Willingness-to-pay for Warnings: Main Tables

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Research Question

- How much do people value alerts (signals) about potential preventable threats?
- How do signal's probabilistic characteristics affect the willingness-to-pay for it and the welfare gains from using it?
- Applications:
  - Natural disaster warnings (tornados, floods, earthquakes)
  - Medical tests for treatable conditions
  - Investing in research on likelihood of catastrophic events (rogue AI, global warming, pandemics)
- Note: most real-life applications provide little practice with using the signal

Overview of the Experiment

- An insurance experiment:
  - Two states of the world: bad ($\omega = 1$) and good ($\omega = 0$)
  - Probability of a bad state is $P(\omega = 1) = \pi$
  - Bad state $\implies$ loss of $\$L$
  - A perfectly protective insurance can be purchased for $\$c$
- Subject can purchase a signal s before purchasing the insurance:
  - A signal is characterized by its true-positive $(P(s = 1|\omega = 1))$ and true-negative rates $(P(s = 0|\omega = 0))$

Research objective

How do signal characteristics affect the WTP?

- Theoretically, what should be the WTP for a signal?
- If bad states are a priori rare ($\pi L << c$) $\implies$ never protect without a signal
- The theoretical WTP b for an expected utility maximizer given a signal s is a solution b^* to the following:

$$P(s=1)u(Y_0 - b^* - c) + \pi P(s=0|\omega=1)u(Y_0 - b^* - L) +$$

$$+(1-\pi)P(s=0|\omega=0)u(Y_0 - b^*) = (1-\pi)u(Y_0) + \pi u(Y_0 - L)$$

- A risk-neutral agent then pays:

$$b^* = \pi(1 - P(s=0|\omega=1))L - P(s=1)c$$

- The formulas become more complicated if subjects can protect without a signal (bad state are not rare enough)
- The theoretical WTP b for an expected utility maximizer given a signal s is a solution b^* to the following:

$$P(s=1)u(Y_0-b^*-c)+\pi P(0|1)u(Y_0-b^*-L)+(1-\pi)P(0|0)u(Y_0-b^*) =$$

$$= \min[(1-\pi)u(Y_0)+\pi u(Y_0-L), u(Y_0-c)]$$

- A risk-neutral agent then pays:

$$b^* = \min[\pi L, c] - \pi(1-P(s=0|\omega=1))L - P(s=1)c$$

Hypotheses

1. Conditional on the signal's value for risk-neutral subjects, false positive and false negative rates reduce the perceived value of the signal (WTP)
    - *The opposite is true: subjects underreact to false positive and false negative rates and overpay for bad signals*
2. Conditional on the signal's value for risk-neutral subjects, false positive and false negative rates increase expected costs
    - *No: FP and FN rates have no significant effects on costs besides their predicted theoretical effect*
3. Extra: how much of these disrepancies result from belief updating issues or risk aversion?

Risk Aversion Measurement

- Measure risk aversion based on blind protection choices:
  - Exclude obs from subjects switching back and forth
  - The lowest probability for which a subject chooses to protect is π^*
  - Calculate their coefficient of relative risk aversion θ as the solution to the following equation:

$$\pi^* u(Y_0 - L; \theta) + (1 - \pi^*) u(Y_0; \theta) = u(Y_0 - c; \theta)$$

  - Where $u()$ is the CRRA utility function:

$$u(x; \theta) = \frac{x^{1-\theta} - 1}{1 - \theta}$$

- Note: risk lovers have $\theta < 0$

CRRA Estimates

- Most subjects are moderately risk averse:

Probability (π^*)	θ	N
Always protect	>2	1
0.1	2	2
0.15	1.216	7
0.2	0.573	17
0.25	0	7
0.3	-0.539	5
Never protect	$<$-0.539	8

- Note:
  - There are 18 subjects (out of 65) switching multiple times
  - Can use more sophisticated methods to measure risk aversion for those

