

CHAPTER 8

ECONOMIC BEHAVIOR AND RATIONALITY

Principles of Economics in Context (Goodwin et al.)

Chapter Overview

This chapter focuses on what goes into the making of economic decisions. The first part discusses the classical view of human rationality, which goes back to Adam Smith, as well as the neoclassical model, which is based upon classical thinking. It also reviews the “rationality axiom” of neoclassical economics, which is related to the notion of self-interest and assumes the existence of perfect information.

The second section is about economic behavior. It discusses a few experimental cases, such as the availability heuristic, framing, and anchoring, examples of how humans often do not behave “rationally” as defined by the neoclassical model. The section also discusses the importance of both time and intuition in the making of economic decisions – factors not previously considered in neoclassical theory.

The final section discusses the roles of political and corporate influence on rational decision-making, as well as the role of human altruism. It also challenges the neoclassical assumption of perfect information, drawing on the work of Herbert Simon (winner of the Nobel Memorial Prize in economics, even though he was a psychologist and computer scientist, not an economist!) to show that in reality our “rationality” is “bounded” in most instances. The final part of this section explores what a more broad-based notion of rationality would require.

Objectives

After reading and reviewing this chapter, you should be able to:

1. Explain the classical economic views of human nature.
2. Compare and contrast the classical view with the neoclassical model.
3. Describe in what key ways behavioral economic is a departure from neoclassical theory.
4. Explain the roles that time and emotions play in economic decisions.
5. Understand the basics of economic rationality, including how it is shaped by constraints, information, and influence.
6. Discuss economic behavior “in context”—that is, from a substantially more complex “real world” perspective.

Key Terms

| | |
|------------------------|---------------------|
| neoclassical model | optimizing behavior |
| rationality axiom | satisfice |
| behavioral economics | meliorating |
| availability heuristic | path dependence |
| framing | bounded rationality |
| anchoring effect | altruistic behavior |
| time discount rate | the common good |

Active Review

Fill in the Blank

1. The theoretical approach that has come to dominate economics is known as the _____ model.
2. According to the rationality axiom, pursuit of anything *other than* _____ is considered irrational.
3. _____ economics is a subfield of microeconomics concerned with how economic decisions are made.
4. The deliberate changing of the presentation of choices in order to influence the final economic decision is known as _____.
5. We say that people with a low _____ place relatively high value on possible outcomes in the distant future.
6. People that _____ generally do so because they possess insufficient information with which to make optimal decisions.
7. We label _____ situations in which a choice depends on what has happened in the past.
8. The idea that people consider some, but not all, relevant information when making a decision is included in a broad concept of _____ rationality.
9. We are being _____ if our actions are focused on the well-being of others instead of our own well-being.

True or false

10. Economics is a “pure” science.
11. The neoclassical model of human behavior is consistent with the behavioral economics approach.
12. The deliberate change in the way in which available information is presented is known as the availability heuristic.
13. When we place less economic importance on the future than on the present, we are engaging in discounting.
14. It is possible to think about a choice among alternatives to an inefficiently excessive degree.
15. Satisficing is a better strategy than optimizing when the decision to be made is highly complex.
16. Meliorating refers to the act of engaging in bounded rationality.
17. “Rational economic man” combines self-interest with altruism in pursuit of his economic goals.

Short answer

18. In *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith expounds on the concept of the invisible hand. Did Smith believe that humans were characterized by blatant self-interest? Explain.

19. Briefly explain how neoclassical and behavioral economics differ from each other.

20. Discuss in what way rationality is related to self-interest. Are the two concepts synonymous?

21. Give a few examples of how we sometimes behave in a seemingly irrational manner. Is such behavior uncommon? Discuss.

22. Is our time discount rate typically the same for all types of choices or decisions? Should it be? Explain.

23. Is it improper or “inefficient” for us to rely on our emotions for some economic decisions instead of our reasoning ability? Discuss.

24. List a few examples of path dependence and explain how they fit the definition.

25. Describe a more broad-based definition of rationality than the one provided by neoclassical theory.

Self Test

1. Which of the following statements about Adam Smith is false?

- a. Smith is the author of *The Theory of Moral Sentiments*.
- b. Smith is the author of *The Wealth of Nations*.
- c. Smith believed that there is no need for altruistic behavior.
- d. Smith's work has been used to justify views that are not necessarily supported by his writing.
- e. Smith wrote about both economic and ethical issues.

2. Some people have argued that if everyone simply follows his or her own self-interest, societal well-being will automatically result. This view overlooks ...

