

# CONTENTS

## PREFACE

xv

## **1 RATIONALITY, IRRATIONALITY, AND RATIONALIZATION** 1

- Rational Choice Theory and Rational Modeling 2
- Rationality and Demand Curves 4
- Bounded Rationality and Model Types 8
- Special Relationship between Behavioral Economics  
and Experimental Economics 10
- Biographical Note: Herbert A. Simon 12
- Thought Questions 13
- References 13
- Advanced Concept: Deriving Demand Curves 13

## PART 1 CONSUMER PURCHASING DECISIONS

## **2 TRANSACTION UTILITY AND CONSUMER PRICING** 17

- Rational Choice with Fixed and Marginal Costs 18
- Fixed versus Sunk Costs 21
- The Sunk Cost Fallacy 22
- Theory and Reactions to Sunk Cost 25
- History and Notes 28
- Rational Explanations for the Sunk Cost Fallacy 28
- Transaction Utility and Flat-Rate Bias 29
- Procedural Explanations for Flat-Rate Bias 31
- Rational Explanations for Flat-Rate Bias 33
- History and Notes 33
- Transaction Utility and Consumer Preferences in Reference 34
- Theory and Reference-Dependent Preferences 35
- Rational Explanations for Context-Dependent Preferences 36
- Biographical Note: Richard H. Thaler 37
- Thought Questions 38
- References 38
- Advanced Concept: Fixed Costs and Rational Choice 39

ix

**3 MENTAL ACCOUNTING 41**

---

- Rational Choice with Income from Varying Sources 42
- The Theory of Mental Accounting 45
- Budgeting and Consumption Bundles 49
- Accounts, Integrating, or Segregating 52
- Payment Decoupling, Prepurchase, and Credit Card Purchases 55
- Investments and Opening and Closing Accounts 57
- Reference Points and Indifference Curves 60
- Rational Choice, Temptation and Gifts versus Cash 61
- Budgets, Accounts, Temptation, and Gifts 62
- Rational Choice over Time 64
- Rational Explanations for Source-Based Consumption and Application 66
- Biographical Note: George F. Loewenstein 67
- Thought Questions 68
- References 69

**4 STATUS QUO BIAS AND DEFAULT OPTIONS 70**

---

- Rational Choice and Default Options 71
- Preference Formation, Framing, and the Default Option 72
- Rational Explanations of the Status Quo Bias 76
- History and Notes 76
- Reference Points, Indifference Curves, and the Consumer Problem 77
- An Evolutionary Explanation for Loss Aversion 81
- Rational Choice and Getting and Giving Up Goods 83
- Loss Aversion and the Endowment Effect 85
- Rational Explanations for the Endowment Effect 87
- History and Notes 88
- Biographical Note: Amos N. Tversky 89
- Thought Questions 89
- References 90
- Advanced Concept: The Shape of Indifference Curves with Constant Loss Aversion 91

**5 THE WINNER'S CURSE AND AUCTION BEHAVIOR 93**

---

- Rational Bidding in Auctions 93
- Procedural Explanations for Overbidding 97
- Levels of Rationality 98
- Bidding Heuristics and Transparency 99
- Rational Bidding under Dutch and First-Price Auctions 101
- History and Notes 105
- Rational Prices in English, Dutch and First-price Auctions 105
- Auction with Uncertainty 106
- Rational Bidding under Uncertainty 107

The Winner's Curse and Anchoring and Adjusting	110
History and Notes	116
Rational Explanations for the Winner's Curse	117
Biographical Note: Matthew Rabin	117
Thought Questions	118
References	119
Advanced Concept: Bayesian Nash Equilibrium and Bidding under Uncertainty	119