WTP for the Signal

- Theoretical value of signal for risk-neutral subject:

$$b^* = \underbrace{\min[\pi L, c]}_{\text{BP costs}} - \underbrace{\pi(1 - P(s = 0|\omega = 1))L}_{\text{False neg. costs}} - \underbrace{P(s = 1)c}_{\text{Protection costs}}$$

- Two potential approaches:

  1. Regress the discrepancy between WTP V and theoretical value b^*:

  $$V - b^* = \alpha_0 + \alpha_1 \text{FN costs} + \alpha_2 \text{Prot. costs} + \epsilon$$

  2. Regress WTP directly on its components and account for censoring at 0:

  $$V = \min[0, \beta_0 + \beta_1 \text{FN costs} + \beta_2 \text{Prot. costs} - \beta_3 \text{BP costs} + \gamma]$$

  3. Note: protection costs include costs due to false positive signals

WTP for the Signal (Approach 1)

- Coefficient sign. different from zero is an anomaly: people overpay for bad signals

Figure: WTP for Information (Discrepancy)

	(1) All	(2) Risk-averse	(3) Risk-loving	(4) Switchers
Prot. costs	.205**	.372**	-.0232	.183
	(2.1)	(2.4)	(-0.1)	(1.0)
False neg. costs	.36***	.259**	.519***	.341**
	(4.4)	(2.0)	(3.1)	(2.6)
Constant	-.543***	-.58*	-.54	-.441
	(-2.8)	(-1.9)	(-1.5)	(-1.2)
Observations	390	156	126	108
Adjusted R^2	0.05	0.05	0.07	0.04

t statistics in parentheses

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

WTP for the Signal (Approach 2, Tobit Estimation)

- Coefficient should **differ from one** in abs. value to show an anomaly (ignore stars for now)

Figure: WTP for Information (Tobit Estimation)

	(1) All	(2) Risk-averse	(3) Risk-loving	(4) Switchers
model				
BP costs	.562***	.63***	.557***	.453**
	(5.8)	(3.9)	(3.3)	(2.5)
Prot. costs	-.342**	-.199	-.561**	-.321
	(-2.5)	(-0.9)	(-2.3)	(-1.3)
False neg. costs	-.398***	-.533***	-.214	-.395**
	(-3.9)	(-3.4)	(-1.0)	(-2.5)
Constant	.141	-.115	.0424	.704
	(0.4)	(-0.2)	(0.1)	(1.2)
sigma				
Constant	1.78***	1.81***	1.84***	1.59***
	(24.8)	(15.5)	(12.9)	(13.4)
Observations	390	156	126	108
AIC	1413.41	575.80	452.26	392.50

t statistics in parentheses

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WTP for the Signal (Risk Aversion)

- Explaining the discrepancy between WTP and value with risk aversion:

Figure: WTP for Information (different risk aversion)

	(1) Heterogeneous	(2) $\theta = 0.5$	(3) $\theta = 1.0$	(4) $\theta = 1.5$
BP costs	-.284***	-.39***	-.157**	.165**
	(-2.7)	(-5.3)	(-2.1)	(2.2)
Prot. costs	.726***	.766***	.686***	.515***
	(4.8)	(6.8)	(6.1)	(4.6)
False neg. costs	.602***	.667***	.743***	.775***
	(5.1)	(7.7)	(8.6)	(8.9)
Constant	-.54	-.277	-1.15***	-2.21***
	(-1.5)	(-1.1)	(-4.7)	(-9.2)
Observations	228	390	390	390
Adjusted R^2	0.14	0.17	0.22	0.30

t statistics in parentheses

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Actual Costs vs Theoretical Costs

- Calculate actual costs based on decisions made in the Informed Protection treatment and actual posterior probabilities of losses.
- Each reported participant's strategy s is a tuple of numbers (r_w, r_b) representing protection responses correspondingly to white and black hints
- Then the expected cost of each decision are:

$$EC(s) = \pi(P(0|1)(1 - r_w) + P(1|1)(1 - r_b))L + P(s = 1)c$$

$$+(P(s = 0)r_w + P(s = 1)r_b)c$$

- Regress expected costs on minimal theoretical costs and other signal characteristics

