Econ 219B
Psychology and Economics: Applications
(Lecture 13)

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April 24, 2019
Outline

1. Happiness
2. Behavioral Political Economy II
3. Methodology: Structural Behavioral Economics
4. Behavioral Finance
Section 1

Happiness
Measuring Utility Through Happiness

- Is there a more direct way to measure utility?

- What about happiness questions?
  - ‘Taken all together, how would you say things are these days, would you say that you are very happy, pretty happy, or not too happy?’
  - or ‘How satisfied are you with your life as a whole?’
  - Response on 1 to 7 or 0 to 10 scale

- Could average response measure utility?
There are a number of issues:

1. *(Noise I)* Is the measure of happiness just noise?
2. *(Noise II)* Even if valid, there are no incentives, how affected is it by irrelevant cues?
3. *(Scale)* Happiness is measured on discrete intervals, with ceiling and floor effect
4. *(Content)* What exactly does the measure capture? Instantaneous utility? Discounted utility?

- Revealed preference approach remains heavily favored by economists (myself included)

- Still, significant progress in last 10-15 years on taking some role in economics
Issue 1: Noise I

- **Issue 1 (Noise I).** To address,
  - Take happiness measure $h$
  - Does it respond to well-identified, important shifters $X$ which affect important economic outcomes?

- **Oreopoulos (AER 2006).** Exploit binding compulsory schooling laws to study returns to education
UK: 1947 increase in minimum schooling from 14 to 15

Figure 1. Fraction left full-time education by year aged 14 and 15
Northern Ireland: 1957 increase from 14 to 15
Clear impact on earnings: compare earnings for adults aged 32-64 as a function of year of birth

**Figure 6. Average Annual Log Earnings by Year Aged 14**

*Great Britain*
Implied returns to compulsory education: 0.148 (0.046)
Did this affect happiness measures?

- **Oreopoulos (JPubE 2007)**
  - Eurobarometer Surveys in UK and N. Ireland, 1973-1998
  - Question on 1-4 scale

### Table 4
The effect of schooling on subjective well-being least squares and IV estimates using UK and Irish changes in school-leaving age

<table>
<thead>
<tr>
<th></th>
<th>(1) Mean</th>
<th>(2) OLS</th>
<th>(3) IV</th>
<th>(4) Initial observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life satisfaction (1 = not at all satisfied, 4 = very satisfied)</td>
<td>3.14</td>
<td>0.073</td>
<td>0.059</td>
<td>89279</td>
</tr>
<tr>
<td>(0.0093)**</td>
<td>(0.0073)**</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Satisfied with life (1 = very or fairly satisfied, 0 = not satisfied or not at all satisfied)</td>
<td>0.86</td>
<td>0.040</td>
<td>0.0516</td>
<td>89279</td>
</tr>
<tr>
<td>(0.0046)**</td>
<td>(0.0033)**</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Very satisfied (1 = very satisfied)</td>
<td>0.325</td>
<td>0.027</td>
<td>0.0235</td>
<td>89279</td>
</tr>
<tr>
<td>(0.0023)**</td>
<td>(0.0135)*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Happy (1 = not so happy, 2 = fairly happy, 3 = very happy)</td>
<td>2.14</td>
<td>0.044</td>
<td>0.0667</td>
<td>24565</td>
</tr>
<tr>
<td>(0.013)**</td>
<td>(0.0093)**</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes: All regressions include fixed effects for age, sex, birth year, and nation interacted with survey year. Data are grouped into means by age, sex, birth year, nation, and survey year. Huber–White standard errors are shown from clustering by nation. Single, double, and triple asterisks indicate significant coefficients at the 10%, 5%, and 1% levels respectively. Samples include all adults aged 18 to 65. See text for more data specifics.
Results

- One year of additional (compulsory) education increases happiness somewhere between 2 and 8 percent
- In addition, large effects on health and wealth
- Reinforces puzzle: Why don’t people stay in school longer?

- Happiness response captures real information
- Happiness answer also responds to cues (Issue 2), has scale effects (Issue 3), but valid enough to use in combination with other measures

- However, Issue 4: How would we use happiness measure as part of economic research?
Happiness in Economic Research

- Research agenda by Dan Benjamin, Ori Heffetz, Miles Kimball, Alex Rees-Jones
  - Study Econ101a-type simple issues with happiness measures
  - Critical to know how to correctly interpret these measures

- Paper 1. **Benjamin, Heffetz, Kimball, and Rees-Jones (AER 2012)**
  - How does happiness (subjective well-being) relate to choice?
  - Compare *forecasted* happiness with choice in several hypothetical scenarios
  - Forecasts of happiness predict choice quite well, but other factors also play a role
Paper 2. Benjamin et al. (AER 2014)
- Medical students choosing match for residency
- Survey to elicit ranking of medical schools for residency + Ask anticipated happiness
- How well does happiness predict choice relative to other factors?
- Some evidence that one can also elicit intertemporal happiness

### Table 4: Weight Estimates for Multi-Question Indices

<table>
<thead>
<tr>
<th></th>
<th>(1) Choice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Happiness during residency</td>
<td>4.5***</td>
</tr>
<tr>
<td></td>
<td>(0.5)</td>
</tr>
<tr>
<td>Happiness in first 10 years</td>
<td>4.6***</td>
</tr>
<tr>
<td></td>
<td>(0.8)</td>
</tr>
<tr>
<td>Happiness in rest of career</td>
<td>2.1**</td>
</tr>
<tr>
<td></td>
<td>(0.9)</td>
</tr>
<tr>
<td>Happiness after retirement</td>
<td>1.2</td>
</tr>
<tr>
<td></td>
<td>(0.8)</td>
</tr>
</tbody>
</table>
Uses of Happiness Data

- **Di Tella, MacCulloch, and Oswald (AER 2011):**
  - How much do people dislike inflation versus unemployment?
  - Life satisfaction from Euro-Barometer: "On the whole, are you very satisfied, fairly satisfied, not very satisfied, or not at all satisfied with the life you lead?"
  - Aggregate to country-year and estimate panel regression

### Table 1—Life-Satisfaction Equations for Europe 1975–1991

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(Pre 84)</td>
<td>(Post 83)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployment t</td>
<td>−2.8</td>
<td>−2.0</td>
<td>−0.4</td>
<td>−2.0</td>
<td>−2.1</td>
</tr>
<tr>
<td></td>
<td>(0.6)</td>
<td>(0.6)</td>
<td>(1.6)</td>
<td>(1.1)</td>
<td>(0.6)</td>
</tr>
<tr>
<td>Inflation t</td>
<td>−1.2</td>
<td>−1.4</td>
<td>−0.5</td>
<td>−2.0</td>
<td>−2.3</td>
</tr>
<tr>
<td></td>
<td>(0.3)</td>
<td>(0.4)</td>
<td>(0.7)</td>
<td>(0.8)</td>
<td>(0.9)</td>
</tr>
<tr>
<td>Inflation² t</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3.5</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(3.0)</td>
</tr>
<tr>
<td>Time trends</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Country dummies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Year dummies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Number of observations</td>
<td>150</td>
<td>150</td>
<td>72</td>
<td>78</td>
<td>150</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.27</td>
<td>0.54</td>
<td>0.57</td>
<td>0.66</td>
<td>0.55</td>
</tr>
</tbody>
</table>