## PART 2 INFORMATION AND UNCERTAINTY

### 6 BRACKETING DECISIONS 125

Multiple Rational Choice with Certainty and Uncertainty	126
The Portfolio Problem	133
Narrow versus Broad Bracketing	135
Bracketing the Portfolio Problem	139
More than the Sum of Its Parts	140
The Utility Function and Risk Aversion	140
Bracketing and Variety	144
Rational Bracketing for Variety	144
Changing Preferences, Adding Up, and Choice Bracketing	145
Addiction and Melioration	146
Narrow Bracketing and Motivation	149
Behavioral Bracketing	149
History and Notes	150
Rational Explanations for Bracketing Behavior	151
Biographical Note: Drazen Prelec	151
Thought Questions	152
References	152
Advanced Concept: The Portfolio Problem	153
Advanced Concept: Bracketing the Portfolio Problem	154

### 7 REPRESENTATIVENESS AND AVAILABILITY 156

Statistical Inference and Information	157
Calibration Exercises	162
Representativeness	165
Conjunction Bias	167
The Law of Small Numbers	169
Conservatism versus Representativeness	178
Availability Heuristic	180
Bias, Bigotry, and Availability	181
History and Notes	183

Biographical Note: Daniel Kahneman	184
Thought Questions	185
References	185

## **8 CONFIRMATION AND OVERCONFIDENCE** 187

---

Rational Information Search	188
Confirmation Bias	192
Risk Aversion and Production	203
Overconfidence	204
Self-Serving Bias	207
Is Bad Information Bad?	208
History and Notes	210
Biographical Note: Colin F. Camerer	211
Thought Questions	211
References	212

## **9 DECISION UNDER RISK AND UNCERTAINTY** 214

---

Rational Decision under Risk	215
Modeling Intransitive Preferences: Regret and Similarity	220
Independence and Rational Decision under Risk	226
Allowing Violations of Independence	234
The Shape of Indifference Curves	236
Evidence on the Shape of Probability Weights	237
Probability Weights without Preferences for the Inferior	239
Practical Implications of Violations of Expected Utility	240
What to Do When You Don't Know What Can Happen	242
History and Notes	246
Biographical Note: Maurice Felix Charles Allais	246
Thought Questions	247
References	248
Advanced Concept: The Continuity Axiom	249

## **10 PROSPECT THEORY AND DECISION UNDER RISK OR UNCERTAINTY** 250

---

Risk Aversion, Risk Loving, and Loss Aversion	253
Prospect Theory	257
Prospect Theory and Indifference Curves	259
Does Prospect Theory Solve the Whole Problem?	267
Prospect Theory and Risk Aversion in Small Gambles	269
History and Notes	275
Biographical Note: Peter P. Wakker	276
Thought Questions	276
References	277

## PART 4 SOCIAL PREFERENCES

**14 SELFISHNESS AND ALTRUISM 389**

- 
- Rationality and Altruism 392
  - Rationally Selfless? 397
  - Selfishly Selfless 403
  - Public Goods Provision and Altruistic Behavior 409
  - History and Notes 413
  - Biographical Note: Robert H. Frank 414
  - Thought Questions 415
  - References 416

**15 FAIRNESS AND PSYCHOLOGICAL GAMES 417**

- 
- Inequity Aversion 420
  - Holding Firms Accountable in a Competitive Marketplace 425
    - Markets Might Not Clear When Demand Shifts 426
    - Prices and Wages Might Not Fully Reflect Quality Differences 426
    - Prices Are More Responsive to Cost Increases than Decreases 426
  - Fairness 427
  - Kindness Functions 432
  - Psychological Games 443
  - History and Notes 446
  - Biographical Note: Ernst Fehr 447
  - Thought Questions 448
  - References 449

**16 TRUST AND RECIPROCTY 450**

- 
- Of Trust and Trustworthiness 455
  - Trust in the Marketplace 460
  - Trust and Distrust 465
  - Reciprocity 466
  - History and Notes 469
  - Biographical Note: Paul Slovic 470
  - Thought Questions 470
  - References 471

GLOSSARY

473

INDEX

495