- a. the fact that people may not have all the information they need to make good decisions.
- b. the fact that people almost always work to advance the common good.
- c. the fact that people optimize.
- d. the fact that people have high discount rates.
- e. the role of markets.

3. Which of the following is *not* considered a hallmark of neoclassical economics?

- a. Rationality
- b. Utility maximizing households
- c. Availability heuristics
- d. Firms that maximize profit
- e. All of the above *are* hallmarks of neoclassical economics.

4. The author of *Economics: An Introductory Analysis*, the economics textbook that would become the best-selling textbook ever, was ...

- a. John Stuart Mill
- b. Adam Smith
- c. Milton Friedman
- d. Paul Samuelson
- e. Alan Greenspan

5. According to neoclassical economics, irrational behavior is ...

- a. not uncommon.
- b. that which is not consistent with self-interest.
- c. not necessary for information to be perfect.
- d. related to people's emotions.
- e. misunderstood.

6. The term "rational behavior" is used in neoclassical economic models to describe behavior that *best* moves a person toward his or her goals. This behavior is known as ...

- a. bounded rationality
- b. satisficing
- c. meliorating
- d. organizational savvy
- e. optimizing

7. The subfield of microeconomics that studies how economic decisions are made is known as ...

- a. situational economics
- b. meso-economics
- c. rationality economics
- d. altruistic economics
- e. behavioral economics

8. When people alter their choices based on how the relevant information is presented to them, this is an example of ...

- a. behavioral economics
- b. an availability heuristic
- c. framing
- d. anchoring
- e. optimizing

9. When people over-rely on information that may or may not be relevant to the decision at hand, it is called ...

- a. neoclassical economics
- b. satisficing
- c. framing
- d. anchoring
- e. optimizing

10. During her first year of college, Jean lived in a small dorm room with an annoying roommate. In her second year, she was happy because she got a room of her own, although it was still small. In her third year, she moved into a spacious apartment with a good friend. Jean's process of finding a better place to live each year could be described as ...

- a. discounting
- b. custom
- c. exchange
- d. meliorating
- e. production

11. The concept that describes the relative weighting of present versus future benefits and costs is known as the ...

- a. time value factor.
- b. time discount rate.
- c. analysis of variance.
- d. quotient of quotidian time.
- e. None of the above are correct.

12. Emotions ...

- a. have no relevance in economics.
- b. are always rational.
- c. are at the foundation of optimization behavior.
- d. sometimes provide wisdom in decision making.
- e. must be balanced with reasoning when conducting neoclassical analysis.

13. Which of the following do *not* play any role in decision-making?

- a. Time
- b. Money
- c. Media influence
- d. Advertising
- e. All of the above play a role.

14. The neoclassical economic model assumes perfect rationality and perfect information. Which of the following situations is most consistent with this model?

- a. You need to buy a pair of shoes. You find out what store sells the best shoes for the lowest prices, and you go shopping there.
- b. You need to buy a pair of shoes, so you buy them at the nearest store.
- c. You get drunk at a fraternity party because you want to impress your friends.
- d. You don't study the night before your economics exam because your roommate is sick and needs your help.
- e. You buy a used car without doing research beforehand, and end up paying more than the car is worth.

15. Which statement about the neoclassical economic model is false?

- a. It assumes the economy is composed entirely of households and firms.
- b. It treats households as organizations with potentially complex internal dynamics.
- c. It assumes that exchange is performed in markets.
- d. It assumes that all economic actors possess perfect information.
- e. It omits consideration of resource maintenance activities.

16. The experiment that asks participants to decide what share of a \$20 payout to give to a partner is known as the ...

- a. prisoner's dilemma game.
- b. chicken game.
- c. path dependence game.
- d. satisficing game.
- e. ultimatum game.

17. Which of the following statements is true?

- a. Anchoring can occur when we pay insufficient attention to information that could be vitally important.
- b. The notion of bounded rationality is central to the neoclassical model.
- c. Following intuition is often a good idea when economic decisions involve a high level of complexity.
- d. The neoclassical model relies heavily on the notion of melioration.
- e. A person who does not care much about the future is said to have a low time discount rate.

18. Bounded rationality ...

- a. is a euphemism for highly irrational behavior.
- b. is always path dependent.
- c. usually does not lead to the "optimal" choice.
- d. was discussed extensively in *The Theory of Moral Sentiments*.
- e. None of the above are true.

19. Which of the following exemplifies a high time discount rate?

- a. Making sure to save money for your child's college education, even though your child is still young.
- b. Deciding to take an expensive vacation now, even if it means not taking a vacation next year.
- c. Taking steps to avoid water pollution, because the pollution could decrease fish yields next year.
- d. Planting an acorn with the intention that your grandchildren will enjoy the full-grown oak tree.
- e. Putting money away for a rainy day.

