CONTENTS

List of Figures	xxi
List of Tables	xxxi
Introduction	1
1 The antecedents of behavioral economics	3
2 On methodology in economics	5
3 The experimental method in economics	10
4 Approach and organization of the book	21
5 Five theoretical approaches in behavioral economics	25
6 Five examples of behavioral evidence	48
Appendix A: The random lottery incentive mechanism	59
Appendix B: In lieu of a problem set	59
References	65

PART 1 Behavioral Economics of Risk, Uncertainty, and Ambiguity

Introduction to Part 1			79
1	The	Evidence on Human Choice under Risk and Uncertainty	83
	1.1	Introduction	83
	1.2	The elements of classical decision theory	84
	1.3	Subjective expected utility theory (SEU)	89
	1.4	Eliciting the utility function under EU	92
	1.5	Violations of expected utility theory	95
2	Beh	avioral Models of Decision Making	110
	2.1	Introduction	110
	2.2	Probability weighting functions	115
	2.3	Rank dependent utility theory (RDU)	124
	2.4	Prospect theory (PT)	130
	2.5	Elicitation of utility and probability weighting functions in PT	140
	2.6	The axiomatic foundations of PT	148
	2.7	Third generation PT and stochastic reference points	152
	2.8	Stochastic reference points in PT under rational expectations	153
	2.9	Limitations of PT	172
	2.10	A selection of other behavioral theories	181
	2.11	Human behavior for extreme probability events	191
	2.12	Risk preferences and time preferences	199
3	Арр	lications of Behavioral Decision Theory	213
	3.1	Introduction	213

	32	The endowment effect and exchange asymmetries	217
	2.2	Prospect theory preferences in primetes	225
	5.5	Prospect meory preferences in primates	200
	3.4	Myopic loss aversion	239
	3.5	Why do people pay taxes?	242
	3.6	Explanation of Rabin's paradox using PT	248
	3.7	Goals as reference points	250
	3.8	Why is it so hard to find a taxi on a rainy day in New York?	256
	3.9	Some implications of inverse S-shaped weighting functions	263
	3.10	Contracts as reference points	264
	3.11	Moral hazard, loss aversion, and optimal contracts	272
	3.12	Renegotiation, long-term contracts, and loss aversion	278
4	Hun	nan Behavior under Ambiguity	284
	4.1	Introduction	284
	4.2	A problem for SEU: The Ellsberg paradox	286
	4.3	Neoclassical models of ambiguity	288
	4.4	Behavioral models of ambiguity	301
		Exercises for Part 1	310
		References for Part 1	316

PART 2 Other-Regarding Preferences

Introduction to Part 2			339
5	e Evidence on Human Sociality	344	
	5.1	Introduction	344
	5.2	Ultimatum and dictator games	349
	5.3	Gift exchange and trust games	357
	5.4	Public goods games	370
	5.5	How representative is the lab evidence?	386
	5.6	Indirect reciprocity	395
6	Мо	dels of Other-Regarding Preferences	398
	6.1	Introduction	398
	6.2	The Fehr–Schmidt model	401
	6.3	The ERC model	410
	6.4	Fairness and stochastic dominance	412
	6.5	Behavioral political economy	417
	6.6	Fairness, general equilibrium, and welfare	426
	6.7	Evidence on models of social preference and reciprocity	431
	6.8	A discussion of other promising models	444
7	Hur	man Morality and Social Identity	453
	7.1	Introduction	453
	7.2	Human virtues	455
	7.3	Social identity	465

xvi | Contents

8 Incentives and Other-Regarding Preferences			478
	8.1	Introduction	478
	8.2	Moral hazard and other-regarding preferences	483
	8.3	Incomplete contracts under other-regarding preferences	495
	8.4	Reciprocity and long-term contracts	510
	8.5	Extrinsic and intrinsic motivation: theoretical framework	527
	8.6	Extrinsic and intrinsic motivation: empirical evidence	540
		Exercises for Part 2	562
		References for Part 2	566

