# ECONOMICS

## Bridging Work – Microeconomics: Theme 1

### Section A: Introduction to Core Economic Concepts

### Part 1: Watch and Reflect

Watch the following short videos:

i. **What is Economics? – CrashCourse Economics #1**:
https://www.youtube.com/watch?v=3ez10ADR_gM

ii. **Scarcity, Opportunity Cost, and Trade-offs – Professor Dave Explains**:
https://www.youtube.com/watch?v=gg_qfPRd-mo

**iii.** **Positive vs Normative Statements – EconplusDal:**

https://www.youtube.com/watch?v=eG-6_Il9daA

**Task 1: After watching, write brief answers (2–3 sentences each) to the following:**

1. What is the purpose of economic models?
2. Why is ceteris paribus important in economics?
3. Give one example each of a positive and a normative statement.
4. What is scarcity, and why is it a fundamental economic problem?
5. What is opportunity cost? Give an example from your own life.

## Part 2: Discussion Prep

**Read this article: Why Economics Isn't Like Physics**
Link: https://www.economist.com/sites/default/files/econbriefs.pdf

### Task 2: Write a short paragraph (4–5 sentences) answering:

1. Why is it difficult to conduct scientific experiments in economics?

2. How do value judgements influence economic policy?

## Comprehension and Discussion Questions (Based on the article)

1. What are the main reasons the article gives for why economics is not like physics?

2. How does the article describe the role of assumptions in economic models?

3. What is meant by the term ceteris paribus, and why is it important in economic analysis?

4. Do you agree with the article's view that economics cannot be as precise as the natural sciences? Why or why not?

5. The article suggests that economic models are useful even if they are not always accurate. Can you think of a real-world example where a simplified model helped explain or predict economic behaviour?

## Section B: Economic thinkers

Adam Smith, Friedrich Hayek and Karl Marx

This work is designed to support the understanding of the distinction between free market, mixed and command economies: reference to Adam Smith, Friedrich Hayek and Karl Marx.

## Karl Marx (1818–1883)

Karl Marx was an extremely influential thinker whose ideas ignited the movement by a third of the world's countries towards communism in the 20th century.

Marx provided a criticism of capitalism. Capitalism is a system where the small minority – the 'bourgeoisie' (the owners of capital such as machines and factories) – are the ruling class, and the masses – the 'proletariat' (the labourers) – provide the labour to produce goods and services. Marx essentially believed that economic systems progress through different stages –capitalism is just one stage in this development process and, due to its weaknesses and flaws, will eventually self-destruct, leading to the final stage of communism.

Marx believed that capitalists (the owners of capital), whose objective is to make a profit, must end up exploiting workers to achieve this objective. This means that workers will earn wages lower than their true value. Capitalists will also have an incentive to replace labour with machines, creating both more monotonous jobs as well as unemployment. The combined effect will be to create an exploited and alienated workforce, leading to social unrest.

He also believed that competition would cause many firms to go bust, leading to a few firms holding monopoly power which would allow them to further exploit both workers and consumers. This would also lead to owners of the bust firms joining the ever-increasing proletariat majority, causing social tensions to further increase.

The capitalist economic system is also weak, Marx said, since it is an unplanned system which causes one crisis after another. This impacts most negatively on the proletariat.

Marx believed that revolution among the proletariat was inevitable. Revolution would enable workers to seize the capital (so that ownership would be among the majority). Economic planning would direct economic activity. As the economic system moves towards communism, there would be abolition of private property replaced by common ownership of resources.
However, although Marx wrote a lot criticising capitalism, he wrote relatively little on how communism would work.

Marxism has had a resurgence lately. Many global problems, such as the Global Financial Crisis and growing inequalities observed in many economies, may have their root cause in the free market system.

## Adam Smith (1723–1790)

Adam Smith is viewed to be the founder of classical economics and was a key advocate of the market economy. *The Wealth of Nations*, which Smith wrote in 1776, remains a classic book in economics. His key conclusion is that, by pursuing their own self-interest, individuals would be led 'as by an invisible hand', with resources allocated in such a way that is in the best interests of society.

