Self Control, Risk Aversion, and the Allais Paradox

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This Version: September 4, 2008

Introduction

Explain quantitatively Allais paradox as a consequence of a self-control problem

A common explanation with effect of cognitive load on decision making

Explains also Rabin paradox

Use self-control framework of Fudenberg and Levine [2006]

Shiv and Fedorikhin [1999]

memorize either two- or a seven-digit number

walk to table with choice of two desserts: chocolate cake or fruit salad

pick a ticket for one dessert

report number and dessert choice in a different room

seven-digit number: cake 63% of time

two-digit number: cake 41% of time

(statistically as well as economically significant)

our interpretation: cognitive resources used for self-control are substitutes for cognitive resources used for memorizing numbers plus increasing marginal cost of cognitive resource usage

An Implication

replace desserts with lotteries giving a probability of a dessert self-control problem reduce, so fewer should give in to temptation of chocolate cake

violates independence axiom

will argue that Allais paradox has a similar nature

Self-Control with a Cash Constraint

periods $t = 1, 2, \ldots$ divided into two sub-periods

bank subperiod and *nightclub* subperiod

state $w \in \Re_+$ wealth at beginning of bank sub-period

"bank" subperiod, no consumption, wealth w_t divided between savings s_t (remains in bank) and cash x_t carried to nightclub (also durable spending)

consumption not possible in bank, so short-run self indifferent between all possible choices, and long-run self incurs no cost of self control

in nightclub consumption $0 \leq c_t \leq x_t$ determined, with $x_t - c_t$ returned to bank at end of period

$w_{t+1} = R(s_t + x_t - c_t)$ no borrowing possible, and no source of income other than return on investment.

Extension of Fudenberg and Levine [2006]

Choice of nightclubs indexed by quality of nightclub $c^* \in (0, \infty)$

"target" level of consumption expenditure

low value of $c\,*$ cheap beer bar

high value of $c\,*$ expensive wine bar

base preference of short-run self $u(c, c^*)$

$u(c,c) = \log c$, ($\log(0) = -\infty$)

$u(c, c^*) \leq u(c,c)$ so best to choose nightclub of same index as amount you want to spend

convenient functional form (with $\rho > 1$)

$$u(c, c^*) = \log c\,* - \frac{(c\,/\,c^*)^{1-\rho} - 1}{\rho - 1}.$$

$g(d+\overline{u}-u)$ cost of self-control when maximum (temptation) utility attainable for short-run self is $\overline{u}$, actual realized utility u, and cognitive load due to or activities d

in calibrations use quadratic: $g(u) = \gamma u + (1/2)\Gamma u^2$.

reduced form preferences for long-run self are (w/o durable)

$$U_{RF} = \sum_{t=1}^{\infty} \delta^{t-1} \left[u(c_t, c_t^*) - g(u(x_t, c_t^*) - u(c_t, c_t^*)) \right]. \quad (2.2)$$

no cost of self-control in bank so choose $c_t^* = c_t = x_t = (1-\delta)w_t$

same as solution without self-control

utility as function of wealth:

$$U_1(w_1) = \frac{\log(w_1)}{1-\delta} + K.$$

Risky Drinking: Nightclubs and Lotteries

Suppose at door to nightclub you are greeted by Maurice Allais who insists that you choose between two lotteries, A and B' with returns $\tilde{z}_1^A, \tilde{z}_1^B$ (losses not to exceed pocket cash)

Assume choice completely unanticipated

Assume that no further lotteries at nightclubs are expected in the future

highest possible short-run utility comes from consuming entire outcome of lottery, temptation utility calculated as
$\overline{u}(x_1, c_1^*) = \max\{Eu(x_1 + \tilde{z}_1^A, c_1^*), Eu(x_1 + \tilde{z}_1^B, c_1^*)\}$

where $\tilde{z}_1^j$ realization of lottery $j = A, B$

$\tilde{c}_1^j(z_1^j)$ consumption chosen contingent on realization of lottery *j*, self-control cost

$$\overline{g}(x_1, \tilde{c}_1^j, c_1^*) = g\Big(\max\{Eu(x_1 + \tilde{z}_1^A, c_1^*), Eu(x_1 + \tilde{z}_1^B, c_1^*)\} - Eu(\tilde{c}_1^j, c_1^*)\Big)$$

random unanticipated income $\tilde{z}_1^j$ at nightclub

z_1 realized income, short-run self constrained to consume $c_1 \leq x_1 + z_1$.

