription, unless you actively cancel the subscription it will automatically be renewed. People tend to let their subscriptions carry on without engaging in an active rational assessment as to whether the magazine will generate sufficient utility for another year. This affects consumption patterns and intelligent firms can exploit this tendency!

Questions:

Q1: According to traditional economic theory, how are consumers assumed to make spending decisions?

Q2: What is behavioural economics attempting to model?

Q3: Why do consumers tend to rely on rules of thumb or heuristics when making choices?

Q4: What is the "status quo" bias?

Q5: What are some reasons why consumers may not behave rationally according to behavioural economists?

Q7: How does the anchoring heuristic affect consumer decision-making?

Q8: How do psychological biases impact consumer decisions?