

Seminar 5: Decision Making Under Risk and Uncertainty

This seminar will explore decision making under risk and uncertainty. Decision making under uncertainty refers to situations where you are faced with a choice between alternatives for which the probabilities associated with the expected outcomes are unknown. By contrast, decision making under risk refers to situations where you are faced with a choice between alternatives for which the probabilities of the different outcomes are meaningful and known. I will begin by describing the component of the standard model that is relevant in these decision making contexts—namely **Expected Utility Theory (EUT)**. Our three speakers will then report some important violations of this theory (viz. framing effects, the phenomenon of mental accounting, and the Allais and Ellsberg paradoxes). I will then describe an important behavioural economic alternative to EUT, known as **Prospect Theory** (Kahneman & Tversky, 1979).

Background reading for all students

It is unlikely that you will be able to cover all of the background reading prior to the seminar. I recommend reading the chapters by Agner (2012) and, time permitting, one of either Wilkinson and Klaes (2012) or Cartwright (2011). You get extra brownie points for reading the original Prospect Theory paper of Kahneman and Tversky (1979) 😊.

Agner, E. (2012; Chapters 6 & 7). *A course in behavioural economics*. Palgrave Macmillan: New York

Cartwright, E. (2011; Chapter 3). *Behavioral economics*. Routledge: New York.

Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. *Econometrica*, 47, 263-291.

Wilkinson, N., & Klaes, M. (2012). *An introduction to behavioural economics*. Palgrave Macmillan: New York.

Readings for speakers

Speaker 1: Framing effects in decision making under risk

Kahneman, D., & Tversky, A. (1986). Rational choice and the framing of decisions. *The Journal of Business*, 59, 251-278.

Tversky, A., & Kahneman, D. (1981). The framing of decisions and the psychology of choice. *Science*, 211, 453-458.

Speaker 2: Bundling and mental accounting

Thaler, R. (1980). Toward a positive theory of consumer choice. *Journal of Economic Behavior and Organization*, 1, 39-60.

Thaler, R. (1985). Mental accounting and consumer choice. *Marketing Science*, 4, 199-214.

Speaker 3: The Allais and Ellsberg paradoxes

The original paper on the Allais problem is written in French but does have a brief summary written in English:

Allais (1953). Le Comportement de l'Homme Rationnel devant le Risque: Critique des Postulats et Axiomes de l'Ecole Americaine. *Econometrika*, 21, 503-506.

The problem is summarised in Chapter 7 of Agner (2012; see below) and in the following book chapter:

Ellsberg, D. (1961). Risk, ambiguity and the savage axioms. *The Quarterly Journal of Economics*, 75, 643-649.