

Making good choices

When faced with complicated decisions, people can identify and then evaluate all of their options. But this takes so much effort that people procrastinate and sometimes avoid ever making these decisions. Alternatively, when faced with complicated decisions, people can use rules of thumb.

The resulting choices usually aren't as good as the decisions that spring from thorough analyses, but people find using rules of thumb so easy that they actually make decisions. For example, recent college graduates must decide: how much to save for retirement each month? These decisions can be complicated. The optimal choices depend on their expected future incomes, their expected future expenses, as well as the values of the assets that they might inherit. These savings decisions are so complicated that many recent graduates do not make any decisions and they end up saving nothing. If these recent grads were to employ the rule of thumb of saving 15 percent of their income, they might not have made the optimal choices, but at least they made choices. They would be saving something, which is better than saving nothing.

Recently, I found myself torn between whether to follow the advice of a rule of thumb or to perform a more complicated analysis. I wanted to buy my daughter a sewing machine for Christmas. I read reviews and picked out the machine I wanted to buy, but I wasn't sure when I should buy it.

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The rule of thumb's advice suggested that I should wait until Cyber Monday, since that is when many firms offer steep discounts. I ended up ignoring this advice and I did my own analysis.

A few days before Black Friday, Amazon was selling the sewing machine I wanted for \$220. This was a sales price and the machine regularly sold for \$340. I was imagining how much cheaper I could get the machine if I waited until Cyber Monday. But then I uncovered some data that caused me to go into full-tilt analyzing mode. On Black Friday, Amazon began selling the machine for \$260. And, the manufacturer's website indicated that the machine was out of stock. My analysis suggested that I should try to find a company that hadn't increased their prices yet (as Amazon had done) and lock in at the \$220 price. It is a good thing I did. By Cyber Monday, Amazon was selling the machine for \$280.

So what analysis did I do? I just applied a little economics to my situation. Economics teaches that when there is a shortage of a good, its price will rise. More specifically, when there is a shortage, buyers line up to buy the product. Sellers can get away with raising their prices without getting stuck with unwanted inventory. Because sellers want to earn profit, when they can get away with raising their prices – they will.

As a result, I expected the price of the sewing machine to increase, which it did. Under normal circumstances, sellers can't get away with increasing their prices because their competitors will keep their own prices constant and get all of the business. But when there is a shortage, a firm's competitors have insufficient inventory to satisfy customers at the old low price, so any firm with the scarce good can increase its prices without getting stuck with unsold items.

I was able to do my analysis without much effort since I have been studying economics for 40 years. I did not have to rely on a rule of thumb to save cognitive effort. I am practiced enough at applying economics principles that I can do an analysis with little effort. But my experience offers a lesson for college students. Students should use their time in college to learn skills that lower their costs of doing their own analyses. If they follow my advice, they will make better decisions since they will use rules of thumb less often.

I would argue that the students in my introductory economics class have picked up the skills necessary to do the type of analysis I did when deciding when to buy a sewing machine. I get evidence that they learned these skills when I run into former students, who tell me anecdotal stories of how they applied economic analysis to make their decisions.

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