Wintersemester 2020

Topics in Behavioral Economics: „Context-Dependent Preferences“

The standard model of choice under risk in economic theory is Expected Utility Theory (EUT). Over the years, however, several descriptive deficiencies of EUT have been identified. These descriptive deficiencies of EUT led to alternative, psychologically motivated theories of choice under risk being proposed – such as Prospect Theory (Kahneman und Tversky, 1979) or Regret Theory (1982).

A relatively recent psychologically motivated theory of choice under risk is Salience Theory (Bordalo et al. 2012). Salience Theory posits that a decision maker's attention in the comparison of several risky choice alternatives is drawn to salient payoff combinations. This leads to the occurrence probabilities of very salient (rather non-salient) payoff combinations being overweighted (underweighted) in the decision making process. At first glance, Salience Theory thus seems to be a theory of probability distortions – not unlike Prospect Theory. Surprisingly, however, the theoretical predictions of Salience Theory bear striking resemblance to the predictions of Regret Theory, which posits no probability distortions at all.

Our goal in this seminar is to dig somewhat deeper and to better understand the relationship of these theories. Questions that we address might take the following form:

1. Working out a more precise explanation of the common ratio effects under Salience Theory (p. 1268-1270 in Bordalo et al., 2012) based on the framework in Starmer und Sugden (1989).
2. Deriving the predictions under Salience Theory for the decision problem in Day und Loomes (2010) and comparing these predictions with the empirical findings in Day und Loomes (2010).
3. Deriving the indifference curves under "smooth" Salience Theory (p.1255 in Bordalo et al. (2012)) in the Marschak-Machina probability triangle and comparing the indifference curves under Salience Theory with the indifference curves under Prospect Theory and Regret Theory.

A good starting point for all these questions is the survey article by Starmer (2000).

Literature:

- P. Bordalo, N. Gennaioli und A. Shleifer (2012): „Salience theory for choice under risk“, Quarterly Journal of Economics.
- Day und G. Loomes (2010): „Conflicting violations of transitivity and where they may lead us“, Theory and Decision.
- D. Kahneman und A. Tversky (1979): „Prospect theory: An analysis of decision under risk“, Econometrica.
- G. Loomes und R. Sugden (1982): „Regret theory: An alternative theory of rational choice under uncertainty“, Economic Journal.
- C. Starmer (2000): „Developments in non-expected utility theory: The hunt for a descriptive theory of choice under risk“, Journal of Economic Literature.
- C. Starmer und R. Sugden (1982): „Probability and juxtaposition Effects: An experimental Investigation of the common ratio effect“, Journal of Risk and Uncertainty.

Requirements:

Presentation and term paper.

Prerequisites:

Participants should have successfully participated in the class „Advanced Microeconomics" and have a sound interest in (even better, fun with) formal theoretic analysis.