



AQA - A Level Economics

Individuals, Firms, Markets & Market Failure

2.1 Individual economic decision making

Revision Notes

Contents

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2.1.1 Consumer behaviour

How Rational Are We in Economic Decisions?

When looking at markets, economists assume that everyone involved makes **rational decisions**, meaning they carefully think about their choices and pick the one with the most benefits.

Here's how different groups are **assumed** to act rationally:

- **Consumers:** They aim to get the most happiness (**maximise utility**) from what they buy.
- **Producers:** They focus on making the **most profit** from selling goods and services.
- **Workers:** They try to balance job satisfaction, pay, and benefits.
- **Governments:** They're expected to put people's welfare first to create the greatest good.

But let's be real, people don't always act rationally. For example, consumers often make emotional purchases (like splurging on something they didn't plan to buy), which isn't exactly logical.

In short, while classical economics assumes everyone is rational, real-life decisions are often influenced by emotions, habits, and other unpredictable factors.

2.1.1 Consumer behaviour

Utility theory: Diminishing Marginal Utility

Marginal utility is the extra satisfaction you get from consuming one more unit of something. But the more you consume, the less satisfying it becomes.

For example:

Imagine you're starving and take your first slice of pizza 🍕, it's amazing. You grab a second slice, and it's still great, but not as satisfying as the first. By the third or fourth slice, you're feeling full, and each bite is less enjoyable. By the fifth slice, you might even feel regret.

The **Law of Diminishing Marginal Utility** explains this:

- The first unit gives the most satisfaction.
- As you consume more, the extra satisfaction (marginal utility) from each additional unit decreases.

This is why the **demand curve slopes down**:

- At first, you're willing to pay a higher price for the first slice of pizza.
- But as your satisfaction drops, you'll only keep consuming if the price goes down too.

Firms know this. That's why they offer deals like **"50% off your second item."** They know you're less excited about buying the second unit unless it's cheaper. It's a win-win, you're tempted to buy more, and they sell more.

In short, diminishing marginal utility shows why the first is often the best, and why prices have to drop to keep us coming back for more.

To find total utility, you simply add up the marginal utility of each unit you consume.

So, even if each extra unit gives you less satisfaction (declining marginal utility), your total satisfaction (total utility) can still grow as long as you keep consuming.

2.1.1 Consumer behaviour

The importance of the margin when making choices

Every day, we make choices like whether to have one more slice of pizza 🍕 or watch one more episode 📺. That's where **marginal analysis** comes in.

✅ What is Marginal Analysis?

Marginal analysis is all about making decisions **one step at a time**, by weighing the **extra benefit** vs the **extra cost** of doing a little bit more (or less) of something.

- **Marginal benefit:** the extra satisfaction or happiness you get from one more unit.
→ e.g. The joy from one more slice of pizza.
- **Marginal cost:** the extra cost (money, time, or effort) of that extra unit.
→ e.g. Feeling too full or spending more money.

💡 Example:

Imagine you're buying ice cream.

You eat the first scoop and it's amazing. That's high **marginal benefit**.

By the third or fourth scoop, the happiness you get from each scoop drops (lower marginal benefit), but you're still paying the same price (same marginal cost).

At some point, it's no longer worth it, that's when you stop. That's **thinking at the margin**.



2.1.1 Consumer behaviour

The importance of the margin when making choices

🧑 Not Just for Consumers

It's not just shoppers or snackers, **businesses and governments** use marginal analysis too.

- Businesses use it to decide how many products to make
- Governments use it to decide how much to spend on services like healthcare or education

They all aim to **use limited resources wisely** by comparing marginal benefit and marginal cost.

🎯 Goal = Optimal Choices

When we compare the extra benefit to the extra cost and make the smartest choice, we're aiming for an **optimal outcome**, doing what's best with what we've got.

2.1.1 Consumer behaviour

In theory, people, businesses, and governments are supposed to make smart decisions, ones that maximise happiness, profit, or overall wellbeing. But let's face it, life's not that simple. Here's why people often stray from "rational" behaviour:

Consideration of the influence of other peoples behaviours (We're Swayed by Others)

- People aren't always independent thinkers; we're often influenced by what everyone else is doing.
- For example, you might buy the latest phone, not because you need it, but because all your friends have one and you don't want to feel left out.
- Ever bought something just because it went viral on social media? That's the "herd mentality" at play. It can even cause big problems, like overhyped concert tickets selling out in minutes, driving prices way up, just because everyone's rushing to buy them.

