

Psychology 458
The Psychology of Economic Decisions
Wednesdays 12:30 – 2:20, Winter 2006

<http://www.arts.uwaterloo.ca/~dkoehler/psych458/>

Instructor: Derek Koehler (dkoehler@uwaterloo.ca; office PAS 4050; ext. 5013).

Throughout our lives we are faced with difficult economic decisions, both major (selecting a pension plan) and minor (buying a new DVD player). How do people make such decisions, and are there ways in which their decisions could be improved? Psychologists and economists have developed an increasingly sophisticated and influential depiction of the processes by which people make choices under conditions of uncertainty and conflicting objectives. This seminar provides a survey of recent research on the psychology of economic decision making, with an emphasis on the ways in which people's financial decisions systematically deviate from those expected under a "rational" economic analysis. We will attempt to understand, among other things, why cab drivers quit earlier on profitable than on unprofitable days, why the stocks that investors sell from their portfolio outperform those that they retain, and how seemingly small changes to a pension plan can have big effects on how much employees save for retirement. Note that readings in this course frequently use mathematical notation to characterize how decisions are and ought to be made.

Course Requirements

This is a seminar course. Its quality will depend on the quality of your contributions to the discussion of each week's topic. As such, it is important that you (a) attend the course meeting each week and (b) arrive each week prepared to discuss the assigned readings. With regard to (a), you are expected to **attend and participate** in each seminar meeting. If you have to miss a meeting, please notify the instructor in advance. Such absences will be dealt with on a case-by-case basis.

With regard to (b), you will be asked to bring a 2-page list of **critical comments** regarding the readings for that week, which will be handed in to the instructor at the end of each meeting. The critical comments you prepare each week are primarily for your own use, to guide your reading and contribution to in-class discussion of the article. You need not write mini-essays, but instead can provide a "bullet-point" list of comments and insights regarding issues raised by the article. Obviously, though, because they will be handed in at the end of each meeting, your comments should not be so terse and cryptic that they make sense only to you. In terms of content, there are two things you should avoid in preparing your critical comments. First, under no circumstances should your "comments" consist merely of a summary of what you have read. If you find it useful to prepare such summary notes, then by all means feel free to do so, and to bring them along to class if you find them helpful, but please do not hand them in. Second, your comments should not consist of a list of things you simply did not understand in the reading, or questions that came to mind which you have made no attempt to answer. The critical comments you prepare and hand in at the end of each meeting are supposed to represent your own careful thoughts on the readings, answering questions such as: Does the author provide adequate support for the claims being made in the article? Is the evidence open to alternative interpretations? Are there other settings or circumstances in which we might expect to find different results? Are there interesting everyday problems to which the issues raised in the article might be applied? What are the implications of the author's claims for, say, public policy? Are there any conclusions we can draw about how we might improve people's decision-making skills? Are there any interesting conceptual connections between the content of the article and something you have experienced or read about?

Each week, two students will serve as **discussion leaders** for the seminar. Their job will be to present a structured overview of the readings for the week, and to guide class discussion of those readings. Each student will likely be required to serve as a discussion leader twice during the term, though this depends to some extent on the size of the class.

As a final requirement, each student will be asked to write a **course paper** reviewing a course-related area of research and proposing a new experiment that would help to address some unanswered question in that area of research. The paper should review several (i.e., at least three) previously published journal articles on a some topic related to economic decision making, and use those findings as the starting point for proposing the new experiment. Your paper should be clearly written, should demonstrate a firm understanding of the research topic under investigation, and should explicitly state how the proposed experiment would further our understanding of that topic. A more detailed handout regarding the paper and how it will be marked will be posted to the course website. The paper should be about 10 double-spaced pages in length. The paper is due by 9am on Friday April 14. Late papers will not be accepted without a legitimate, documented excuse (i.e., medical or family emergency). As always, the paper you turn in must be your own work, and can not have been submitted for any other course. (For more information, see University of Waterloo Policy #71 on student academic discipline.)

Final grades in the course will be based on the following components:

Critical comments:	30%
Seminar attendance/participation:	15%
Discussion leadership:	15%
Final course paper:	40%

Schedule and Readings

All readings can be downloaded from the Psych 458 site on UW ACE.

Week 1 (January 4): **Introduction**

Overview of normative and descriptive models of decision making

Week 2 (January 11): **Loss Aversion**

Kahneman, D., Knetsch, J. L., & Thaler, R. H. (1991). The endowment effect, loss aversion, and status quo bias. *Journal of Economic Perspectives*, 5, 193-206.

Rabin, M., & Thaler, R. H. (2001). Risk aversion. *Journal of Economic Perspectives*, 15, 219-232.

List, J. A. (2004). Neoclassical theory versus prospect theory: Evidence from the marketplace. *Econometrica*, 72, 615-625.

Week 3 (January 18): **Mental Accounting**

Camerer, C., Babcock, L., Loewenstein, G., & Thaler, R. (2000). Labor supply of New York City cab drivers: One day at a time. In D. Kahneman and A. Tversky (Eds.), *Choices, Values, and Frames*. Cambridge: Cambridge University Press.

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

Week 4 (January 25): **Repeated Decisions**

Gneezy, U., & Potters, J. (1997). An experiment on risk taking and evaluation periods. *Quarterly Journal of Economics*, 112, 631-645.

Hertwig, R., Barron, G., Weber, E. U., & Erev, I. (2004). Decisions from experience and the effect of rare events in risky choice. *Psychological Science*, 15, 534-539.

