

Is Behavioral Economics Doomed?

The ordinary versus the extraordinary

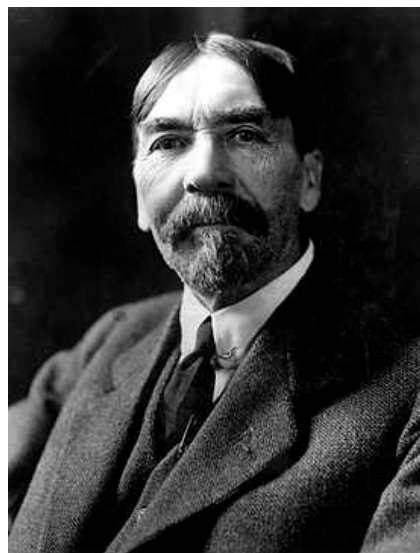
Introductory Lecture

David K. Levine

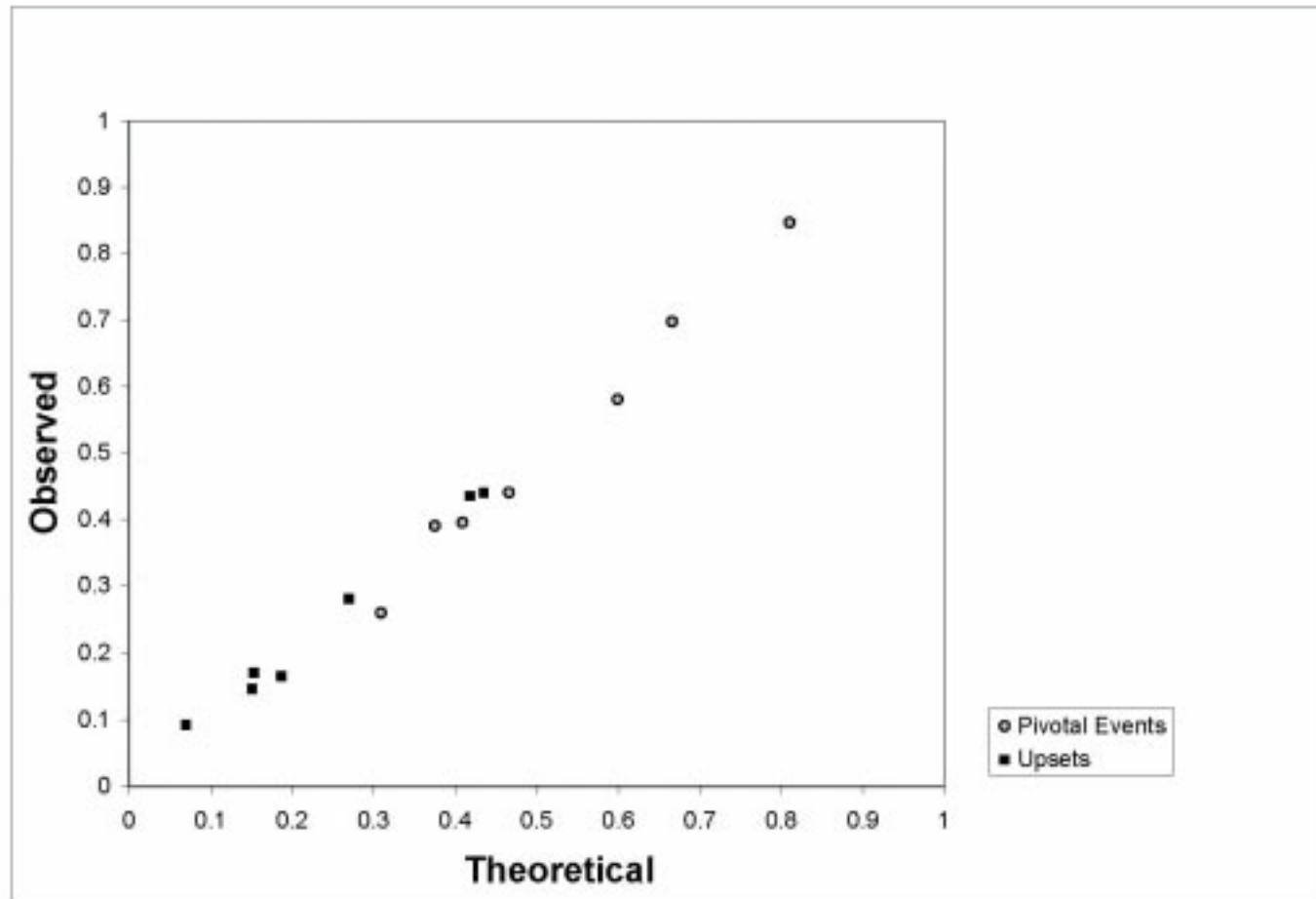
Rational Economic Man

“a lightning calculator of pleasures and pains, who oscillates like a homogenous globule of desire of happiness under the impulse of stimuli” Thorstein Veblen 1899

“The implicit presumption in these ... models was that people could be fooled over and over again.” Robert Lucas 1995



Theory That Works: Voting



Levine and Palfrey [2007]

Theory That Works? Ultimatum Bargaining

x	Offers	Rejection Probability
\$2.00	1	100%
\$3.25	2	50%
\$4.00	7	14%
\$4.25	1	0%
\$4.50	2	100%
\$4.75	1	0%
\$5.00	13	0%
	27	

US \$10.00 stake games, round 10

Roth, Prasnikar, Okuno-Fujiwara, Zamir [1991]