*Notes:* Standard errors are in parentheses. Time trends are country specific. Three-year moving averages of the explanatory variables are used. This is a second-stage regression. It uses as a dependent variable the regression-corrected life-satisfaction levels from a first-stage OLS regression of the general kind given in the Appendix.
Other Important Work on Happiness

- **Luttmer (QJE 2005):** Documents relative aspect of happiness: An increase in income of neighbors (appropriately instrumented) lower life satisfaction

- **Stevenson and Wolfers (Brookings 2008):**
  - Debunks Easterlin paradox (income growth over time does not increase happiness)
  - Clear link over time between log income and happiness

- **Finkelstein, Luttmer, Notowidigdo (JEEA 2014):**
  - How does marginal utility of consumption vary with health? Needed for optimal policies
  - Observe changes in happiness for varying health
Other Important Work on Happiness

- Ori Heffetz’s latest
Example SWB Q (life satisfaction)

All things considered, how satisfied are you with your life as a whole these days?

Please give a number between 0 (extremely dissatisfied) and 10 (extremely satisfied):
Life Satisfaction Question: All things considered, how satisfied are you with your life as a whole these days? Please give a number between 0 (extremely dissatisfied) and 10 (extremely satisfied).

You answered: 8

Many important surveys ask people questions much like the Life Satisfaction Question you have just answered (copied above, along with your answer), but little is known about how respondents understand such questions and how they form their answer. The purpose of this study is to better understand how people reason when they answer this Life Satisfaction Question. This will help researchers to make better use of the resulting data, in particular when they compare the responses of different people.

On the following screens, we will ask you questions about how you answered the Life Satisfaction Question. To help you remember the Life Satisfaction Question and the answer you have just given, the question and your answer will keep appearing at the top of the following screens (just like they appear above).

When you are ready to continue, please click “Next.”
**Life Satisfaction Question:** All things considered, how satisfied are you with your life as a whole these days? Please give a number between 0 (extremely dissatisfied) and 10 (extremely satisfied).

You answered: 8

When you answered the Life Satisfaction Question, did you evaluate your situation as it is right this moment or over a longer period of time, in the past or in the future? To what extent did you evaluate your situation...

**Please note:** When you decide where the slider belongs for each time period, consider the importance of that time period on its own, and not in comparison with the other items in the table.

<table>
<thead>
<tr>
<th></th>
<th>Not at All</th>
<th>A Lot</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right this moment (while answering the survey)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Today</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In the last few days</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In the last few months</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In the last few years</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Reported Weight Placed on Each Time Category, by Question

Raw Responses

- Right this moment
- Today
- Last few days
- Last few months
- Last few years
- Next few months
- Next few years
- Entire life so far
- Entire life incl. exp.

Weight Placed

Options & Possibilities
- Dealing Well
- Raw Responses
- Reported Weight Placed on Each Time Category, by Question

Ladder
- Happiness
- Family Well-Being
- Personal Well-Being
- Meaning & Value

Life Satisfaction

50 55 60 65 70
Reported Weight Placed on Each Time Category, by Question

Raw Responses

Weight Placed

Right this moment
Today
Last few days
Last few months
Last few years
Next few months
Next few years
Entire life so far
Entire life incl. exp.

Ladder
Life Satisfaction
Happiness

Reported Weight Placed on Each Time Category, by Question
Main Question [1-3] (widely used)

- **[Ladder]** Please imagine a ladder with steps numbered from 0 at the bottom to 10 at the top. The top of the ladder represents the best possible life for you, and the bottom of the ladder represents the worst possible life for you. On which step of the ladder would you say you personally feel you stand at this time? Please give a number from 0 to 10: ______

- **[Life Satisfaction]** All things considered, how satisfied are you with your life as a whole these days? Please give a number between 0 (extremely dissatisfied) and 10 (extremely satisfied): ______

- **[Happiness]** Taking all things together, how happy would you say you are? Please give a number between 0 (extremely unhappy) and 10 (extremely happy): ______
Main Question [4-5] (new)

- **[Family Well-Being]** On a scale from 0 to 10, how would you rate the overall well-being of you and your family? Please give a number between 0 (lowest rating) and 10 (highest rating): ______

- **[Personal Well-Being]** On a scale from 0 to 10, how would you rate your overall personal well-being? Please give a number between 0 (lowest rating) and 10 (highest rating): ______
Main Question [6-7] (new)

• [Meaning and Value] On a scale from 0 to 10, to what extent do you feel that your life is meaningful and has value? Please give a number between 0 (not meaningful and has no value) and 10 (extremely meaningful and has lots of value): ______

• [Options and Possibilities] On a scale from 0 to 10, to what extent do you feel that your life is full of options and possibilities that you are free to choose from? Please give a number between 0 (extremely limited options to choose from) and 10 (very many options to choose from): ______
Main Question [8] (new)

• [Dealing Well] People’s situation in life depends on both the circumstances they have been given and how they deal with these circumstances. To what extent do you feel that you have dealt well so far with the circumstances you have been given in life? Please give a number between 0 (“I have dealt extremely poorly with the circumstances I have been given”) and 10 (“I have dealt extremely well with the circumstances I have been given”): _____
Survey Details

• Conducted: June 13–30, 2014.
• Sample: Clear Voice Research.
  – 18+, broad but not nationally representative.
• 3,926 started, 3,040 completed the survey.
  – Rs had to answer (only) Main SWB Q to proceed.
    • N = ~360–400 Rs per Main SWB Q.
Section 2

Behavioral Political Economy II
• Explain voter turnout with social preferences
• Tie to social interactions
• Identify using field experiment design
Determinants of Voting

Four determinants of voting

1. **Pivotality** $pV$
   - $p$ = subjective probability of being pivotal
   - $V$ = value of deciding the election

2. **Warm glow** $g$

3. **Cost of voting** $c$
   - cost of voting

4. **Social Image utility**
   - $s_V$ = utility from saying one voted
   - $s_N$ = utility from saying one did not vote
   - $L$ = psychological cost of lying

Focus of this paper

- Social image
- Dishonesty

- Non-voters lie about voting if $s_V - L > s_N \iff s_V - s_N > L$
- Voters lie if $s_N - L > s_V$
(Net) Expected Utility from Voting

Voting iff

\[ pV + g - c + N \left[ \max (s_V, s_N - L) - \max (s_N, s_V - L) \right] \geq 0 \]

\[ = \varepsilon \]

= net utility gain from having voted, due to being asked once

Can rewrite as:

\[ N \Phi (s_V - s_L, L) + \varepsilon \geq 0 \]

where \( \Phi (s_V - s_L, L) = \begin{cases} 
\min (s_V - s_N, L) & \text{if } s_V - s_N \geq 0 \\
\max (s_V - s_N, L) & \text{if } s_V - s_N < 0 
\end{cases} \)
Experimental Design

- Field experiment: door-to-door survey
  - Match households to voting records
  - Identify all-voter and all-non-voter households

- Cross-randomize
  1. Whether individuals receive advance notice of survey.
     - Individuals can avoid (or seek) surveyor at a cost.
  2. Vary payment and length of survey to estimate elasticity
  3. Incentives to lie / tell truth about voting.

