2.10: Rationality and Self-Interest

Learning Objectives

- Define rationality in an economic context
- Provide examples of rational decision-making

Figure 1. Rodin's *The Thinker*. Maybe he's thinking about economic decisions?

If you say that someone is behaving "rationally," you probably mean that he or she is acting in a thoughtful, clear-headed way (as opposed to *irrationally*, which suggests that someone is acting emotionally or illogically). In the context of economics, the term *rationality* has a very specific meaning. It refers to an assumption that economists make about how people behave—remember that this is the starting point of all economics—*in the face of scarcity*. There simply aren't enough resources to satisfy all needs and wants. Charlie has only $10, he's hungry, and he needs to get to work. What will he do? An economist predicts that Charlie will behave in a predictable, rational manner, balancing costs against benefits to arrive at an action that maximizes his personal happiness or utility. As a result, he will choose a certain number of burgers and a certain number of bus tickets.

To put it differently, if an individual acts in an economically rational way, anything that increases the benefits or decreases the costs of some action is likely to increase the probability that the individual will choose that action. Anything that decreases the benefits or increases the costs will likely reduce the probability that the individual will choose that action.

Economists assume that people will make choices in their own self-interest. They will choose those things that provide the greatest personal benefit, and they'll avoid or forego those that aren't as personally valuable and compelling. That's what we mean by the **assumption of rationality**.

Do economists really believe that we only think of ourselves and don't ever try to benefit others? Not at all. The assumption that individuals are purely self-interested doesn't imply that individuals are greedy and selfish. People clearly derive satisfaction from helping others, so "self-interest" can also include pursuing things that benefit other people. One example is charitable behavior. When National Public Radio holds a fund drive, they often announce a situation where a benefactor has agreed to match the contributions made over a certain time period. If you pledge money during that time period, your action raises twice the amount you contribute. These matching fund situations tend to increase the amount of contributions, because people respond rationally, even when they are giving money to charity.

The assumption of rationality—also called the **theory of rational behavior**—is primarily a simplification that economists make in order to create a useful model of human decision-making.

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If you consider your own personal choices, you will probably find that they are quite complex. You are balancing what you want right now with options you want to have in the future. You probably value the people around you—friends, family, neighbors—and you may consider the impact that your choices have on them.

Setting aside the messy realm of personal choices for the time being, let's take a look at how decisions are made by consumers, by students, and by businesses in a world of economic rationality.

Rationality and Consumers

When a consumer is thinking about buying a product, what does he or she want? The theory of rational behavior would say that the consumer wants to maximize benefit and minimize cost.

Figure 2. Is it worth the cost to see a movie in the theater, or would you prefer to wait until you can buy the DVD or watch it on Netflix?

Let's look at a simple example. When a new movie is released, will you see it in the theater, or will you wait for it to be released on Netflix or on TV? If we consider only the monetary costs of your choice, a movie ticket might cost $10 and you will only be able to see that movie one time. If you wait, you can probably watch it as part of your monthly Netflix or cable subscription without spending any more than you would spend without watching the movie.

Why would you pay $10 to watch the movie in the theater? You might want to see it right away, when it is only showing in the theater. You might want the theater experience, with the big screen and high-quality image and sound. You will make a decision that is economically rational, based on the following consideration: "Is the benefit and enjoyment that I get from seeing the movie in a theater worth the $10 cost?"

As a consumer, you are making an economically rational decision about the costs and benefits.

Since we will build upon this later in the course, it's important to understand that this assumption creates a link between the cost of a product and the degree to which a consumer will want to buy it. As the cost of the product increases, it becomes less likely that the consumer will decide that the benefits of the purchase outweigh the costs.

Rationality and Students

How do students decide on a major? A number of things may factor into the decision, such as what type of career a student is interested in, the reputation of specific departments at the university a student is attending, and the student's preferences for specific fields of study. Let's take an example.

You go to college with the idea that you want to major in Business Management. During your first year, you discover that Business Analytics majors earn significantly higher salaries. This discovery increases the benefits in your mind of the Analytics major, and you decide to choose that major. You've just made an economically rational decision.

Rationality and Businesses

Businesses also have predictable behavior, but rather than seeking to maximize happiness or pleasure, they seek to maximize profits. When economists assume that businesses have a goal of maximizing profits, they can make predictions about how companies will react to changing business conditions.

For example, if wages in the United States increase, how will U.S. companies react? The rational reaction may be to move those jobs that can be performed elsewhere to countries with lower wages. This prediction is based on an oversimplification, and it might not hold true in every case—individual businesses would obviously need to understand the full cost of moving certain work out of the country before doing so. But the decision would be made according to the impact on profit and would still be rational. If a company stands to earn more profit by moving some jobs overseas, then that's the result that economists would predict.

Rationality suggests that consumers will act to maximize self-interest and businesses will act to maximize profits. Both are taking into account the benefits of a choice, given the costs.

Learning Objectives

[glossary-page][glossary-term]assumption of rationality: [/glossary-term]
[glossary-definition]also called the theory of rational behavior, it is the assumption that people will make choices in their own self-interest[/glossary-definition][/glossary-page]

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