What the Theory Tells us: Losses In Ultimatum

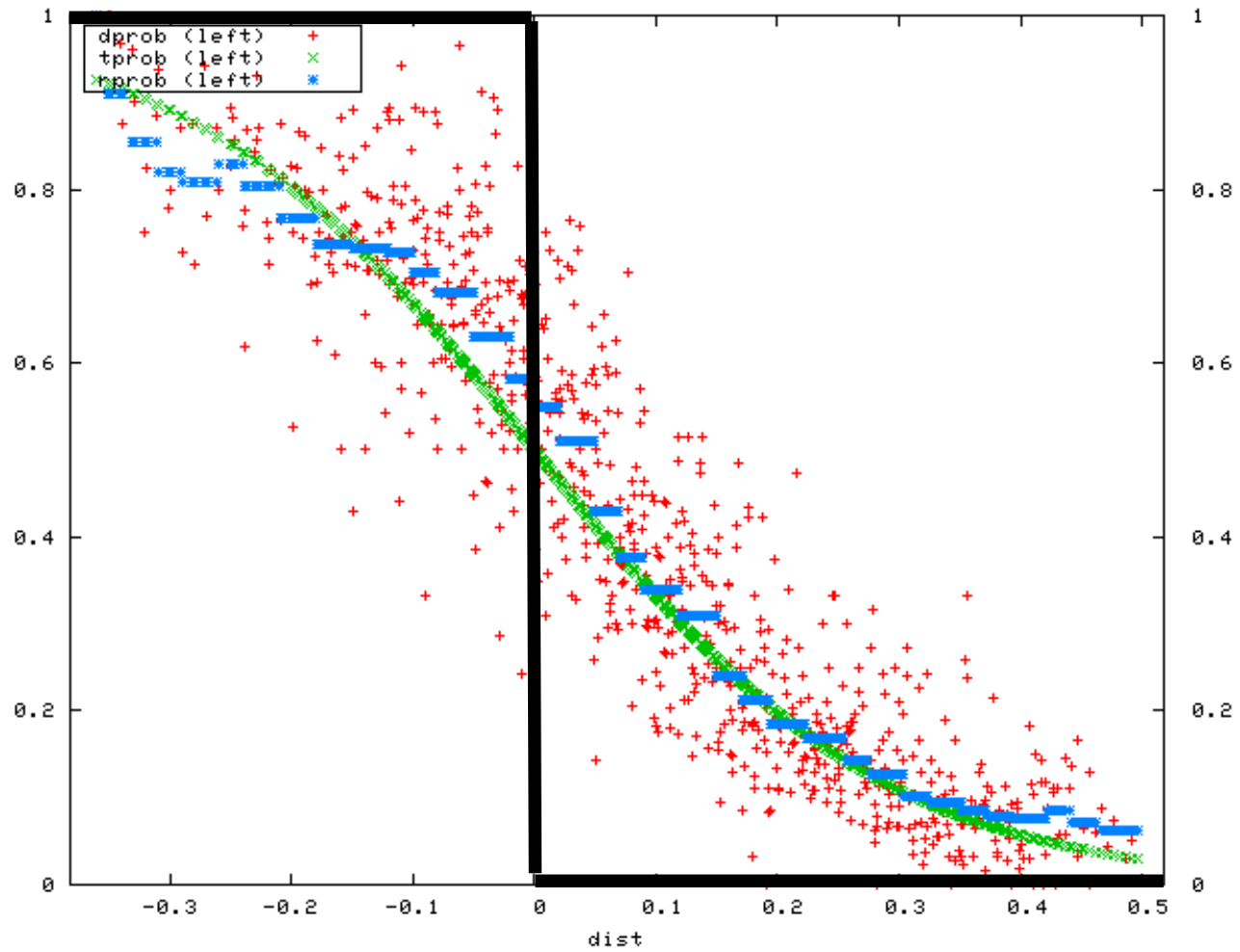
Out of \$10

	Losses
Knowing	\$0.34
Unknowing	\$0.99

Fudenberg and Levine [1997]

- Learning and short-term errors are an important part of mainstream economics

Individual Play in Voting



Procrastinating at the Health Club

- people who choose membership pay more than \$17, even though a \$10-per-visit fee is also available
- agents overestimate ... delay contract cancellation whenever renewal is automatic (\$70 per month)

DellaVigna, Malmendier 200

Hypothesis 1: people think incorrectly that they will cancel tomorrow

Hypothesis 2: people think it will be an expensive hassle to cancel; wait for “hassle” cost to be low

Takes 2.3 months to cancel after stopping attendance

- Eliot Spitzer, Rush Limbaugh and the Las Vegas vacation

Prospect Theory to the Rescue

Suppose that p_i is the chance of winning one of two prizes $x_i \geq 0$