- Get-Out-The-Vote experiment related to model
  - Inform some people that we will visit them after the election to ask whether they voted
Field Experiment - Implementation

- Single-family homes in towns around Chicago
Exp 1: Announcing Content of Survey

Control: Unannounced Visit

University of Chicago Study

Researchers will visit this address tomorrow ( / ) between and to conduct a 5 minute survey.

University of Chicago Study

Researchers will visit this address tomorrow ( / ) between and to conduct a 5 minute survey on your voter participation in the 2010 congressional election.
Model Predictions

- **Prop. 1.** With pride in voting \((s_V > 0)\), voters should be more likely to be at home and answer the door if informed of election survey.

- **Prop. 2.** With stigma from not voting \((s_N < 0)\), non-voters should be less likely to be at home and answer the door if informed of election survey.

- **Prop. 3.** The probability of lying about voting should increase in the incentive to do so.

- **Prop. 4.** The probability of voting should increase in the number of times asked.
• Sorting in Response to Election Survey -- Voters
• Voters -> No evidence of sorting in, some evidence of sorting
• No evidence of pride in voting on average
• Sorting in Response to Election Survey -- Voters
• However, 2010 election was low point for democratic voters
• 2/3 of registered voters in towns we reached are Democrats
• What if we split by voting record in primaries?
• Evidence of sorting in for Republicans

<table>
<thead>
<tr>
<th>Republican Voters (N=1,918)</th>
<th>Democratic Voters (N=3,018)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Answered the Door</td>
<td>Completed Survey</td>
</tr>
</tbody>
</table>
• Sorting in Response to Election Survey – Non-Voters
• Non-voters-> Strong evidence of sorting out
• Evidence of stigma from not voting and lying costs

Non-Voters (N=6,324)
Exp 2: Varying payment and length of svy

University of Chicago Study

Researchers will visit this address tomorrow ( / ) between ___ and ___ to conduct a **5 minute survey**.

You will be paid **$10 in cash** for your participation.

University of Chicago Study

Researchers will visit this address tomorrow ( / ) between ___ and ___ to conduct a **10 minute survey**.

University of Chicago Study

Researchers will visit this address tomorrow ( / ) between ___ and ___ to conduct a **5 minute survey**.

You will be paid **$10 in cash** for your participation.
• **Response to Incentives**
• **Response to payment and duration**
• **Election warning effect on non-voters** ~ **$10 decrease in pay**
Exp. 3: Lying Incentives

- Crossed treatment: Incentive to lie in 10-minute survey
- No Incentive. Just ask whether voted in 2010 election
- 8-Minute Incentive. (8 minute incentive to say ‘did not vote’)
  - “We have 10 minutes of questions about your voter participation in the 2010 congressional election, but if you say that you did not vote then we only have 2 minutes of questions. Either way you answer you will be paid $10. [Show the end of the survey if answer to #2 is NO]
  Did you vote in the 2010 congressional election?”

- For voters it is incentive to lie
- For non-voters this is incentive to tell truth

- Novel survey instrument → Use to estimate counterfactual utility
Lying Incentives

- In 5-minute surveys:
  - No Incentive. Just ask whether voted in 2010 election
  - $5 Incentive. ($5 incentive to say did not vote)
    - “We have 5 minutes of questions about your participation in the 2010 congressional election, but if you say that you did not vote then we would like to ask you an extra 1 minute of questions and we will pay you an extra $5 for answering these additional questions [IF PAID: for a total of $15]. If you say that you voted then we will just ask you the original 5 minutes of questions. [IF PAID: Either way you answer you will be paid $10.] Did you vote in the 2010 congressional election?”

- Incentive to lie for voters, to tell the truth for non-voters
- **Response to Incentives to Say ‘Did Not Vote’**
- Small impact on voters: 2 percentage points increase in lying → Strong social image utility and/or lying cost
- Sizeable impact on non-voters: 12 percentage point decrease in lying → Non-voters are closer to indifference
Structural Estimation

- **Structural estimates (Minimum-distance estimator)**

- Minimize distance between predicted moments $m(\varphi)$ and observed ones $\hat{m}$

$$\min_{\varphi} (m(\varphi) - \hat{m})'W(m(\varphi) - \hat{m})$$

- Moments $m(\varphi)$:
  1. Probability of opening door to surveyor $(P(H)^S_j)$
  2. Probability of filling survey $(P(S)^S_j)$
  3. Probability of checking the opt-out box
  4. Probability of lying about voting

- All moments $\hat{P}$ are probabilities, straight from Figures
Election Field Experiment - Estimation

- What is \( \vartheta \)?

- Main parameters
  - mean and s.d. of \( s_i^Y \) – signalling utility of saying one voted
  - mean and s.d. of \( s_i^N \) – signalling utility of saying one did not vote
  - \( L_i \geq 0 \) – lying cost

- Auxiliary parameters:
  - Willingness to do survey
  - Value of time
  - Cost of avoiding surveyor
Estimation with Selection

- Estimation approach: Incorporate selection into V/NV

- Parameters \((s_V, s_N)\) predict becoming voter or non-voter

\[
pV + g - c + N \left[ \max (s_V, s_N - L) - \max (s_N, s_V - L) \right] \geq 0
\]

\[
= \varepsilon
\]

- Assume epsilon Normal
- Voters and non-voters drawn from same population
- Draw parameters, determine selection into voters or non-voters
- Match to moments using simulations
- Assume number of times asked \(N\) from survey
- Additional moment: baseline turnout rate (60 percent)

- Total value of voting depends on \(N\)
- Survey: How often have you been asked whether you voted?
- 9 times for 2008 presidential election
### Estimation with Selection

#### Table 3. Simulated Minimum-Distance Estimates, Benchmark Results

<table>
<thead>
<tr>
<th>Voting Parameters</th>
<th>Voters and Non-Voters Have Same Auxiliary Parameters</th>
<th>Voters and Non-Voters Have Different Auxiliary Parameters</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean Social Image Value of Saying Voted ($s_v$)</td>
<td>-6.3</td>
<td>-3.9</td>
</tr>
<tr>
<td></td>
<td>(2.07)</td>
<td>(1.47)</td>
</tr>
<tr>
<td>Mean Social Image Value of Saying Did Not Vote ($s_n$)</td>
<td>-21.7</td>
<td>-11.3</td>
</tr>
<tr>
<td></td>
<td>(3.19)</td>
<td>(1.77)</td>
</tr>
<tr>
<td>Std. Dev. of $s_v$ and $s_n$</td>
<td>19.7</td>
<td>9.5</td>
</tr>
<tr>
<td></td>
<td>(2.83)</td>
<td>(1.29)</td>
</tr>
<tr>
<td>Lying Cost L (in $)</td>
<td>16.4</td>
<td>7.6</td>
</tr>
<tr>
<td></td>
<td>(2.82)</td>
<td>(1.21)</td>
</tr>
<tr>
<td>Mean Value of Other Reasons to Vote ($\varepsilon$)</td>
<td>95.0</td>
<td>64.1</td>
</tr>
<tr>
<td></td>
<td>(114.33)</td>
<td>(167.90)</td>
</tr>
<tr>
<td>Std. Dev. of Other Reasons to Vote ($\varepsilon$)</td>
<td>490.6</td>
<td>318.7</td>
</tr>
<tr>
<td></td>
<td>(454.75)</td>
<td>(691.37)</td>
</tr>
</tbody>
</table>

