

Utility Theory

1 Question

Do people choose the options that they will most enjoy? Do they maximize *experienced utility*? Contrast: are their preferences consistent with one another and the axioms of rational choice?¹

2 Four errors of hedonic forecasting

1. Current emotional state: projection bias

Hungry shopper example, “projection bias”, “hot-cold empathy gap”, health club memberships, high-brow movies.

2. Context: focus on irrelevant factors

Stereo speakers: focus on sound in the store, looks at home. Predictions about food enjoyment with an irrelevant alternative in view.

Music and snack selection: *diversification bias* when planning.

3. Evaluating the past: duration neglect

a. Like predictions, memories are anchored to present emotional state.

b. *Peak/end rule*. 60 seconds in cold water vs. 90 seconds with warming in last 30. Colonoscopies: shorter vs. longer with merely uncomfortable ending.

4. Affective forecasting

¹ Daniel Kahneman and Richard H. Thaler, “Utility Maximization and Experienced Utility”, *Journal of Economic Perspectives* 20:1 (2006), pp. 221–2. I’m told that this book describes cutting edge research in this area: Daniel Gilbert, *Stumbling on Happiness*. (2007). I know that it’s a wonderful read.

- a. Focusing bias: when thinking about California, focus on weather. But quality of life is influenced by many other things.
- b. Adaptation: paraplegics, lottery winners. *Duration bias*, neglect future change in focus away from injury, money, etc..

3 Political theory: libertarian paternalism

Sunstein, C. R. and Thaler, R. H. (2003). Libertarian paternalism is not an oxymoron. *University of Chicago Law Review*, 70(4):1159–1202. This version has more examples and is addressed to lawyers.

Thaler, R. H. and Sunstein, C. R. (2003). Libertarian paternalism. *The American Economic Review*, 93(2):175–179. This version is terse and addressed to economists.

Thaler, R. H. and Benartzi, S. (2004). Save more tomorrow: Using behavioral economics to increase employee saving. *Journal of Political Economy*, 112(1):S164 - S187.

Sunstein, C. R. and Thaler, R. H. (2006). Preferences, paternalism, and liberty. In *Preferences and well-being*, pages 233–264. Cambridge University Press, Cambridge. And this is the one on our syllabus.