He was writing at a time when most firms were owned and run by single individual capitalists who had an active, hands-on approach to running their businesses. Like today, most capitalistsran their businesses with the self-interested aim of maximising profit. Consumers also had their own self-interest at heart when making decisions about what to buy.

Smith argued that these self-interest objectives, via the operation of the price mechanism, leads to the optimum resource allocation and therefore the best outcome for society.
The 'invisible hand' enables consumers and producers to interact in the market so that both can achieve their objectives.

For example, if consumers suddenly want more robot vacuum cleaners, then this will push up the price in the market: consumers are competing with each other for the existing number of robot vacuum cleaners. Firms currently in the market will react by wanting to supply more of the product since there is greater scope to make higher profits, while new suppliers will be enticed into the market to take advantage of the profit opportunity. (Smith said low barriers to entry were essential to make this happen.) More resources are then being allocated to the production of robot vacuum cleaners, which is precisely what consumers wanted. Therefore everyone is happy.

Smith believed that competition in markets ensures that firms, whose main objective is to maximise profits, produce their goods at the lowest possible cost. This benefits society and ensures markets will use resources efficiently.

Smith recognised the dangers of monopoly power but at the time of his writing this was not viewed as being too significant. He also believed prices would end up being 'fair' but that competition was essential in achieving this (low barriers to entry are necessary to prevent firms from gaining monopoly power).

Smith also wrote about the process of specialisation and the division of labour, and how this production method could increase production and create wealth. By breaking down the production process into smaller, specialised parts, productivity rises. This is because this process helps incorporate some automation into the production process, which speeds up production. Workers also spend less time switching between tasks and the repetition of tasks makes their efficiency increase.

## Friedrich Hayek (1899–1992)

Friedrich Hayek was a key supporter of the free market and deeply critical of socialism (state planning). He believed that the resource allocation brought about by individuals, spontaneously, by the operation of market forces, would be far superior to any state planning system. He believed that governments should not intervene in resource allocation decisions, except in the provision or protection of public goods. While Hayek did not think that individuals make decisions about what to demand or supply based on perfect information, he did believe that they have the best knowledge of their own situation. For example, a consumer will have the most accurate knowledge of his/her particular tastes, and a manager will know what raw materials he needs to make his product.

Price movements will occur as individuals and firms participate in the market. These price movements will be observed, and individuals and firms can choose how they wish to act interms of their demand or supply decisions, with the information they each have. The price mechanism acts as a communication network.

The market will aggregate all these individual decisions, so ultimately the market will reflect all the information available to society as a whole. This means the outcome in terms of resource allocation will be the best that it can be. If government officials made decisions on how resources should be allocated, this would not be successful since these officials lack sufficient information about markets to be able to make informed decisions.

With the real-world failings of communism and the questioning of the effectiveness of Keynesian demand-side management, free market advocates such as Hayek have had more prominence again since the late 20th century.

## Section B Questions:

1. Compare and contrast the ideas of Adam Smith and Friedrich Hayek regarding the role of self-interest in resource allocation.

2. Explain how Adam Smith's concept of the "invisible hand" guides the allocation of resources in the market economy.

3. Analyse the impact of competition on resource allocation according to both Adam Smith and Friedrich Hayek.

## Section C: Rational or irrational consumers?

This work is designed to support the understanding of Rational decision making and Alternative views of consumer behaviour: The reasons why consumers may not behave rationally:

a) consideration of the influence of other people's behaviour

b) the importance of habitual behaviour

c) 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 proficientlittle 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? Althoughwe 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 newfield 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 makeinvolve both systems interacting together.

Because our time is precious, (we cannot spend hours analysing all our spending decisions) andinformation 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 providea 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 housingmarket 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 currentsituation. We observe this in the weekly shop of most families at the supermarket, and in thetendency 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 happinessfor 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 useto help them *when uncertainty exists* and *where assessing the probabilities involved would betoo 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 amental 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 themarket 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 ofinformation (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 withthe *‘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!

## Section C 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?