

## **Syllabus for Econ 226: Behavioral Economics (preliminary)**

**Summer 2009**

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Office hours: TBA

This course is an introductory course to behavioral economics. It has two main objectives. First, review the main evidence on violations of classical economic assumptions that has been provided by recent psychological and experimental-economics, neuroeconomic studies, and other research. Second, study economic models that incorporate these new evidence, as well as its applications. The models include decision-making under uncertainty, cognitive dissonance, mental accounting, hyperbolic discounting and others as time permits. Applications comprise savings for retirement, insurance, the equity premium puzzle, investor trading behavior, gym membership, and labor economics.

The prerequisites for this course are Math 118, Econ 150 and Econ 161 or their equivalents.

Students are required to read papers assigned for each class (1 or 2 per class) that will be drawn from the list below. The following recommended books contain many of the papers we will discuss:

Choices, Values, and Frames (2000), edited by Daniel Kahneman and Amos Tversky

Heuristics and Biases: The psychology of Intuitive Judgment (2002), edited by Thomas Gilovich, Dale Griffin, and Daniel Kahneman

Advances in Behavioral Economics (2004), edited by Colin F. Camerer, George Lowenstein, and Matthew Rabin

There will be two problem sets, midterm exam and a final exam. The problem sets counts for 25 percent of the grade, the midterm for additional 25 percent, and the final exam for 50 percent of the grade.

### **Introduction (Week 1)**

### **Decision-Making under Risk and Uncertainty (Week 1+2)**

- (1) The expected utility model
- (2) Reference Dependence and Loss-Aversion
- (3) Mental Accounting and the Endowment Effect
- (4) Prospect Theory
- (5) Application: Labor Supply of Cab Drivers in NYC, Real-Estate in Boston.

### **Beliefs Biases (Week 3)**

- (1) Affective Decision-Making
- (2) Optimal Expectations
- (3) Neuroeconomics research
- (4) Applications: insurance, portfolio and savings

## **Time Discounting and Incentives (Week 4)**

- (1) Hyperbolic discounting
- (5) Neuroeconomics research
- (2) Application: Gym Membership and climate change
- (3) The W effect

## **Behavioral Finance (Week 5)**

- (1) Application: The equity premium puzzle
- (2) Noise traders and limits to arbitrage
- (3) Over- and under-reaction
- (4) Investors trading behavior

## **Reading:**

### **Introduction (Week 1)**

Camerer, C. (1995) "Individual Decision Making" in J. Kagel and A. Roth (eds.) *Handbook of Experimental Economics*, Princeton University Press.

Kahneman, D. and A. Tversky (1974) "Judgment Under Uncertainty: Heuristics and Biases" *Science*, 185, pp. 1124-1131.

Rabin, M. (1998) "Psychology and Economics", *Journal of Economic Literature*, pp. 11-46.

Thaler, R. (1988) "The Winners Curse" *Journal of Economic Perspectives* 2(1), pp. 191-202.

### **Decision-Making under Risk and Uncertainty (Week 1+2)**

Camerer, C., L Babcock, G. Lowenstein and R. Thaler (1997) "Labor Supply of New York City Cab Drivers: One Day at a Time." *The Quarterly Journal of Economics*, pp. 407-441.

Kahneman, D. and A. Tversky (1979) "Prospect Theory: An Analysis of Decision under Risk." *Econometrica*, pp. 263-292.

Kahneman, D., J. Knetsch and R. Thaler (1991) "The Endowment Effect, Loss Aversion, and Status Quo Bias" *Journal of Economic Perspectives*, 5(1), pp. 193-206.

Rabin, M. and R. Thaler (2001) "Risk Aversion" *Journal of Economic Perspectives*, 15(1), pp. 219-232.

Thaler, R. (1990) "Mental Accounting Matters", *Journal of Behavioral Decision Making*.

### **Beliefs Biases (Week 3)**

Bracha, A. and D. Brown (2008) "Affective Decision-Making", Yale University.

Kahneman, D. (2002) "Maps of Bounded Rationality: A Perspective on Intuitive Judgment and Choice", Nobel Prize Lecture, December.

Koszegi, B and Rabin, M., "Reference-Dependent Consumption Plans" *American Economic Review*, forthcoming, <http://elsa.berkeley.edu/~botond/drp.pdf>

Shiv, B. and A. Fedorikhin (1999) "Heart and Mind in Conflict: The Interplay of Affect and Cognition in Consumer Decision Making," *The Journal of Consumer Research*, pp. 278-292.

Thaler, R. and H. Shefrin (1981) "An Economic Theory of Self-Control" *The Journal of Political Economy*, pp. 392-406.

#### **Time Discounting and Incentives (Week 4)**

George A. Akerlof (1991) "Procrastination and Obedience," *The American Economic Review Papers and Proceedings*, pp. 1-19.

David Laibson (1997) "Golden Eggs and Hyperbolic Discounting," *The Quarterly Journal of Economics*, pp. 443-477.

McClure, S., D. Laibson, G. Loewenstein, and J. Cohen (2004) "Separate Neural Systems Value Immediate and Delayed Monetary Rewards" *Science*, pp. 503 – 507.

Della Vigna, S. and U. Malmendier (2006) "Paying Not To go To The Gym" *The American Economic Review*, pp. 694-719.

Uri Gneezy, and Aldo Rustichini (2000) "Pay Enough or Don't Pay at All," *The Quarterly Journal of Economics*, pp. 791-810.

#### **Behavioral Finance (Week 5)**

Barber, B. and T. Odean (2000) "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors", *Journal of Finance*, 55, pp. 773-806.

Barberis, N. and R. Thaler (2003) "A Survey of Behavioral Finance", in g. Constantinides, M. Harris and R. Stulz (eds.), *Handbook of the Economics of Finance*, North Holland.

De Bondt W. and R. Thaler (1986) "Does the Stock Market Overreact?", *Journal of Finance*, XL(3), pp. 793-807.

De Long, B., A. Shleifer, L. Summers and R. Waldmann (1990) "Noise Trader Risk in Financial Markets", *Journal of Political Economy*, 98(4), pp. 703-738.

Odean, T. (1998) "Are Investors Reluctant to Realize Their Losses?", *Journal of Finance*, 53, pp. 1775-1798.

Shlomo B. and R. Thaler (1995) "Myopic Loss Aversion and the Equity Premium Puzzle", *Quarterly Journal of Economics*, 110, pp. 73-92.