20. Which of the following situations best illustrates the concept of satisficing?
- a. Claudillo looks for a job that will pay better than his last job.
 - b. Johanna researches every possible option before she chooses what model of car she will buy.
 - c. Albert eats a peanut butter sandwich for lunch every day because that's all he can afford.
 - d. Juan wants an affordable three-bedroom apartment. He rents the first one he finds.
 - e. Carla saves her money carefully so she can take a year off from work and write a novel.

Answers to Active Review Questions

- 1. neoclassical
- 2. self-interest
- 3. behavioral
- 4. framing
- 5. time discount rate
- 6. satisfice
- 7. path dependent
- 8. bounded
- 9. altruistic
- 10. False. Economics is a “social” science. It is not a pure science since the economy is far more difficult to analyze using the traditional scientific method than controlled laboratory experiments.
- 11. False. These are very different; in fact, weaknesses in neoclassical economics with regard to how people make decisions are what have given rise to behavioral economics.
- 12. False. It is known as framing.
- 13. True.
- 14. True.
- 15. True.
- 16. False. Meliorating is continuously attempting to improve upon one’s situation.
- 17. False. Rational economic man only pursues self-interest, never altruism.
- 18. No, he did not. He believed that people often were motivated by self-respect, and having the respect of others.
- 19. Neoclassical economics narrowly holds that all economic decisions are dictated by rationality, which is the pursuit of self-interest. Behavioral economics offers a more nuanced approach to economic decision making, which maintains that rationality in a neoclassical sense is practically impossible (given existing real-world constraints) and that people are sometimes altruistic instead of self-interested.
- 20. Discuss in what way rationality is related to self-interest. Are the two concepts synonymous? According to the neoclassical model, the two are indistinguishable,

since rationality is defined as the incessant pursuit of self-interest. The broader behavioral model, however, believes that rationality neither requires nor is required by self-interest. It allows for bounded rationality or satisficing (which it deems rational), as for altruistic behavior. Moreover, according to this model, self-interest can also be pursued irrationally.

21. One example is where we allow ourselves to be confused by the framing of a problem requiring a decision. “Lives saved” and “deaths averted” mean the same thing, but which is used often influences the choices people make. Another example is where we allow, say, one video transmission influence our thinking to a greater extent than a summary of many responses that contradicts the video. Such behavior is “irrational” according to the neoclassical model, but it is actuality quite common and *not* irrational according to the behavioral model.
22. No, it generally is not, nor should it be. For example, we tend to value the future to a significant degree when it comes to our finances, meaning that many save a fair share of their income for future use. On the other hand, many of us tend to be more shortsighted when it comes to making decisions (often related to consumption of products, energy, or materials) that have an adverse impact on the natural environment. For a variety of reasons, we tend to prefer pushing these “costs” on to future generations.
23. It is not necessarily inefficient to rely on our emotions; in fact, the opposite might be the case. For especially complicated economic decisions, it is almost impossible to obtain enough information that could be relevant to our ultimate choice. So wasting too much time gathering enough information might end up being inefficient in such situations (hence irrational), and it often is more efficient to rely on our intuition or emotions by “satisficing.”
24. The QWERTY arrangement of keys on a keyboard is a classic example. It was initially developed in order to *slow down* professional secretaries, since their extreme typing speed with more efficient arrangements would invariably lead the typewriter keys to become tangled and stuck. Of course this has not mattered for at least a few decades, but the less efficient system stuck. Another example might be where a concentration of businesses in a particular geographical area might ultimately lead to disproportionate economic development, where buyers cluster around the initial sellers, attracting more businesses to the area, etc. It may not be the most efficient geographical distribution of businesses, but it follows logically from its starting point.
25. A more broad-based definition would involve goals that are well-being enhancing but also that pursuit of the goals themselves contributes to well-being. More important, naked self-interest is not required. Altruism might often also contribute to well-being by, for example, strengthening the local community. Finally, a more broad-based definition would presume – more realistically than the neoclassical model – that it is often not possible to be rational (even though people mostly *try* to act rationally) on account of lack of relevant information in making decisions.

Answers to Self Test Questions

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|-------|-------|
| 1. d | 11. b |
| 2. a | 12. d |
| 3. c | 13. e |
| 4. d | 14. a |
| 5. b | 15. b |
| 6. e | 16. e |
| 7. e | 17. c |
| 8. c | 18. c |
| 9. d | 19. b |
| 10. d | 20. d |