- Lying cost $L$ estimated
Estimation with Selection

- Implications: estimate impact on voting if
  - No one asked
  - Twice as many people asked
  - Also impact of being asked one more time (next)
Estimation with Selection

- Other implications of estimates

Table 4. Implied Value of Voting and Welfare Effects of GOTV

<table>
<thead>
<tr>
<th>Implications for Value of Voting to Tell Others</th>
<th>Voter</th>
<th>Non-Voter</th>
<th>Voter</th>
<th>Non-Voter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implied Value of Voting &quot;To Tell Others&quot; (N=5.4)</td>
<td>41.4</td>
<td>26.1</td>
<td>18.3</td>
<td>13.3</td>
</tr>
<tr>
<td>Baseline Turnout</td>
<td>0.604</td>
<td>0.599</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Implied Change in Turnout if Never Asked About Voting</td>
<td>-0.027</td>
<td>-0.019</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Implied Change in Turnout if Asked About Voting Twice as Often</td>
<td>+0.025</td>
<td>+0.018</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Implications for GOTV</th>
<th>Voter</th>
<th>Non-Voter</th>
<th>Voter</th>
<th>Non-Voter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Utility from being Asked about Voting Once</td>
<td>-3.7</td>
<td>-10.6</td>
<td>-2.8</td>
<td>-5.9</td>
</tr>
<tr>
<td>Implied GOTV Effect (N+1)</td>
<td>+0.005</td>
<td>+0.003</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Implied Number of GOTV Subjects to Get One Additional Vote (N+1)</td>
<td>206</td>
<td>295</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disutility Cost of Getting One Additional Vote (N+1)</td>
<td>-1326</td>
<td>-1189</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes: Standard errors are in parentheses.
Prospective Election Field Experiment

- If estimates are correct, being asked one more time increases the value of voting by $1.50-$3.00

- Experiment in week before elections in 2010 and 2012
  - Control (C) group: No contact
  - Control Flyer (CF) group: Flyer reminds households to vote
  - Treatment Flyer (TF) group: Flyer reminds households to vote, AND announces that a surveyor will come by to ask whether they voted in one of the following three weeks

- Comparison of turnout rate in TF group versus CF group provides evidence on impact of social image motive on voting
Prospective Election Field Experiment

- Control Flyer
- Treatment Flyer

University of Chicago Study

Don’t forget to vote in the 2012 Presidential Election.

Election Day is Tuesday, November 6, 2012.

University of Chicago Study

Researchers will contact you within three weeks of the election (between 11/7 and 11/27) to conduct a survey on your voter participation.

Don’t forget to vote in the 2012 Presidential Election.

Election Day is Tuesday, November 6, 2012.
Prospective Election Experiment

Table 7. Results for Get-Out-The-Vote Treatments

<table>
<thead>
<tr>
<th>Specification:</th>
<th>OLS Regressions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent Variable:</td>
<td>Indicator for Voting in Election in Year t</td>
</tr>
<tr>
<td>Constant</td>
<td>0.6000***</td>
</tr>
<tr>
<td></td>
<td>(0.0109)</td>
</tr>
<tr>
<td>Flyer with Voting Reminder</td>
<td>-0.0020</td>
</tr>
<tr>
<td></td>
<td>(0.0152)</td>
</tr>
<tr>
<td>Flyer with Announcement Will Ask About Voting</td>
<td>0.0120</td>
</tr>
<tr>
<td></td>
<td>(0.0157)</td>
</tr>
<tr>
<td>Omitted Treatment</td>
<td>No Flyer</td>
</tr>
<tr>
<td>Control for past Voting since 2004</td>
<td>X</td>
</tr>
<tr>
<td>Difference (Flyer Will Ask - Flyer Reminder)</td>
<td>0.0140</td>
</tr>
<tr>
<td>p-value for test of equality, 2-sided</td>
<td>p=0.365</td>
</tr>
<tr>
<td>p-value for test of equality, 1-sided</td>
<td>p=0.182</td>
</tr>
<tr>
<td>R2</td>
<td>0.0001</td>
</tr>
<tr>
<td>N</td>
<td>N = 31,306</td>
</tr>
</tbody>
</table>

- 1.3pp. effect in 2010 (marg. Significant 1-sided)
- 0.1pp. Effect in 2012 (highly competitive election)
- Estimates consistent with predicted small effect from model
Section 3

Methodology: Structural Behavioral Economics
Overview

- Structural estimation in behavioral economics
  - Use model for estimation
  - Estimate key model parameters
- What do we mean by structural?
  “Estimation of a model on data that recovers parameter estimates (and c.i.s) for some key model parameters”
- Chapter in *Handbook of Behavioral Economics*
Overview

- Chapter Focused on applications to field evidence. Structural lab evidence is way ahead (Card, DellaVigna, Malmendier, JEP 2012)
Overview Advantages

Five advantages to Structural Behavioral Econ:

1. (Calibration) It builds on, and expands, great behavioral tradition of calibrating models: Are magnitudes right?
2. (Model and Assumptions) Helps to better understand the model and clarifies implicit assumptions
3. (Stability) Helps to understand whether key behavioral parameters are stable, including out of sample
4. (Out of Sample) Allows for out of sample predictions which can be tested
5. (Design) Can lead to better experimental design
6. (Welfare and Policy) It allows for welfare evaluation and policy counterfactuals
Overview Limitations

Three limitations to Structural Behavioral Econ:

1. (Not the Right Tool) Not all questions lend themselves obviously to parameter estimation
2. (Complexity and Time Costs) It will, generally, take long, and there is higher possibility of errors
3. (Robustness) Need extra work to make sure estimates are robust, and which assumptions are driving them
Calibration

- Importance of calibrating models is lesson ONE from behavioral economics
- Example 1: Inertia in retirement savings
  - Standard model can explain *qualitative* pattern given switching costs $k$
  - But magnitudes? Costs would need to be ridiculous *(O’Donoghue and Rabin, 1998)*
  - Instead, procrastination plausible for naïve $\beta$-$\delta$ model even with $\beta$ very close to 1 *(O’Donoghue and Rabin, 1999; 2001)*
  - Problem set 1: Extend O’Donoghue and Rabin calibration with more realistic assumptions (stochastic $k$)
- Example 2: *Rabin (EMA 2000)* calibration theorem on risk
The lesson of calibration is that it is important to check for reasonable values of the parameters.

