Some Exam Questions With Notes About Answering Them

Note: The essays below were each constructed to be answered in about 40 minutes. This would be enough time for well-prepared students to write answers of about 1000 words per essay without having to write at such a pace as to cause their writing to be illegible. In other words, they could probable take up about three and a half pages of examination paper, with an introduction, half a dozen paragraphs devoted each a particular main point, and a conclusion. An introduction should not waste time restating the question but rather should focus on showing that one has a sense of what important issues underlie the question, the debates to which it alludes, and so on. The notes below are not 'model answers' and are much shorter, per question, than the answers that could be written. Their main purpose is to draw attention to ingredients and lines of argument from which effective answers could be constructed.

1. Discuss the following two contentions:

   (a) Economists can safely ignore the 'old behavioural'/evolutionary approaches to the firm on the basis that, in the long run, firms will discover optimal ways of operating by experimenting under the pressure of competition.

   (b) There is no need for consumer protection policies since consumers can experiment and can use reviews posted on the Internet and information from their social networks to find out which products will be the best means for enabling them to meet their goals.

Part (a) of this question implicitly pits the work of Alchian (195) and Winter (1964, 1971) against the work of Day (1967) on the convergence of satisficing to marginalism.

Alchian pointed out that survival requires merely that one is good enough to survive in the environment in question. However, as Downie (1958) emphasized via his 'transfer mechanism' notion, in the long run, this could mean that, with a stable environment, and falling average cost curves, the market ends up being dominated by a monopolist that has driven all of its rivals out – rather than ending up with a number of firms that are producing at minimum average cost on a U-shaped cost curve. A monopolist might end up operating with X-inefficiency due to staff no longer feeling under pressure to keep finding ways of reducing costs.

Winter (1964) suggests that firms with simple decision rules that happen to suit their environments well will drive out firms that take their decisions in a more thorough manner, as the latter will always be running behind in finding out what the optimal thing to do would have been. However, in the long run, even if rule-using firms are the only survivors, iterative adjustments would, according to Day, mean that eventually they would stumble upon the best choices and find no way of improving on them with further tinkering and rule refinement (this begs the question of whether they would discover global or local optima).

The key problem with Day's perspective, as Winter (1971) showed, is that the environment is unlikely to stand still in a world of innovation and hence the firms that survive never get to arrive at a point on which it is impossible to improve. Innovations may come from firms that are pushed to think creatively, instead of simply following satisficing rules, because they face the prospect of going under if they cannot come up with better products, processes and procedures, so market leadership may keep changing as per Schumpeter's cycles of creative destruction, as per Downie's 'innovation mechanism. Being able to bounce back from a period of falling behind requires firms to call upon more resources, in some sense, than they had previously been using, to get the room for being creative and to implement new ways of doing business. To understand how this may be possible, the idea of organizational slack (from Cyert and March's behavioural theory of the firm) is helpful. It may also be useful to be familiar with Leibenstein's views about X-efficiency

Part (b) requires a consideration of the contexts in which consumers can experiment (often mainly with low-value supermarket products that they consume frequently, and which are offered by many brands), versus those that involve major outlays and are difficult to sell for anything like what we paid for them if they make a mistake, as with rarely purchased consumer durables. Products that entail contractual lock-in with expensive exit clauses (as with mobile phone contracts) could also be considered as problematic. With long gaps between purchasing products, due to their durability or contractual aspects, the choice environment will be different each time the consumer is 'in the market', and brands that were disappointing last time may have raised their game in the meantime. For these kinds of situations, reviews may serve as substitutes for expensive experiments, so long as consumers have skills in finding good sources of reliable reviews (there is an infinite regress problem to be noted here, as choices of reviews/review sites have to be made to assist with choices) and in 'deconstructing' what they find there. Naïve consumers may not set their aspirations high enough to realize that they could be doing much better or may lack skills in using reviews. Not all consumers will have social networks whose members have relevant knowledge.

2. Use material from this course to analyse why the 'new' behavioural economics that is popular today largely ignores 'old' behavioural approaches of scholars such as Herbert Simon, the recipient of the 1978 Alfred Nobel Memorial Prize in Economic Sciences.