$$U = \sum_i \frac{.846 p_i^{.414}}{.846 p_i^{.414} + (1 - p_i)^{.414}} x_i^{1.056}$$

Bruhin, Fehr-Duda, and Epper [2007]

Would you rather have:

A. \$5,000 for sure

B. a 50-50 coin-flip between \$9,700 dollars and nothing

and you don't exhibit the Allais paradox

Framing and the Becker Marschak DeGroot Elicitation Procedure

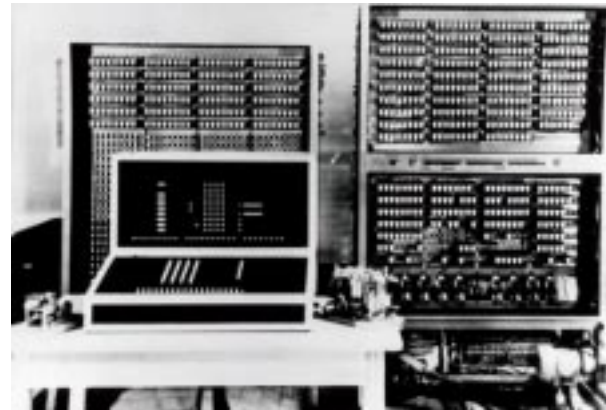
➤ Willingness to pay versus willingness to accept

Zeiler and Plott 2004



Psychology versus Economics

- non-functional versus functional people
- narrow models versus broad models
- individual versus group behavior
- arithmetic versus axiomatic models and the domain of concern
- pieces of paper, computers and neuroeconomics



Strengthening Economic Theory

Mainstream models

- learning
- habit formation
- consumer lock-in

Works in progress

- ambiguity aversion and the dishonest
- level-k thinking and one-off play
- menu choice and self-control
- interpersonal preference