Example. **DellaVigna et al., 2017** on job search

- Exp discounting and $\beta \delta$ model have about same fit
- BUT $\delta$ model has 15-day $\delta = .9$ (implausible impatience)
- $\beta$ model instead has $\beta = .6$ (in range of other estimates)
- estimated values for exp discounting outside the range of plausible, not so for $\beta \delta$ model
Point 1. **Strengthens evidence-theory debate**
- Sketch of model will not suffice
- Full specification in order to do estimation, forced to work out details
- Run countless simulations at different parameter values
- → Leads to understanding model better
- Does model really do what you thought it would do?
- → Can even lead to theoretical break-throughs

**Barseghyan, Molinari, O’Donoghue, Teitelbaum** in working out AER 2013 estimation of insurance choice got result on non-identification of loss aversion with KR preferences
Model and Assumptions

- Point 2. Better empirical test
- Example 1: Genesove and Mayer (QJE) is pioneering application of reference dependence to housing
  - Individuals hate to sell house at loss relative to purchase price
  - Yet, GM did not work out a model of reference dependence
  - If one writes one, one does not get the GM specification
  - One does get, though, the prediction of bunching at the last house price sale (which they did not test)
- Example 2: Similar issues (as well known now) for Camerer et al. (1997) cab drivers paper
Model and Assumptions

- Point 3. Clarify needed assumptions
- Real-effort experiment (e.g., Gneezy et al., 2003; Gill et al., 2016)

$$Effort_{n,s,r} = \beta T + \gamma X_{n,s} + \varepsilon_{n,s,r}$$

What assumption are behind such specification?

- Effort is outcome of maximization decision,
  $$\max_{e_i} s(T_i) e_i - \frac{\exp(\gamma e_i)}{\gamma} \eta_i$$
- Assume $\eta$ log-normal, $\ln(\eta_i) \sim N(\gamma k(X_i), \gamma^2 \sigma^2)$.
- Taking first order conditions,
  $$e_i = \frac{1}{\gamma} \log [s(T_i)] - k(X_i) + \epsilon_i.$$

- Can estimate with Non-linear Least Squares, almost like OLS (nl in Stata) – Easy!
Do you buy the needed assumptions?
Can assume alternative functional form assumptions

**Power Cost Function:**

\[ c(e) = \frac{e^{1+\gamma}}{1 + \gamma} \]

Implied expression for effort is (DellaVigna, List, Malmendier, and Rao, 2016)

\[ \log(e_i) = \frac{1}{\gamma} \log[s(T_i)] - k(X_i) + \epsilon_i \]
Stability

- Behavioral economics has convergence on some parsimonious models:
  - Beta-delta model of time preference (Laibson, 1997; O'Donoghue and Rabin, 1999)
  - Reference-dependence model of risk preferences (Kahneman and Tversky, 1979; Koszegi and Rabin, 2006)

- For these models, is there reasonable agreement in parameters across settings?

- Case 1. Beta-delta model
  - Evidence from the field provided evidence of present bias
  - BUT Laboratory evidence (Andreoni and Sprenger AER) estimated $\beta$ close to 1
  - Design with effort choice a la Augenblick, Niederle, and Sprenger, QJE appears to solve the puzzle: $\beta = 0.9$ over effort, not on money since timing of money is fungible
Stability

- Case 2. Reference-dependent model
- Most of the focus is on loss aversion parameter $\lambda$ and on reference point $r$.
- But probability weighting $\pi(p)$ plays an important role
  - overweighting of small probabilities
  - Sydnor (2012) and Barseghyan et al: helps explain home insurance purchases
  - Barberis (2018): can explain preferences for IPOs which are skewed
  - Evidence from laboratory lottery choices is strong: $\pi(0.01) = 0.06$
**Stability**

- Inspired by this, simple design: compare effect of two incentives
  - A. Piece rate of $p$
  - B. Piece rate of $100p$, paid with probability 0.01
  - With probability weighting, B should be more effective

<table>
<thead>
<tr>
<th>Paper</th>
<th>Subjects</th>
<th>Effort Task</th>
<th>Sample Size</th>
<th>Treatments (Certain Reward vs. Probabilistic Reward with low $p$)</th>
<th>Effort with Certain Reward, Mean (S.D.)</th>
<th>Effort with Probabilistic Reward, Mean (S.D.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>DellaVigna and Pope (forthcoming)</td>
<td>Mturk</td>
<td>Button Presses</td>
<td>555 (P), 558 (C)</td>
<td>1% chance of winning US$1 (P) vs. fixed payment of US$0.01 (F) per 100 presses</td>
<td>2029 (27.47)</td>
<td>1896 (28.44)</td>
</tr>
<tr>
<td>Halpern et al. (2011)</td>
<td>Resident Physicians in a US Database</td>
<td>Survey Response</td>
<td>358 (P), 400 (C)</td>
<td>0.4% chance of winning US$2500 (P) vs. fixed payment of US$10 (F) for response</td>
<td>0.558 (0.497)</td>
<td>0.511 (0.500)</td>
</tr>
<tr>
<td>Thirumurthy et al. (2016)</td>
<td>Men aged 21 to 39 years old in Kenya</td>
<td>Uptake of Circumcision</td>
<td>302 (P), 308 (C)</td>
<td>Mixed lottery with expected retail value of US$12.50 (P) vs. food voucher worth US$12.50 (F)</td>
<td>0.084 (0.278)</td>
<td>0.033 (0.179)</td>
</tr>
<tr>
<td>Diamond and Loewy (1991)</td>
<td>Undergraduates in State University</td>
<td>Recycling</td>
<td>78 (P), 113 (C)</td>
<td>5% chance of winning $5 and 1% chance of winning $25 (P) vs. $0.50 voucher for campus store (F)</td>
<td>0.212 (0.409)</td>
<td>0.308 (0.462)</td>
</tr>
<tr>
<td>Dolan and Rudisill (2014)</td>
<td>16 to 24 year olds in England</td>
<td>Return Test Kit via Mail</td>
<td>247 (P), 549 (C)</td>
<td>10% chance of a 50 GBP Tesco voucher (P) vs. 5 GBP Tesco voucher (F)</td>
<td>0.732 (0.443)</td>
<td>0.706 (0.455)</td>
</tr>
</tbody>
</table>

*Table 2b. Evidence for Overweighting of Small Probabilities, Studies with Probabilistic Incentives*

Do not find evidence of probability weighting!
Out of Sample

- Structural estimates allow for out of sample predictions (McFadden et al. 1977; Todd and Wolpin, 2006)
- Some examples in behavioral economics
  - Estimate impact of get-out-the-vote intervention based on flyer experiment
- Example 2. Job Search. DellaVigna et al. (2017 QJE)
  - Estimate reference dependent model has good fit, even with just 1 type
  - A specific “standard” model (3-type heterogeneity in elasticity) can also fit well
  - Examine out of sample, consider smaller reform 2 years prior
  - Also consider group with lower earnings which had different reform
Stability

(a) Out-of-sample predictions of models for unemployment system 2 years prior to reform and empirical hazard

(b) Out-of-sample predictions of models for low earnings sample, pre-reform period
Experimental Design