The process of getting academic sources in a library is like that of shopping in a supermarket, only much worse in terms of the sheer range of choice – which means there is a major role for mentors and citations in shaping which sources academics choose to check out. Skills in choosing search terms may also be important (Google doesn't give the same results for US and UK spellings of behavio[u]ral!) Forgetfulness and impatience may also mean that sources that are not immediately available do not get followed up. So, this is serious territory for bounded rationality to result in huge chunks of literature not being known to those who might benefit from it. There is scope for considering the blinkering effect of search routines, and potential for failures in journal refereeing processes due to referees not being aware of omitted sources, either, or not being as industrious as they might have been. Reviewers of books or discussions of journal articles may put potential users off, even though, if they had bothered to read the sources they would have discovered in some cases that the reviewers had misunderstood what they were reviewing. Simple rules such as 'don't routinely read anything more than five years old' may rule out looking at 'old' sources even if they come up in searches.

However, it is important also to call upon material about the way in which people organizae their thinking (via Kelly's personal construct psychology and Lakatos's view of the nature of 'scientific research programmes') to explore resistance to change of ideas and how ideas that are cognitively dissonance with core notions will be prone to be argues away. Simon's satisficing ideas can be portrayed in this sense: they were theoretical perspectives at odds with core theoretical notions of orthodox economics, whereas Thaler, Kahneman, etc. were using empirical findings to challenge the predictive capacities of the mainstream without really mounting a comprehensive challenge on the core, and hence the latter were much more acceptable. It would also be possible to discuss, in relation to cognitive heuristics and biases why Richard Thaler's strategy of using anecdotes to challenge the mainstream was so successful.

3. What lessons does behavioural economics have for understanding how people choose (a) their partners/spouses, (b) the number of children they have, and (c) when to terminate a relationship?

A useful paragraph could be written on the relevance of the 'secretary problem' discussed in the search literature to the first part of the question, with an eye to how the analysis of that problem gives one pause for thought about whether we might expect couples to take longer to form in today's age of online dating, with potentially a far bigger range of choice than in the past.

Following on from that, this question provides ample opportunities for using material on trade-off versus non-trade-off-based choices and the effect that information overload has on which mode people use (as has been shown empirically using work by Lenton and Stewart on internet dating search results). The potential consequences of having demanding templates for one's prospective partner can also be considered, via Kelly's personal constructs perspective on the 'old maid' situation. Social pressures on whether a partner is acceptable are also worth raising via the Fishbein-Ajzen model.

The no-trade-off issue may also arise in relation to ending a relationship where things are getting 'too dangerous' due to a violent partner, regardless of, say, high material living standards. Likewise, non-compensatory thinking could help explain why some people switch to other partners that they find irresistible despite then having to incur ruinous alimony costs (or were they simply not thinking about the consequences of their affairs, due to finite attentive capacity?).

There is plenty of scope also for considering the role of social norms ('the hidden persuaders') as driving the ways that people go about finding their partners and deciding how many children to have. Emotional aspects of choice can also be aired: for example, guilt if not providing grandchildren, or 'go with the flow' behaviour that results in children, where rational deliberation would have indicated other behaviour would have been wise. *Principles of Behavioral Economic* uses the example of terminating a relationships when discussing the significance of hyperbolic discounting, dread and dislocation costs on tendencies to procrastinate or lose nerve, so this material is expected to be used in answering this question. Sunk cost bias would also be worth weaving into the answer, especially after an expensive wedding, leading to attempts to 'make a go of it' if things soon prove disappointing, and cognitive dissonance reduction can be considered in relation to this.

Don't forget to consider in relation to present bias the economics of dread in relation to the upfront downside costs of ending relationships and/or getting back into dating and the challenges of finding a new partner.

4. Examine the role assigned to 'customer goodwill' in the analyses of the growth of the firm and price-setting behaviour offered by Alfred Marshall and P.W.S. Andrews. For which kinds of products and services do you expect the management of customer goodwill to be a significant issue for suppliers in today's economy? Explain your reasoning.