PART 3 Behavioral Time Discounting

Inti	oduo	ction to Part 3	583
9	The	Evidence on Temporal Human Choice	586
	9.1	Introduction	586
	9.2	The discounted utility model	587
	9.3	The exponential discounted utility model (EDU)	588
	9.4	Anomalies of the EDU model	594
10	Beh	avioral Models of Time Discounting	605
	10.1	Introduction	605
	10.2	Explaining the sign and magnitude effects	607
	10.3	Explaining the common difference effect	611
	10.4	Attribute-based models	627
	10.5	The reference time theory (RT)	632
11	Арр	plications of Present-Biased Preferences	644
	11.1	Introduction	644
	11.2	Two frameworks for modeling present-biased preferences	646
	11.3	Optimal consumption under hyperbolic discounting	651
	11.4	Endogenous retirement decisions	664
	11.5	Procrastination and preproperation	669
	11.6	Interdependence, multiple activities, and competition	677
	11.7	Optimal sin taxes	679
	11.8	Investment and leisure goods	683
	11.9	Other applications of hyperbolic discounting	688
		Exercises for Part 3	692
		References for Part 3	700

PART 4 Behavioral Game Theory

Introduction to Part 4	709
12 The Evidence on Strategic Human Choice	713
12.1 Introduction	713

	12.2	Iterated deletion of dominated strategies	724
	12.3	Mixed strategy Nash equilibria	738
	12.4	Coordination games	758
	12.5	Bargaining games	786
	12.6	Asymmetric information, signaling, and cheap talk	819
	12.7	Public signals and correlated equilibria	843
	12.8	Strategic complements and strategic substitutes	852
	12.9	A digression on competitive equilibrium experiments	863
13	Mod	els of Behavioral Game Theory	875
	mou	els of Benavioral Game meory	0.0
	13.1	Introduction	875
	13.2	Quantal response equilibrium (QRE)	881
	13.3	Level-k and cognitive hierarchy models	894
	13.4	Applications of level-k and CH models	904
	13.5	Psychological game theory	925
	13.6	Correlated equilibrium and social norms	962
	13.7	Other behavioral models of how people play games	966
	13.8	Behavioral economics of auctions	988
		Exercise for Part 4	1003
		References for Part 4	1013

PART 5 Behavioral Models of Learning

Intr	roduction to Part 5	1033
14	Evolutionary Game Theory	1037
	14.1 Introduction	1037
	14.2 Some preliminaries	1041
	14.3 Evolutionary stable strategies in two-player games	1043
	14.4 Relation of ESS with other equilibrium concepts	1047
	14.5 Replicator dynamics	1048
	14.6 Applications of evolutionary game theory	1053
	14.7 Playing the field	1063
	14.8 Gene-culture coevolution	1063
	14.9 The evolution of altruism and reciprocity	1073
	14.10 Social learning and replicator-like dynamics	1085
15	Models of Learning	1092
	15.1 Introduction	1092
	15.2 Reinforcement learning	1097
	15.3 Belief-based models of learning	1106
	15.4 The experience weighted attraction model of learning	1120
	15.5 Learning models: two points of view	1131
	15.6 The class of learning direction theories	1132
	15.7 Rule-based learning	1142
	15.8 Multiple games, complexity, and categorization	1148
	15.9 Possibility and impossibility of rational learning	1153

xviii | Contents

16	Stoc	hastic Social Dynamics	1158
	16.1	Introduction	1158
	16.2	Fixing ideas in stochastic dynamics	1159
	16.3	Perturbed Markov dynamics in 2 × 2 games	1166
	16.4	Memory, conventions, and risk dominance in 3×3 games	1174
	16.5	Social networks	1182
		Appendix A: Ordinary differential equations	1186
		Appendix B: A note on choice under stochastic utility	1193
		Appendix C: A brief user's guide to Markov Chains	1196
		Exercises for Part 5	1205
		References for Part 5	1210