Haigh, M. S., & List, J. A. (2005). Do professional traders exhibit myopic loss aversion? An experimental analysis. *Journal of Finance*, 60, 523-534.

Week 5 (February 1): **Preference Construction**

- Shafir, E., Simonson, I., & Tversky, A. (1993). Reason-based choice. *Cognition*, 49, 11-36.
- Ariely, D., Loewenstein, G., & Prelec, D. (2003). Coherent arbitrariness: Stable demand curves without stable preferences. *Quarterly Journal of Economics*, 118, 74-105.

Week 6 (February 8): **Anticipating Future Experiences**

- Kahneman, D., Fredrickson, B.L., Schreiber, C.A., & Redelmeier, D.A. (1993). When more pain is preferred to less: Adding a better end. *Psychological Science*, 4, 401-405.
- Gilbert, D. T., Gill, M. J., & Wilson, T. D. (2002). The future is now: Temporal correction in affective forecasting. *Organizational Behavior and Human Decision Processes*, 88, 430-444.
- Hsee, C. K., & Zhang, J. (2004). Distinction bias: Misprediction and mischoice due to joint evaluation. *Journal of Personality and Social Psychology*, 86, 680-695.

Week 7 (February 15): **Self-control**

- Heath, C., & Soll, J. (1996). Mental budgeting and consumer decisions. *Journal of Consumer Research*, 23, 40-52.
- Ariely, D., & Wertenbroch, K. (2002). Procrastination, deadlines, and performance: Self-control by precommitment. *Psychological Science*, 13, 219-224.
- Kivetz, R., & Simonson, I. (2002). Self-control for the righteous: Toward a theory of precommitment to indulgence. *Journal of Consumer Research*, 29, 199-217.

February 22 – No Class (Reading Week)

Week 8 (March 1): **Affect**

- Lerner, J. S. and Keltner, D. (2001). Fear, anger, and risk. *Journal of Personality and Social Psychology*, 81, 146-159.
- Lerner, J. S., Small, D. A., and Loewenstein, G. (2004). Heart strings and purse strings: Carry-over effects of emotions on economic transactions. *Psychological Science*, 15, 337-341.
- Gladwell, M. (January 12, 2004). Big and bad: How the S.U.V. ran over automotive safety. *New Yorker*, 28-33.

Week 9 (March 8): **Maximization and Choice Overload**

- Hsee, C. K., Yu, F., Zhang, J. & Zhang Y. (2003). Medium maximization. *Journal of Consumer Research*, 30, 1-14.
- Iyengar, S., Jiang, W., & Huberman, G. (2003). *How much choice is too much? Contributions to 401(k) retirement plans*. Pension Research Council Working Paper.

Week 10 (March 15): **Conflict and Cooperation**

- Henrich, J., Boyd, R., Bowles, S., Camerer, C., Gintis, H., McElreath, R., & Fehr, E. (2001) In search of homo economicus: Experiments in 15 small-scale societies. *American Economic Review*, 91, 73-79.
- Fehr, E., & Gaechter, S. (2002). Altruistic punishment in humans. *Nature*, 415, 137-140.
- Fehr, E., & Rockenbach, B. (2003). Detrimental effects of sanctions on human altruism. *Nature*, 422, 137-140.

Week 11 (March 22): **Egocentrism**

Babcock, L., & Loewenstein, G. (1997). Explaining bargaining impasse: The role of self-serving biases. *Journal of Economic Perspectives*, 11, 109-126.

Camerer, C., & Lovallo, D. (1999). Overconfidence and excess entry: An experimental approach. *American Economic Review*, 89, 306-318.

Moore, D. A., & Kim, T. G. (2003). Myopic social prediction and the solo comparison effect. *Journal of Personality and Social Psychology*, 85, 1121-1135.

Week 12 (March 29): **Neuroeconomics**

Bechara, A., Damasio, H., Tranel, D., & Damasio, A.R. (1997). Deciding advantageously before knowing the advantageous strategy. *Science*, 275, 1293-1294.

Sanfey, A. G., Rilling, J. K., Aaronson, J. A., Nystrom, L.E., & Cohen, J. D. (2003). The neural basis of economic decision-making in the ultimatum game. *Science*, 300, 1755-1758.

McClure, S. M., Laibson, D. I., Loewenstein, G., & Cohen, J. D. (2004). Separate neural systems value immediate and delayed monetary rewards. *Science*, 306, 503-507.

Knutson, B., & Peterson, R. (2005). Neurally reconstructing expected utility. *Games and Economic Behavior*, 52, 305-315.

Note from Sheila L. Ager, Associate Dean of Arts:

Note on avoidance of academic offences: All students registered in the courses of the Faculty of Arts are expected to know what constitutes an academic offence, to avoid committing academic offences, and to take responsibility for their academic actions. When the commission of an offence is established, disciplinary penalties will be imposed in accord with Policy #71 (Student Academic Discipline). For information on categories of offences and types of penalties, students are directed to consult the summary of Policy #71 which is supplied in the Undergraduate Calendar (section 1; on the Web at <http://www.adm.uwaterloo.ca/infosec/Policies/policy71.htm>). If you need help in learning how to avoid offences such as plagiarism, cheating, and double submission, or if you need clarification of aspects of the discipline policy, ask your TA or course instructor for guidance. Other resources regarding the discipline policy are your academic advisor and the Undergraduate Associate Dean. Students who believe that they have been wrongfully or unjustly penalized have the right to grieve; refer to Policy #70, Student Grievance, <http://www.adm.uwaterloo.ca/infosec/Policies/policy70.htm>.