The importance of habitual behaviour (We're Creatures of Habit)

- Habits can lock us into routines, even when better options are available.
- Imagine someone who always orders the same meal at a restaurant, even though they'd probably enjoy trying something new. Why? It's just easier to stick to what they know.
- Another example: People sticking to old energy providers or phone plans, even if switching would save them money. They simply don't think about it because it's become automatic.



2.1.1 Consumer behaviour

We Struggle With Math and Self-Control

- Not everyone's great at comparing prices or thinking about long-term consequences.
- A shopper might grab a bigger box of cereal because they assume "bigger is better," without checking if it's actually a better deal (spoiler: it might not be).
- And then there's self-control, like splurging on that fancy coffee every morning instead of brewing it at home. Sure, it's small, but those costs add up over time.

2.1.2 Imperfect information

Markets don't always work perfectly because people don't have **all the info they need**; this is what we call an **information gap**.

In a perfect world, buyers and sellers would have the **same information** about products and services. We call this **symmetric information**, everyone's on the same page.

But in reality? It's usually **asymmetric information**, meaning one side knows way more than the other. For example:

- In the **used car market**, sellers know the car's true condition, but buyers? They're guessing. This creates a trust issue, nobody wants to end up with a bad deal.

Why It Messes Things Up

When one side has more info, markets can go haywire. This leads to:

1. Over-provision (too much of something bad):

- **Example:** Fast fashion brands might hide poor working conditions. If buyers knew, they'd buy less, and fewer resources would go into making those clothes.

2. Under-provision (too little of something good):

- **Example:** Solar panels could help reduce energy bills, but not everyone knows about government rebates. If they did, more people would invest in solar, and society would benefit.



2.1.2 Imperfect information

The Fix

Fixing information gaps can help markets work better. This means:

- Educating consumers about harmful products (like warning labels on cigarettes).
- Spreading the word about benefits (like government incentives for electric cars).

When people have the right info, markets get closer to **fair and efficient**.

2.1.3 Aspects of behavioural economic theory

What is Behavioural Economics?

Behavioural economics is all about how real people make decisions, not robots or perfectly logical humans, but people like us with emotions, habits, and the occasional poor impulse control.

Traditional economics assumes people are completely rational, meaning we always make the best decision to maximise our happiness (or “utility”). For example, if we see two sandwiches for the same price, we’ll choose the tastier one. Simple, right?

But behavioural economists say, “Hang on, real life isn’t that neat.”

Traditional vs Behavioural Economics (in plain English)

- **Traditional Economics** thinks people:
 - Always think logically
 - Know what they want and how to get it
 - Weigh up all their options calmly before deciding
 - Always go for what gives them the most benefit
- **Behavioural Economics** knows people:
 - Often make decisions based on feelings or habits
 - Don’t always have time or brain space to think everything through
 - Might choose something that’s “good enough” rather than perfect
 - Are affected by **cognitive biases** — mental shortcuts or mistakes (like impulse buying snacks at the checkout)

2.1.3 Aspects of behavioural economic theory

Bounded rationality and bounded self-control

Common Behavioural Limits (with real-life flavour)

- **Bounded rationality** – Bounded rationality is the idea that people don’t always make perfectly logical decisions. Our brains are amazing, but not perfect. We don’t always have the time, knowledge, or brainpower to make the smartest choice. Like picking the first insurance policy we see instead of comparing them all.
- **Bounded self-control** – This theory says people struggle to resist temptations, especially when they’re tired, emotional or just not thinking straight. We know eating veggies is better than cake, but guess what ends up on the plate? People often choose short-term pleasure over long-term benefit.
- **Biases** – These are mental shortcuts that can lead to dodgy decisions. For example:
 - **Confirmation bias** – You only listen to things that support what you already believe.
 - **Anchoring** – If the first price you see for a phone is £1000, then £800 suddenly seems like a bargain.

Why This Matters

Behavioural economics helps explain why we sometimes:

- Overspend on Black Friday
- Stick with bad subscriptions
- Avoid switching energy providers even if it's cheaper

Governments and businesses use behavioural insights to:

- Design better policies (like “nudge theory” to get people to save more)
- Help people make smarter choices (e.g. putting healthy food at eye level in shops)

2.1.3 Aspects of behavioural economic theory

Biases in decision making

Biases are mental shortcuts or habits that influence how we think, process information, and make choices, even if they aren't the most logical. Let's look at some common ones you probably use without even realizing it:

1 Rule of Thumb 🛒👉

We often go with what we've always done, our "default" choice, instead of thinking it through.

Example:

👉 You always buy the same chicken sandwich from the corner shop even though they just introduced a spicy tofu wrap 🥬 you might love!

🧠 Why it matters: Sticking to your "go-to" choice can stop you from finding better or newer options.