- Structural estimation is most often used on observational data (e.g. consumption/savings).
  - In fact, sometimes used as substitute for clear identification (not recommended).
- BUT estimation is perfect for experiments.
- Advantage 1. Get best of both worlds.
  1. Get reduced-form results / treatment effects.
  2. PLUS estimate parameters based on experimental results.
Experimental Design

- Advantage 2: estimation informs the exp. design

- Idea:
  1. set up model + estimation before running experiment
  2. Create simulated data set (possibly using pilot data)
  3. Attempt to estimate on this data

- Often you will realize that
  - you need an extra treatment in design...
  - or more sample in one treatment...
  - or you are badly underpowered
  - →Change design! (Cannot do this in obs. studies)

- Different from reduced-form power studies, as this is about estimating the parameters
Experimental Design

- Example 1: Time preference experiments a la Andreoni and Sprenger or Augenblick et al.
  - Designed so as to estimate time preferences
  - Also, design to estimate confounding parameters (curvature of utility and cost of effort function)
- Example 2: Charity and Social Pressure Experiment (DLM QJE)
  - Add entire set of experiments to estimate cost of sorting in/out of the home
- Example 3. Limited attention and taxation
  - Allcott and Taubinsky (AER 2016) on energy inattention
  - Taubinsky and Rees-Jones (2016) on limited attention to taxes
Experimental Design

- What design tricks facilitate estimation?
- **Trick 1. “Price out” behavioral parameters comparing to an intervention in $**
  - **DLM (2012)** — survey treatment where advertise $ payment
  - **Andreoni and Sprenger (AER 2011); Augenblick, Niederle, and Sprenger (QJE 2014)** — variation in interest rate
- **Trick 2. Within-subject experiment**
  - Often allows to extract more information
  - BUT trade-off with simplicity of design
  - **Allcott and Taubinsky (AER 2016)** on energy inattention
  - **Taubinsky and Rees-Jones (2016)** on limited attention to taxes
  - Real Effort experiments and identification of cost of effort
    - **(DellaVigna, List, Malmendier, and Rao, 2016)**
Advantage of estimating model is... you can use it!
- Compute welfare of setting versus counterfactuals
- Estimate effect of potential policies

Some examples:
- DellaVigna, List, and Malmendier (QJE 2012) on charity
- Handel (AER 2013) on health insurance
- DellaVigna, List, Malmendier, Rao (REStud 2017) on voting
- Bernheim, Fradkin, Popov (AER 2015) on retirement saving
- Allcott and Taubinsky (AER 2015) on energy
Overview Limitations

Three limitations to Structural Behavioral Econ:

1. (Not the Right Tool) Not all questions lend themselves obviously to parameter estimation.
2. (Complexity and Time Costs) It will, generally, take long, and there is higher possibility of errors.
3. (Robustness) Need extra work to make sure estimates are robust, and which assumptions are driving them.
Limitation 1: Not Right Tool

- Not all questions lend themselves obviously to parameter estimation
  - Exploratory question on which we do not have a good model
    - Example: Framing effects (eg Benartzi and Thaler, 2002)
  - Many reduced form/policy question
    - Bhargava and Manoli AER
  - Models and Axioms
    - Models can provide comparative statics test of different models, or axioms
    - Can do so without structural estimation, do not need to specify all assumptions
Limitation 2: Complexity and Time Costs

- Estimation can be relatively easy, but it typically is not.
- You will learn a lot about optimization methods!
- And... there will be bugs in your code.
  - Test very extensively, have other people peer review the code.
  - Use simulations: simulate and estimate.
  - Example of error: Apesteguia and Ballester (JPE forthcoming) point flaw in earlier Harrison paper.
- Keep in mind the objective: Complexity of the model and estimation is not the aim, it is a necessary evil.
- BUT structural model can be simple.
  - If rich data provides necessary variation (*sufficient statistic* approach)
  - OR if data collection / experiment is set up to make estimation simple.
Limitation 3: Robustness to Assumptions

- What about pitfalls?
- Assume you fully specify model and estimate it
  - You spend years of life doing it
  - Model implies welfare and policy implications
  - Now you sell the implications for policy and welfare

**Warning 1.** Estimation and implications are only as good as assumptions going into it
  - Test much robustness

**Warning 2.** Standard errors do not acknowledge model mis-specification → Point estimates are likely too precise

**Warning 3.** Do you do as well out of sample as in sample?
**Limitation 3: Robustness to Assumptions**

- How to avoid pitfall: **Allcott and Taubinsky (AER 2016)**
- Consumers make choices between incandescent and CFL

One group receives information on energy savings, other not
Limitation 3: Robustness to Assumptions

- Moderate Shift in demand curve due to information
- What if not sure about some key assumptions?

<table>
<thead>
<tr>
<th>Row</th>
<th>Scenario</th>
<th>(1) Optimal Subsidy ($/pckg)</th>
<th>(2) Welfare Effect of Ban ($/pckg)</th>
<th>(3) Effect of Ban (Percent of “Perceived Surplus”)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Base</td>
<td>3</td>
<td>-0.44</td>
<td>-41</td>
</tr>
<tr>
<td>2</td>
<td>WTP={$12,-$12}</td>
<td>3</td>
<td>-0.34</td>
<td>-36</td>
</tr>
<tr>
<td>3</td>
<td>WTP={$20,-$20}</td>
<td>3</td>
<td>-0.60</td>
<td>-47</td>
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<tr>
<td>4</td>
<td>self-reported hypothetical WTP</td>
<td>3</td>
<td>-0.61</td>
<td>-43</td>
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<tr>
<td>5</td>
<td>consumers who pass review “quiz”</td>
<td>3</td>
<td>-0.41</td>
<td>-38</td>
</tr>
<tr>
<td>6</td>
<td>consumers w/ “correct” endline beliefs</td>
<td>3</td>
<td>-0.13</td>
<td>-12</td>
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<tr>
<td>7</td>
<td>Balanced Treatment group</td>
<td>3</td>
<td>-0.48</td>
<td>-45</td>
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<tr>
<td>8</td>
<td>10 percent confidence bound</td>
<td>1</td>
<td>-0.92</td>
<td>-86</td>
</tr>
<tr>
<td>9</td>
<td>90 percent confidence bound</td>
<td>(Ban)</td>
<td>0.05</td>
<td>4</td>
</tr>
<tr>
<td>10</td>
<td>Excess mass consumers have $v$= 7.66</td>
<td>8</td>
<td>1.22</td>
<td>114</td>
</tr>
</tbody>
</table>

If censored, assume ...

Scale average marginal bias to match ...