PART 6 Emotions

Introduction to Part 6		1223	
17	Emo	tions and Human Behavior	1226
	17.1	Introduction	1226
	17.2	Visceral influences and the rationality of emotions	1229
	17.3	Cue-conditioned behavior and habit formation	1235
	17.4	Anticipation and delay under certainty	1242
	17.5	Fear and anxiety under uncertainty	1245
	17.6	Projection bias	1250
	17.7	Temptation preferences: a revealed preference approach	1258
	17.8	Temptation and conflicts between commitment and flexibility	1266
	17.9	Happiness economics	1270
18	Inter	actions between Emotions and Cognition	1288
	18.1	Introduction	1288
	18.2	Emotions and a two-modules view of the brain	1290
	18.3	A dual selves model with costly commitment	1298
	18.4	Information asymmetries between emotions and cognition	1304
	18.5	Strategic ignorance, confidence, and self-esteem	1308
		Exercises for Part 6	1322
		References for Part 6	1328

PART 7 Bounded Rationality

Introduction to Part 7		1339
19 Judg	gment Heuristics	1342
19.1	Introduction	1342
19.2	The law of small numbers	1350
19.3	Conjunction fallacy	1361
19.4	The availability heuristic	1365

	19.5 The affect heuristic	1367
	19.6 Anchoring and adjustment	1370
	19.7 Base rate neglect and conservatism	1375
	19.8 Hindsight bias	1383
	19.9 Confirmation bias	1389
	19.10 Other judgment heuristics	1395
	19.11 Dual process models and judgment heuristics	1398
	19.12 Coarse thinking and persuasion	1401
	19.13 Mental models	1407
	19.14 Herbert Simon's approach to bounded rationality	1409
	19.15 The great rationality debate	1426
	19.16 Shrouded attributes	1431
	19.17 Limited attention	1436
	19.18 Do experts exhibit biases?	1449
20	Mental Accounting	1451
	20.1 Introduction	1451
	20.2 Framing and mental accounting	1455
	20.3 Prospect theory and mental accounting	1456
	20.4 The behavioral life-cycle model	1459
	20.5 The red and black of mental accounting	1463
	20.6 Choice bracketing	1469
	20.7 Coherent arbitrariness	1471
	20.8 Sunk costs and mental accounting	1473
	20.9 Some other mental accounting phenomena	1476
21	Bounded Rationality in Financial Markets	1485
	21.1 Introduction	1485
	21.2 The efficient markets hypothesis	1488
	21.3 Noise trader risk	1502
	21.4 The limits to arbitrage	1509
	21.5 Gradual flow of information	1516
	21.6 Stock market underreaction and overreaction	1520
	21.7 Behavioral corporate finance	1526
	Exercises for Part 7	1544
	References for Part 7	1552

PART 8 Behavioral Welfare Economics

Introduction to Part 8	1577
22 Behavioral Welfare Economics	1579
22.1 Introduction	1579
22.2 Fixing basic ideas	1583
22.3 Soft paternalism	1590
22.4 Regulation under imperfect self-information	1601
22.5 Choice and non-choice data: What is the scope of economics?	1603

xx | Contents

22.6	Choice-based behavioral welfare economics	1611
22.7	Revealed preference under limited attention	1618
22.8	The contractarian approach	1623
22.9	Behavioral public finance and welfare	1625
	Exercises for Part 8	1635
	References for Part 8	1638

PART 9 Neuroeconomics

Introduction to Part 9	16
23 Neuroeconomics	164
23.1 Introduction	164
23.2 A brief introduction to the brain	164
23.3 An introduction to neuroeconomic techniques	16
23.4 The neuroeconomics of risky decisions	166
23.5 The neuroeconomics of social preferences	160
23.6 The neuroeconomics of time preferences	168
23.7 The neuroeconomics of strategic interaction	168
23.8 Pharmacoeconomics: an application to the social effects of oxytocin	169
References for Part 9	169
Appendix on Game Theory	17
ndex of Named Authors	
Subject Index	173