2 Anchoring & Framing 💰✍️

- **Anchoring** 📌: The first number or fact we hear "sticks" in our brain and affects everything else we judge.
 - 🧠 *Example:* A hoodie is labelled "Now £30, was £80!" You feel like you're getting a massive deal, even if the real value is £25.
- **Framing** ✍️: How something is presented changes how we feel about it, even if the info is the same.
 - 📖 *Example:* You're more likely to buy chocolate labelled "90% sugar-free" than one that says "10% sugar," even though they're identical.

🧠 Why it matters: Presentation and first impressions have *huge* power over what we choose.

2.1.3 Aspects of behavioural economic theory

Biases in decision making

3 Availability Bias 📱🔥

When something is fresh in our minds, usually from the news or social media, we think it's more likely than it actually is.

Example:

🔥 After seeing TikToks about phone batteries exploding, you start worrying your own phone might blow up, even though it's super rare.

🧠 Why it matters: We base decisions on what we remember easily, not on facts or probabilities.

4 Social Norms 📊👥

We follow what others do to fit in, even when it's not smart or needed.

Example:

👥 Everyone at school starts wearing a specific brand of jeans, so you buy a pair too, not because you love them, but to blend in.

🧠 Why it matters: Peer pressure and trends can override personal taste or smarter choices.



2.1.3 Aspects of behavioural economic theory

Altruism and perceptions of fairness

Economics often assumes people are *selfish decision-makers*, always doing what's best for themselves. But real life? It's not always like that. People often do good things for others even if it doesn't benefit them personally. That's where **altruism** and **perception** come in 💡

👉 What is Altruism?

Altruism means doing something to help others, even if it costs you. It's about being kind or generous, not because you get anything back, but just because it feels right.

Example:

You buy a sandwich for someone experiencing homelessness 🏠 even though it costs you money and brings you no personal gain. You're not getting a reward, just that warm fuzzy feeling ❤️

🧠 So... why do people act this way?

Sometimes, people:

- Care more about the group than themselves
- Are influenced by what's *seen as right*
- Follow the crowd or "fit in" with social expectations

👤🔄 Social Norms Play a Role Too

Social norms are the unwritten rules we follow in society. They influence how we behave especially when we want to be accepted or do the "ethical" thing.

Example:

You bring your reusable cup to the café ☕ because most of your friends do and you don't want to be the "wasteful one" using plastic. 🌱

2.1.3 Aspects of behavioural economic theory

Altruism and perceptions of fairness

👉 What About Perception of Fairness?

Fairness is what people *believe* is right or just. Sometimes, people make choices to support a *fairer* world, even if it doesn't benefit them directly.

Example:

You buy bananas that are Fairtrade-certified 🍌 even though they're more expensive because you believe the farmers deserve a fair wage.

2.1.4 Behavioural economics and economic policy

Governments use behavioural economics to design smarter policies based on how real people behave. They tweak how choices are offered to help us make better decisions (without even realising it sometimes).

Choice architecture and framing

Choice architecture means how the options in front of us are laid out. The setup can make a big difference in what we pick, even if the choices stay the same.

◆ **Example:** At a cafeteria, if the fruit salad is placed at the front of the counter and chocolate cake at the end, more people will pick the fruit salad just because they see it first.

Framing is how a choice is worded or presented. The message can stay the same, but how it's delivered changes how we react.

◆ **Example:** A mobile data plan that says, "Only \$1 per day" sounds more tempting than one that says "\$365 per year," even though they're exactly the same.

Nudges

A **nudge** is a clever little trick to steer people in the right direction—without forcing them.

◆ **Example:** In a video game, the default setting for screen brightness might be set to "eco mode" to save energy. You can change it, but most players stick with what's already chosen.

Nudges help people make better decisions, especially when they don't have all the info, or they're overwhelmed. It's like a gentle whisper: "Hey, maybe try this?"



2.1.4 Behavioural economics and economic policy

Default choices, restricted choice and mandated choice

Let's break down three types of decision setups used in everyday life:

Default Choice

This is what happens if you don't make an active decision; your "autopilot" option.

◆ **Example:** Your email newsletter settings automatically subscribe you to weekly updates unless you uncheck the box. Most people stay subscribed because they don't bother to change it.

Restricted Choice

You still get to choose, but from a limited menu.

◆ **Example:** A school limits vending machine options to only water and juice. You still pick, but not from sugary sodas or energy drinks.

Mandated Choice

You must make a decision; you can't skip it.

◆ **Example:** Before booking a concert ticket, the website asks: "Would you like to offset your carbon emissions for £1?" You can't move on until you pick yes or no.

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