Additional Distortion Computed from Excess Mass Test
Common Methods of Estimation

1. Minimum Distance Estimator / Method of Moments
2. Maximum Likelihood
3. Others (OLS / NLLS / “Bunching”)
Minimum Distance

Minimum Distance Steps

1. Pick the observed empirical moments to match, $\hat{m}$
2. Solve/ Simulate the model at a given set of parameters $\theta$ and generate the same moments, $m(\theta)$
3. Find the set of parameters that minimize the distance between the empirical and model-generated moments

$$\hat{\theta} = \text{argmin} (m(\theta) - \hat{m})' W (m(\theta) - \hat{m})$$

Example: Laibson, Repetto, Maxted, and Tobacman (2015)

- Study consumption-savings of households
- Step 1: Many possible moments, pick important ones
- Step 2 (hardest for them): Write full consumption-savings problem as function of model parameters
- Step 3 (easy): Grid search of parameters such that would have good fit
Minimum Distance

- **Advantages of Minimum Distance:**
  - Transparent in what identifies: moments you pick. Perfect for experiments:
    - Moment 1 is $X$ in control, Moment 2 is $X$ in treatment
  - Also, allows you to post the moments even if data is confidential

- **Disadvantages of Minimum Distance:**
  - Does not use all the information in the data, only what is contained in moments
  - Sensitive to choice of moments
Maximum Likelihood

Maximum Likelihood Steps

1. Specify fully the statistical model, deriving likelihood $L(x|\theta)$, where $x$ is data

2. Maximize likelihood given the data, picking parameters $\hat{\theta}$

Augenblick and Rabin (RES, forthc.)

Model implies that optimal effort is given by

$$e^* = \arg \max_e \delta^{T-k} \cdot (e \cdot w) - \frac{1}{\beta^{1(k=t)}} \cdot \frac{1}{\beta^{1(p=1)}_h} \cdot \delta^{t-k} \cdot \frac{1}{\varphi \cdot \gamma} (e + 10)^\gamma.$$ 

Leads to first order condition

$$e^* = \left( \frac{\delta^{T-k} \cdot \varphi \cdot w}{\frac{1}{\beta^{1(k=t)}} \cdot \frac{1}{\beta^{1(p=1)}_h} \cdot \delta^{t-k}} \right)^{\frac{1}{\gamma-1}} - 10.$$ 

Assuming additive noise in observed effort yields likelihood

$$L(e_j) = \phi \left( \frac{e_j^* - e_j}{\sigma} \right)$$
Maximum Likelihood

- **Advantages of Maximum Likelihood:**
  - Uses all the information in the data

- **Disadvantages of Minimum Distance:**
  - Identification is less transparent
  - Observations with a very low likelihood could be driving the results
II. Randomness

Consider a typical model solution, e.g., Nash eq., or Market Equilibrium

Solution often is one equilibrium action, or one price

Yet, in reality we always a distribution of outcomes

Where does the randomness come from?

That will be key step to take model into econometrics.

Three broad categories

1. Random utility (Mcfadden logit)
2. Random coefficients
3. Implementation error
Section 4

Behavioral Finance
Behavioral Finance Anomalies

- How do ‘smart’ investors respond to investors with biases?
- First, brief overview of anomalies in Asset Pricing (from Barberis and Thaler, 2004)
1 Underdiversification.

1 Too few companies.
- Investors hold an average of 4-6 stocks in portfolio.
- Improvement with mutual funds

2 Too few countries.
- Investors heavily invested in own country.
- Own country equity: 94% (US), 98% (Japan), 82% (UK)
- Own area: own local Bells (Huberman, 2001)

3 Own company
- In companies offering own stock in 401(k) plan, substantial investment in employer stock
Naive diversification.
- Investors tend to distribute wealth ‘equally’ among alternatives in 401(k) plan (Benartzi and Thaler, 2001; Huberman and Jiang, 2005)

Excessive Trading.
- Trade too much given transaction costs (Odean, 2001)

Disposition Effect in selling.
- Investors more likely to sell winners than losers
5. **Attention Effects in buying.**
   - Stocks with extreme price or volume movements attract attention (Odean, 2003)

6. **Inattention to Fees.**
Attention Effects in buying.
- Stocks with extreme price or volume movements attract attention (Odean, 2003)

Inattention to Fees.

Should market forces and arbitrage eliminate these phenomena?
Behavioral Finance

Arbitrage

By assumption:
- Individuals attempt to maximize individual wealth
- They take advantage of opportunities for free lunches

Implications of arbitrage: ‘Strange’ preferences do not affect pricing

Implication: For prices of assets, no need to worry about behavioral stories

Is it true?
Fictitious Example

- Asset A returns $1 tomorrow with $p = 0.5$
- Asset B returns $1 tomorrow with $p = 0.5$

Arbitrage $\rightarrow$ Price of A has to equal price of B
- If $p_A > p_B$,
  - sell A and buy B
  - keep selling and buying until $p_A = p_B$
- Viceversa if $p_A < p_B$
But...

- Problem: Arbitrage is limited (de Long et al., 1991; Shleifer, 2001)
- In Example: can buy/sell A or B and tomorrow get fundamental value
- In Real world: prices can diverge from fundamental value

Real world example. Royal Dutch and Shell
- Companies merged financially in 1907
- Royal Dutch shares: claim to 60% of total cash flow
- Shell shares: claim to 40% of total cash flow
- Shares are nothing but claims to cash flow
- Price of Royal Dutch should be $60/40 = 3/2$ price of Shell
Royal Dutch and Shell

- $p_{RD}/p_S$ differs substantially from 1.5 (Fig. 1)

![Graph showing log deviations from Royal Dutch/Shell parity. Source: Froot and Dabora (1999).]

- Plenty of other examples (Palm/3Com)
What is the problem?

- Noise trader risk, investors with correlated valuations that diverge from fundamental value
  - Example: Naive Investors keep persistently bidding down price of Shell
- In the long run, convergence to cash-flow value
- In the short-run, divergence can even increase
  - Example: Price of Shell may be bid down even more
Behavioral Finance

Noise Traders

- DeLong, Shleifer, Summers, Waldman (JPE 1990)
- Fundamental question: What happens to prices if:
  - (Limited) arbitrage
  - Some irrational investors with correlated (wrong) beliefs
- First paper on Market Reaction to Biases
- *The* key paper in Behavioral Finance
Behavioral Finance

Model Assumptions

A1: arbitrageurs risk averse and short horizon

→ Justification?

- Short-selling constraints
  (per-period fee if borrowing cash/securities)
- Evaluation of Fund managers.
- Principal-Agent problem for fund managers.
A2: noise traders (Kyle 1985; Black 1986)

- misperceive future expected price at $t$ by $\rho_t \sim N(\rho^*, \sigma^2_\rho)$
- misperception \textit{correlated} across noise traders ($\rho^* \neq 0$)

→ Justification?

- fads and bubbles (Internet stocks, biotechs)
- pseudo-signals (advice broker, financial guru)
- behavioral biases / misperception riskiness
What else?