Actual Costs vs Theoretical Costs

Figure: Actual Exp. Costs vs Theoretical Costs

	(1) OLS	(2) OLS	(3) OLS	(4) FE	(5) FE	(6) FE
Optimal exp. costs	.958***	.967***	.956	.987***	1.04***	.938***
	(9.2)	(8.2)	(1.6)	(17.5)	(6.3)	(11.4)
Prior prob.		.102	.0367		.632	
		(0.1)	(0.0)		(0.3)	
False neg. rate			-.106			-.111
			(-0.0)			(-0.1)
False pos. rate			.0229			-.841
			(0.0)			(-0.4)
Constant	-1.07***	-1.08**	-1.07	-1***	-1.06***	-.999***
	(-2.8)	(-2.2)	(-1.6)	(-7.9)	(-4.9)	(-8.4)
Observations	390	390	390	390	390	390
Adjusted R^2	0.10	0.10	0.10	0.11	0.11	0.11

t statistics in parentheses

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Additional Complementary Tables

1. Factors affecting informed protection responses
2. The effect of beliefs on informed protection
3. How accurate are their beliefs?
4. Decomposition of belief updating: priors vs signals

Informed Protection: Determinants

Figure: Informed Protection

	(1) All	(2) All	(3) Smart	(4) Smart
Informed protection				
Posterior prob.	2.14***	.668**	2.29***	.708**
	(14.0)	(2.5)	(12.7)	(2.4)
Prior prob.		1.32***		1.34***
		(3.4)		(3.0)
Gremlin says Black		1.32***		1.43***
		(6.3)		(6.2)
Constant	-.702***	-1.12***	-.761***	-1.2***
	(-11.0)	(-8.6)	(-10.8)	(-8.2)
Observations	780	780	636	636
AIC	774.36	736.93	608.24	573.32

t statistics in parentheses

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Informed Protection: Do Subject's Beliefs Matter?

Figure: Informed Protection: Response to Reported Beliefs

	(1) All	(2) All	(3) Smart
Informed protection			
Belief	2.49***	1.57***	1.71***
	(13.8)	(7.0)	(6.8)
Posterior prob.		1.22***	1.23***
		(6.9)	(5.8)
Constant	-.887***	-.985***	-1.07***
	(-12.0)	(-12.8)	(-12.7)
Observations	780	780	636
AIC	767.11	720.08	558.84

t statistics in parentheses

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Belief Updating: Correlation

Figure: Belief Elicitation: Belief vs Posterior

	(1) All	(2) Not_honest	(3) Good quiz
Posterior prob.	.669***	.711***	.523***
	(29.0)	(29.1)	(15.7)
Constant	.151***	.147***	.226***
	(16.2)	(14.1)	(17.8)
Observations	780	636	520
Adjusted R^2	0.57	0.61	0.39

t statistics in parentheses

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Belief Updating: Decomposition

- Posterior probability $\mu = P(B|S = x)$ that the ball is black conditional on a hint $S = x$ can be written as:

$$\ln\left(\frac{\mu}{1-\mu}\right) = \lambda_0 + S_B + S_W$$

- With $\lambda_0 \equiv \ln(p/(1-p))$ representing (transformed) prior beliefs
- And S_B, S_W describing the effect of new evidence:

$$S_B \equiv I(S = B)\ln(P(s = B|B)/P(s = B|W))$$

$$S_W \equiv I(S = W)\ln((1 - P(s = B|B))/(1 - P(s = B|W))$$

Belief Updating: Decomposition

Figure: Belief Elicitation: Decomposition

	(1) OLS	(2) FE	(3) Smart, FE
lt_prior	.162**	.132**	.141**
	(2.0)	(2.6)	(2.3)
signalB	.477**	.937***	1.04***
	(2.2)	(5.0)	(4.6)
signalW	.46**	0	0
	(2.5)	(.)	(.)
Constant	-.0878	-.595***	-.637***
	(-0.4)	(-5.3)	(-4.8)
Observations	172	172	140
Adjusted R^2	0.26	0.31	0.31

t statistics in parentheses

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