Behavioural Economics

Problems with Human Decision making

- Bounded rationality: Decision making not always rational because of limits
- Bounded self-control: Do not always stop consuming once benefit no longer exceeds cost
- Anchoring: Irrelevant info as ref point for estimation
- Altruism: Making decisions not based on self (not maximise personal utility)
- Rule of thumb: General rule to use on numerous occasions to save time as time is scarcer resource than what is sacrificed using this
- Social norms potentially reduce personal utility
- Availability: Buy inferior product when preference not available

Externalities & Market Failure

- Externality: Side-effect of production/consumption on someone other than produces/consumer
- MPB: Benefit to consumer only of consuming one more unit
- MSB: Total benefit to society as a whole of one more unit
- MPC: Cost to producer only of producing one more unit
- MSC: Total cost to society as a whole of one more unit
- MEB: Side benefit to someone other than producer/consumer
- **CONSUMPTION**
    - Positive externality of consumption: MSB > MPB (Socially desirable = underproduction)
    - Negative externality of consumption: MPB > MSB (Socially undesirable = overproduction)
- **PRODUCTION**
    - Positive externality of consumption: MPC > MSC
    - Positive externality of consumption: MSC > MPC
- MSC = MPC + MEC
- Total market failure = no market; partial market failure = externality
- NSC = NPC + NEC
  = (PC – PB) + (EC – EB)