- $\mu$ noise traders, $(1 - \mu)$ arbitrageurs
- OLG model
  - Period 1: initial endowment, trade
  - Period 2: consumption
- Two assets with identical dividend $r$
  - safe asset: perfectly elastic supply
    $\implies$ price $= 1$ (numeraire)
  - unsafe asset: inelastic supply (1 unit)
    $\implies$ price?
- Demand for unsafe asset: $\lambda^a$ and $\lambda^n$, with $\lambda^n\mu + \lambda^a(1 - \mu) = 1$.
- CARA: $U(w) = -e^{-2\gamma w}$ ($w$ wealth when old)
\[
E [U(w)] = \int_{-\infty}^{\infty} -e^{-2\gamma w} \cdot \frac{1}{\sqrt{2\pi \sigma_w^2}} \cdot e^{-\frac{1}{2\sigma^2}(w-\bar{w})^2} \, dw
\]

\[
= -\int_{-\infty}^{\infty} \frac{1}{\sqrt{2\pi \sigma_w^2}} \cdot e^{-\frac{4\gamma w \sigma_w^2 + w^2 + \bar{w}^2 - 2\bar{w}w}{2\sigma_w^2}} \, dw
\]

\[
= -\int_{-\infty}^{\infty} \frac{1}{\sqrt{2\pi \sigma_w^2}} \cdot e^{-\frac{(w-[\bar{w}-2\gamma \sigma_w^2])^2 - 4\gamma^2 \sigma_w^4 + 4\gamma \sigma_w^2 \bar{w}}{2\sigma_w^2}} \, dw
\]

\[
= -e^{-\frac{4\gamma \sigma_w^2 \bar{w} - 4\gamma^2 \sigma_w^4}{2\sigma_w^2}} \int_{-\infty}^{\infty} \frac{1}{\sqrt{2\pi \sigma_w^2}} \cdot e^{-\frac{(w-[\bar{w}-2\gamma \sigma_w^2])^2}{2\sigma_w^2}} \, dw
\]

\[
= -e^{-\frac{4\gamma \sigma_w^2 \bar{w} - 4\gamma^2 \sigma_w^4}{2\sigma_w^2}} = -e^{-2\gamma (\bar{w}-\gamma \sigma_w^2)}
\]

\[
\downarrow
\]

\[
\max E [U(w)] \quad \xrightleftharpoons{\text{pos. mon. transf.}} \quad \max \bar{w} - \gamma \sigma_w^2
\]
Arbitrageurs:

\[
\max(w_t - \lambda^a_t p_t)(1 + r) \\
+ \lambda^a_t (E_t[p_{t+1}] + r) \\
- \gamma (\lambda^a_t)^2 \text{Var}_t(p_{t+1})
\]

Noise traders:

\[
\max(w_t - \lambda^n_t p_t)(1 + r) \\
+ \lambda^n_t (E_t[p_{t+1}] + \rho_t + r) \\
- \gamma (\lambda^n_t)^2 \text{Var}_t(p_{t+1})
\]

(Note: Noise traders know how to factor the effect of future price volatility into their calculations of values.)
f.o.c.

Arbitrageurs: \[ \frac{\partial E[U]}{\partial \lambda_t^a} = 0 \]

\[ \lambda_t^a = \frac{r + E_t[p_{t+1}] - (1 + r)p_t}{2\gamma \cdot Var_t(p_{t+1})} \]

Noise traders: \[ \frac{\partial E[U]}{\partial \lambda_t^n} = 0 \]

\[ \lambda_t^n = \frac{r + E_t[p_{t+1}] - (1 + r)p_t}{2\gamma \cdot Var_t(p_{t+1})} + \frac{\rho_t}{2\gamma \cdot Var_t(p_{t+1})} \]
Interpretation

- Demand for unsafe asset function of:
  - (+) expected return \((r + E_t[p_{t+1}] - (1 + r)p_t)\)
  - (–) risk aversion \((\gamma)\)
  - (–) variance of return \((Var_t(p_{t+1}))\)
  - (+) overestimation of return \(\rho_t\) (noise traders)

- Notice: noise traders hold more risky asset than arb. if \(\rho > 0\) (and viceversa)

- Notice: Variance of prices come from noise trader risk. “Price when old” depends on uncertain belief of next periods’ noise traders.
Impose general equilibrium: $\lambda^n \mu + \lambda^a (1 - \mu) = 1$ to obtain

$$1 = \frac{r + E_t[p_{t+1}] - (1 + r)p_t}{2\gamma \cdot \text{Var}_t(p_{t+1})} + \mu \frac{\rho_t}{2\gamma \cdot \text{Var}_t(p_{t+1})}$$

or

$$p_t = \frac{1}{1 + r} [r + E_t[p_{t+1}] - 2\gamma \cdot \text{Var}_t(p_{t+1}) + \mu \rho_t]$$

To solve for $p_t$, we need to solve for $E_t[p_{t+1}] = E[p]$ and $\text{Var}_t(p_{t+1})$

$$E[p] = \frac{1}{1 + r} [r + E_t[p] - 2\gamma \cdot \text{Var}_t(p_{t+1}) + \mu E[\rho_t]]$$

$$E[p] = 1 + \frac{-2\gamma \cdot \text{Var}_t(p_{t+1}) + \mu \rho^*}{r}$$
Rewrite $p_t$ plugging in

$$p_t = 1 - \frac{2\gamma \cdot \text{Var}_t(p_{t+1})}{r} + \frac{\mu \rho^*}{r(1+r)} + \frac{\mu \rho_t}{1+r}$$

$$\text{Var}[p_t] = \text{Var}\left[\frac{\mu \rho_t}{1+r}\right] = \frac{\mu^2}{(1+r)^2} \text{Var}(\rho_t) = \frac{\mu^2}{(1+r)^2}\sigma^2_\rho$$

Rewrite $p_t$

$$p_t = 1 + \frac{\mu \rho^*}{r} + \frac{\mu(\rho_t - \rho^*)}{1+r} - 2\frac{\gamma \mu^2 \sigma^2_\rho}{r(1+r)^2}$$

Noise traders affect prices!

- Term 1: Variation in noise trader (mis-)perception
- Term 2: Average misperception of noise traders
- Term 3: Compensation for noise trader risk
Relative returns of noise traders

- Compare returns to noise traders $R^n$ to returns for arbitrageurs $R_a$:

$$\Delta R = R^n - R^a = (\lambda^n_t - \lambda^a_t) [r + p_{t+1} - p_t (1 + r)]$$

$$E (\Delta R | \rho_t) = \rho_t - \frac{(1 + r)^2 \rho^2_t}{2\gamma \mu \sigma^2_\rho}$$

$$E (\Delta R) = \rho^* - \frac{(1 + r)^2 (\rho^*)^2 + (1 + r)^2 \sigma^2_\rho}{2\gamma \mu \sigma^2_\rho}$$

- Noise traders hold more risky asset if $\rho^* > 0$
- Return of noise traders can be higher if $\rho^* > 0$ (and not too positive)
- Noise traders therefore may outperform arbitrageurs if optimistic!
- (Reason is that they are taking more risk)
Welfare

- Sophisticated investors have higher utility
- Noise traders have lower utility than they expect
- Noise traders may have higher returns (if $\rho^* > 0$)
- Noise traders do not necessarily disappear over time
Three fundamental assumptions

1. OLG: no last period; short horizon
2. Fixed supply unsafe asset \((a \text{ cannot convert safe into unsafe})\)
3. Noise trader risk systematic

Noise trader models imply that biases affect asset prices:

- Reference Dependence
- Attention
- Persuasion
Section 5

Next Lecture
Next Lecture

- Behavioral Public
- Teaching Evaluations