Period 2 wealth given by

$$w_2 = R(s_1 + x_1 + z_1 - c_1) = R(w_1 + z_1 - c_1) .$$

utility of long-run self starting in period 2 given by solution of problem without self control

$$U_2(w_2) = \frac{\log(w_2)}{1-\delta} + K$$

$\tilde{c}_1$ optimal response to unanticipated income $\tilde{z}_1$

overall objective of long-run self to maximize

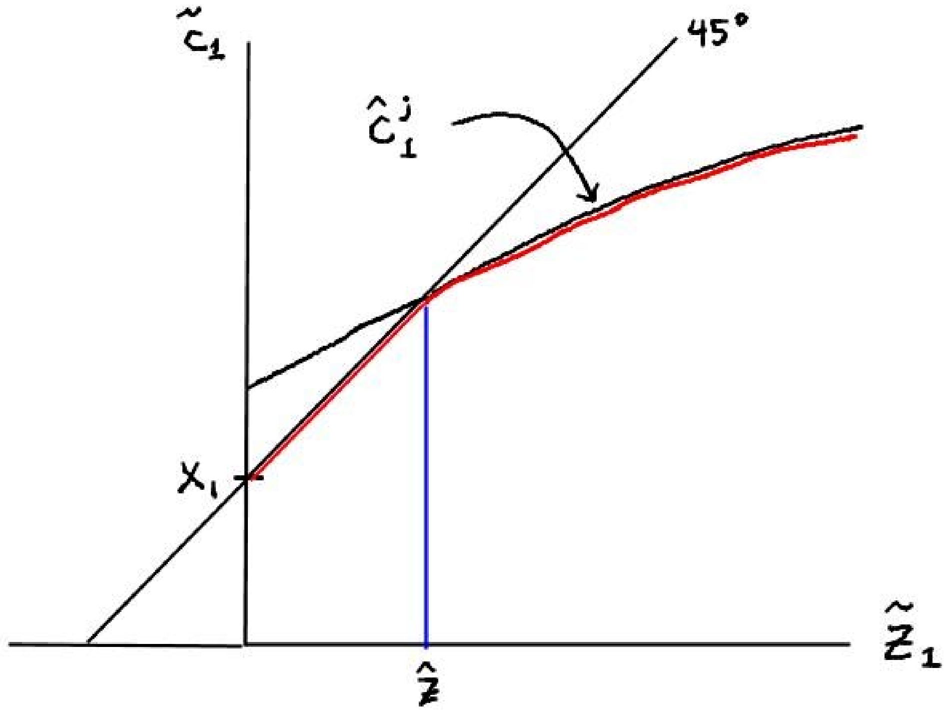
$$Eu(\tilde{c}_1^j, c_1^*) - \overline{g}(x_1, \tilde{c}_1^j, c_1^*) + \frac{\delta}{(1-\delta)} E\log(w_1 + \tilde{z}_1^j - \tilde{c}_1^j) + K$$

marginal cost of self-control:

$$\gamma_1 = g'(\overline{u} - Eu(\tilde{c}_1, c_1{*}))$$

can show objective function globally concave w.r.t. first period consumption

“consumption function” $\tilde{c}_1^j = \min(\hat{c}_1^j(\gamma^j)(z_1^j), x_1 + z_1^j\}$



Making Evening's Plans: Pocket Cash and Choice of Club

Simple case: you didn't anticipate Maurice Allais, no self-control problem at bank, so choose $c_1^* = x_1$ and plan to spend all pocket cash in nightclub of choice. Problem purely logarithmic, so solution to choose $x_1 = (1 - \delta)w_1$

Basic Calibration

Department of Commerce Bureau of Economic Analysis, real per capital disposable personal income in December 2005 was $27,640. will use three levels of income $14,000, $28,000, and $56,000.

do not use currently exceptionally low savings rates, but higher historical rate of 8% (see FSRB [2002])

gives us consumption from income; then wealth is consumption divided by subjective interest rate

pocket cash

expenditures not subject to temptation: housing, durables, and medical expense

adjust basic model of utility by assuming it is separable (and logarithmic) between "durable" consumption c^D that not subject to temptation, with weight on "tempting" or "nightclub" consumption equal to "temptation factor" τ

NIPA Q4 2005

personal consumption expenditure $8,927.80.