In Marshall and Andrews, the focus is on developing long-term attachments with customers as a means of increasing sales, rather than on the firm's sales depending on the slope/position of its demand curve (and rightward shifts in the curve through time). New firms have to battle to win customers from established firms unless their founding entrepreneurs get their businesses started with the aid of customers that they take with them from their previous employers. However, opportunities arise if existing suppliers fail to meet customers' needs/expectations due to lapses in quality (which Marshall sees as a likely problem as a firm gets older and complacency sets in) or because they are so successful that they cannot serve all their would-be clients. There will also be a churning of the population of customers as people pass through lifecycle stages or move from place to place. Inexperienced buyers, who lack social connections in the relevant area, may randomly buy from hew firms, be pleased with what they get and spread the word to others as they develop their networks.

The focus on building goodwill leads Marshall and Andrews to argue that firms set their prices with a keen focus on not drifting out of line with actual and potential competition (being greedy could make their customers search and remove their loyalty)' firms do not have the kind of discretion in pricing that is assumed in models of imperfect competition. Also, they will tend to try to expand capacity ahead of the growth in their target sales so that, if they get lucky in winning new customers, they can serve these without disappointing their established customers: spare capacity is thus strategically chosen rather than due to too many firms crowding into an industry as per the analysis in theories of imperfect competition.

The key basis for building goodwill relationships is repeat business, so the longer the prospective period over which repeat business might be conducted, the more there will be a focus on building goodwill rather than on trying to milk as much out of the consumer as possible on an individual deal done today. Also, having a long-term relationship with customers makes it easier to anticipate their demands, which both gives the firm potential for reduced costs due to better planning and a competitive edge over potential suppliers with similar capabilities but less knowledge of the customer. Goodwill is thus likely to be a key aspect of financial services and other professional services markets (lawyers, doctors, dentists, vehicle maintenance, serving local customers in the hospitality sector) and in business to business supply chains. In tourism, its absence may result in rip-offs from suppliers who know or suspect that it is unlikely they will ever see a customer again, though it may work at a different level in terms of relationships with other firms, such as hotels, who may be able to steer customers towards them if they maintain a good reputation.

5. Use material covered in this course as the basis for a discussion of the impact of globalization and market deregulation policies on (a) the rate of productivity growth and (b) human happiness.

This question tests skills in making connections between different parts of the course. It provides students with an opportunity to consider, via the behavioural theory of the firm and Leibenstein's X-inefficiency concept, how increased pressure of competition, whether between firms or between workers, may induce search for ways of improving productivity or what is offered to customers. This may result in higher customer aspirations becoming capable of being met via the uptake of organizational slack, the generation of new knowledge and greater X-efficiency (via tighter job contracts, uptake of best practice business methods and better allocation of management talent between firms). There is scope for linking this perspective to Sallter's view of structural change and how lower-cost production methods capture increased market share, and this could be illustrated with a suitably used 'Salter diagram' and a discussion emphasizing that the heights of the blocks on the diagram would be reduced via innovation or better use of existing technologies. The link between the profit margins of the lower-cost firms and their market share, via their greater abilities to invest in further capacity expansion and/or new products could also be explored.

All this may produce higher material standards of living via rising output per head, but at a cost in terms of higher workplace stress and job insecurity, and (insofar as much of the gains are spent on managers, transaction costs and monitoring costs) on increased income inequality. However, don't just focus on its impacts on people in mature industrial economies: also take note of the opportunities that globalization opens up in newly industrializing economies.

With consumers being more interested in their relative consumption rather than their absolute consumption, the growing income inequality means that average happiness may not increase despite rising average consumption levels, especially if the pressures of keeping one's job make it harder for worker's to engage in self-actualization. There is also scope for discussing how consumers get used to having more/expensive products, with their aspirations rising without them necessarily feeling happier. There would also be scope for considering the global distribution of benefits, with many poor people being brought out of poverty and their happiness rising until they have got their basic needs satisfied, as the cost of higher pressures for workers/consumers in higher wage economies.

There is scope for a major paragraph on how market deregulation may also increase the stress associated with shopping, despite the view that more choice is a good thing. The choice overload literature and material on the mobile phone choice contract choice problem could be brought in. However, having raised these overload issues, one might also note that matters might not be so bad insofar as the proliferation of products is prevented from becoming a confusopoly problem by the emergence of product comparison websites.