$1,019.60 durables, $1,326.60 housing, and $1,534.00 medical care

gives temptation factor $\tau = 0.57$.

subjective interest rate real market rate, less growth rate of per capita consumption

Shiller [1989]

average growth rate of per capita consumption has been 1.8%

average real rate of returns on bonds 1.9%

real rate of return on equity 7.5%

use three values: 1%, 3%, and 5%

prefer 1% as that is what Gabaix and Laibson use in a compatible model of lock-in that is consistent with the equity premium puzzle time horizon of short-run self

most plausible period based on evidence from the psychology literature seems to be about a day

mental accounting

Percent interest *r*		$y_1 =$ 14K		$y_1 =$ 28K		$y_1 =$ 56K	
annual	daily	w_1	x_1	w_1	x_1	w_1	x_1
1	.003	1.3M	20	2.6M	40	5.2M	80
3	.008	.43M		.86M		1.7M	
5	.014	.30M		.61M		1.2M	

reasonable range of self control costs

how does marginal propensity to consume “tempting” goods change with unanticipated income?

Older literature on permanent income hypothesis

study using 1972-3 CES data Abdel-Ghany et al [1983]

examine marginal propensity to consume semi- and non-durables out of windfalls

windfalls = “inheritances and occasional large gifts of money from persons outside family...and net receipts from settlement of fire and accident policies”

windfalls less than 10% of total income MPC is 0.94

windfalls more than 10% of total income MPC of 0.02

reason for 10% unclear so take it as a general indication in our model consumption cutoff between high MPC of 1.0 and low MPC of order $\tau(1-\delta)$ given by

$$\hat{c} = (x_1)^{\frac{\rho-1}{\rho}}\left[\frac{\tau(1-\delta)}{\delta}(1+\gamma)[w_2]\right]^{1/\rho}$$
$$\approx x_1(1+\gamma)^{1/\rho}$$

Note that γ here is $g'(0)$: since all gains are spent below cutoff – so there is no cost of self-control

$$\mu_1 = (1+\gamma_1)^{1/\rho}$$

cutoff relative to income, will report this rather than marginal cost of self-control

10% of annual income $\mu_1 \approx 70$

Rabin Paradox

A $(.5 : -100, .5 : 105)$

B to get nothing for sure

Many people choose B

However, this implies also rejecting lose \$4,000 win \$635,670

For large gambles, we have logarithmic preferences, so that isn't a problem

What about rejecting the small gamble

Our model predicts all the income should be spent, so individual is risk averse with wealth equal to pocket cash and risk aversion coefficient ρ

A logarithmic consumer with pocket cash of \$2100 would reject this gamble, so not much to see here

Rabin gamble $(.5 : -100, .5 : 105)$ chosen to make a point

Actual laboratory risk aversion much greater

Holt and Laury [2002]

subjects given a list of ten choices between an A and a B lottery.

Option A		Option B		Fraction Choosing A			
$2.00	$1.60	$3.85	$0.10	1X	20X	50X	90X
0.1	0.9	0.1	0.9	1.0	1.0	1.0	1.0
0.2	0.8	0.2	0.8	1.0	1.0	1.0	1.0
0.3	0.7	0.3	0.7	.95	.95	1.0	1.0
0.4	0.6	0.4	0.6	.85	.90	1.0	1.0
0.5	0.5	0.5	0.5	.70	.85	1.0	.90
0.6	0.4	0.6	0.4	.45	.65	.85	.85
0.7	0.3	0.7	0.3	.20	.40	.60	.65
0.8	0.2	0.8	0.2	.05	.20	.25	.45
0.9	0.1	0.9	0.1	.02	.05	.15	.40
1.0	0.0	1.0	0.0	.00	.00	.00	.00

Yellow 50%, blue 85%

Paid one row picked at random, then can turn in payment for a higher value lottery

stakes plus pocket cash well below our estimate of $\hat{c}$

so fit a CES with respect to our pocket cash estimates of $21, $42, $84, $155, $310 and $620, in each case estimating value of ρ that would leave a consumer indifferent to given gamble

		Pocket Cash x_1					
		$20	$40	$80	$141	$282	$563
ρ 50th		1.06	1.3	1.8	2.4	3.8	6.5
ρ 85th		2.1	2.8	4.3	6.3	12	22

Allais Paradox

Kahneman and Tversky [1979] version of Allais Paradox

A_1 $(.01:0,.66:2400,.33:2500)$

B_1 2400 for certain

$A_2 = (.33:0,.34:2400,.33:2500)$

$B_2 = (.32:0,.68:2400)$

paradox: choose B_1 and A_2

base case

annual interest rate $r = 1\%$

annual income is \$28,000

wealth is \$860,000

short-run self's horizon a single day

pocket cash and chosen nightclub are $x_1 = c_1^* = 40$.

linear cost of self-control

$\Gamma = 0 \;\; {\gamma_1}^A = {\gamma_1}^B = \gamma$

solve for numerically unique value ${\gamma_1}^*$ (${\mu_1}^* = 9.6$)

such that indifference between A and B (same in scenario 1 and scenario 2 because of linearity)

quadratic cost of self-control

from decision problem

$$\gamma_1{}^A = \gamma + \Gamma\Big(\overline{u}_1 - Eu(\tilde{c}_1^A(\gamma_1{}^A))\Big)$$

$$\gamma_1{}^B = \gamma + \Gamma\Big(\overline{u}_1 - Eu(\tilde{c}_1^B(\gamma_1{}^B))\Big)$$

solve to find solution near γ_1 *

income	$x_1 = c_1 *$	ρ	$\mu_1(\gamma_1 *)$	γ	Γ	$\mu_1(\gamma_1^A[1])$	$\mu_1(\gamma_1^B[1])$	$\mu_1(\gamma_1^A[2])$	$\mu_1(\gamma_1^B[2])$
14000	20	1.06	19.4	21.6	0.473	19.60	19.59	19.39	19.38
14000	20	2.10	7.19	26.5	23.9	7.35	7.20	6.76	6.61
28000	40	1.30	9.57	15.35	1.61	9.76	9.73	9.41	9.39
28000	40	2.80	4.03	10.4	37.3	4.16	4.05	3.82	3.71
56000	80	1.80	4.79	13.6	1.45	4.90	4.89	4.78	4.77
56000	80	4.20	2.45	2.57	58.4	2.50	2.42	2.34	2.26

original Allais paradox

A_1 $(.01 : 0, .89 : 1{,}000{,}000, .1 : 5{,}000{,}000)$

B_1 1,000,000 for certain, paradoxical choice B_1.

$A_2 = (.90 : 0, .10 : 5{,}000{,}000)$ paradoxical choice being A_1

$B_2 = (.89 : 0, .11 : 1{,}000{,}000)$

income	$x_1 = c_1$	ρ	$\mu_1(\gamma_1{*})$	γ	Γ	$\mu_1(\gamma_1^A[1])$	$\mu_1(\gamma_1^B[1])$	$\mu_1(\gamma_1^A[2])$	$\mu_1(\gamma_1^B[2])$
28000	40	1.3	10500	169000	1.55	10500	10500	10500	10500
28000	40	2.8	130	431000	8250	149.1	103.6	148.7	103.0

Cognitive Load

experiment by Benjamin, Brown and Shapiro [2006] shows the impact of cognitive load on risk preferences

Chilean high school juniors

choices about uncertain outcomes both under normal circumstances and under the cognitive load of having to remember a seven digit number while responding

key fact: students responded differently to choices involving increased risk when the level of cognitive load was changed

real not hypothetical reward; safe option was 250 pesos

paid in cash at end of session

1 $US= 625 pesos; average weekly allowance including lunch money around 10,000 pesos

Fraction Choosing Risky Option

50-50 gambles

650/0 versus 250		650/0 versus 300/200	
No load (13)	Load (21)	No Load (15)	Load (22)
70%	24%	73%	68%

Parameters needed to explain Chilean data

r	income	w_1	$x_1 = c_1^*$	ρ	$\mu_1(\gamma_1 *)$ 1	$\mu_1(\gamma_1 *)$ 2
5%	1.6K	29K	2.29	1.06	24.66	24.71

Key fact: $\mu *$ in second scenario higher than in first: the risky “safe” option *lowers* the marginal cost of self-control

Note that the self-control parameters are consistent with the Allais calibration