**Identification of the Preference Effect**

John Vandivier

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**1 Introduction**

Prices, price effects, income, and income effects are all foundational to theoretical and applied economics. There is a third key variable in theory without which no economic problem may be solved, but this variable is routinely exempted from inclusion in applied work. This paper presents experimental evidence to the effect that preferences and preference effects are key independent determinants of demand.

Hicks and Allen (1934) presented a contribution to price theory and the neoclassical approach to microeconomic problem solving. This paper is only one of many illustrating the wide use of a particular microeconomic approach. Shortly thereafter, Hicks and Allen published a follow up piece (1934) called *A Reconsideration of the Theory of Value. Part II*. In this paper we already see an emphasis on price-elasticity and income effects. There is no consideration about the possibility of a change to demand in a situation of constant prices. The thesis of this paper is that such a consideration is needed.

The second writing from Hicks and Allen elaborated and extended the mathematical approach of the first paper. The second paper did not have any illustrations. In the microeconomic literature today it is uncommon to find explicit illustrations in the manner of their first writing, but microeconomic models in the literature today continue to follow the mathematical approach of the second writing.

Almeida et al (2004) and Foster et al (2016) are examples of modern microeconomic analyses. These papers assume a constrained optimization approach consistent with the earlier work by Hicks and Allen. There is one notable difference, which is that the modern papers model firm behavior while Hicks and Allen proposed their model as a representation of individual choice.

One important difference is that the modern papers do not model firms as maximizing subjective utility. Instead of maximizing utility the firms maximize profit or dividends. This is an example of method which this paper is meant to criticize. Firms are organizations of people and a realistic model of firm behavior must ultimately refer to the preferences of individuals.

As Von Mises (2016) recognized early on, the removal of preferences from an economic problem causes the problem to fundamentally transform into a simple technical or engineering problem. This removes the ability of any optimization to reflect an improvement to human welfare. Instead, solving a technical problem simply indicates that output is maximized for a given level of expenditure. Mises stated, referring to the socialists:

There hovers before the holders of this tenet a muddled conception of technical rationality, which stands in antithesis to economic rationality, on which also they are not very clear. They are wont to overlook the fact that "all technical rationality of production is identical with a low level of specific expenditure in the processes of production." They overlook the fact that technical calculation is not enough to realize the "degree of general and teleological expediency" of an event; that it can only grade individual events according to their significance; but that it can never guide us in those judgments which are demanded by the economic complex as a whole.

Admittedly, full modelling of each agent in an organization is a difficult task and assuming profit maximization is empirically useful. The ideal complexity of a model is such that the marginal benefit of the model equals the marginal cost of the creation and use of that model, so it does not follow that maximum complexity is ideal. That being said, this paper will highlight a case where an extended model is empirically feasible. The contention of this paper is that analysts will often, not always, find that the inclusion of preference data is more beneficial than costly. The inclusion of such information also allows the analyst to better make stronger claims about welfare rather than claims only about productivity.

Figure 1 illustrates how the preference effect can be isolated in theory.

Essentially, when demand for some good changes relative to demand for another good, ceteris paribus, the explanation is attributed to a shift in the indifference curve. The indifference curve captures many components of the economy and it can be considered to represent the ecological preference of an individual. The ecological preference stands in contrast to what can be considered a pure preference effect.

Consider that Joe likes to smoke cigarettes, but his friends think that this is a bad habit and they exert a social pressure on Joe not to engage in this behavior. If Joe values the opinions of his friends he is expected to voluntary consume fewer cigarettes than he otherwise would. It may be convenient to consider such social pressure to be an indirect cost, but in fact it is better represented as a transformation to the indifference curve rather than a change to prices. Joe’s preference for cigarettes in the absence of this social pressure is his pure preference, while his preference conditional on social pressure is his ecological preference.

Social pressure is only one example of the many factors captured in an indifference curve. Another factor which will later be included in the model is gender. There are particular products which women systematically prefer to consume more frequently than men. Such a fact is better modeled as a difference in presences rather than a difference in costs.

While the microeconomic graphs shown in his earlier piece are infrequent in the modern literature, most economic models are still mathematically laid out using his mathematical approach, and that

The remainder of the paper proceeds beginning with a review of the model in section 2. Section 3 reviews the results, and section 4 concludes.

Organization of paper:

1. Intro
   1. Thesis: “the preference elasticity of demand is a key economic parameter which has been underdeveloped in both theory and applied work”
2. How can we say it is underdeveloped?
   1. Because there are non-exhausted gains to accuracy which can be inexpensively obtained.
   2. That is, the current situation is remediable and thereby inefficient under the TCE framework of Oliver Williamson http://www.nobelprize.org/nobel\_prizes/economic-sciences/laureates/2009/williamson\_lecture.pdf
   3. These gains do not exist under a Stigler-Becker framework, but their framework contains theoretical error. We review various fields of economics and argue that the Stigler-Becker framework is requires augmentation in a specified way.
      1. Why might their approach be highly useful? Variable elasticities are hard and lots of benefit can be had without them.
3. We present the specified alternative
   1. We refine their approach by generalizing it a bit, allowing their approach as one kind of contextually useful simplification, but also pointing out that another approach is superior in many cases, continuing the mainstream “many tools” approach to economics.
   2. Plausibility of information-preference; science of happiness amnesiac experiments by Dan Gilbert https://www.youtube.com/watch?v=c-4flnuxNV4
4. We apply the specified alternative
   1. Survey-as-experiment, or
   2. Regression discontinuity design, or
   3. (chancy) diff-in-diff or synthetic control
   4. Analyze results: Did preferences change?

Paper

This paper argues that the preference elasticity of demand is a key economic parameter which has been underdeveloped in both theory and applied work. In the course of making the central argument, a few supplemental arguments are presented. First, it is argued that several fields of economics support a specified model of preference-based explanations for changes to demand. Second, it is argued under the specified model that the information context of a transaction is captured in the utility curve and is thereby indistinguishable from preference.

How can we say it is underdeveloped?

This is argued as a contributing factor to the widely acknowledged underperformance of the predictive power of mainstream economic models, while also acknowledging that such interdisciplinary comparisons of predictive power are underdeveloped and often inappropriately made themselves.

First, it is argued that the Stigler-Becker approach of non-admittance of preference-based explanations for changes to demand is a contextually useful methodological simplification rather than a generally optimal method or an accurate description of reality. Second, it is argued that several other fields of economics are compatible

By granting that the utility curve represents the information context and individual preference uno actu, the requirement to hold the information state constant while analyzing the preference elasticity of demand is removed. (Human Action, p335 for use of term uno actu).

In mainstream economics there are three key determinants of demand including income, relative prices, and preferences. No economic problem is solvable without these three inputs. Much of the theoretical and applied work has occurred with respect to prices. Price theory is a well-formed literature and the price elasticity of demand and supply are regularly calculated for all sorts of applied work.

The income effect has also been widely acknowledged as important, although it is frequently discussed as a side note in the course of price theory. The applied literature notes the empirical importance of income and the income elasticity of demand is regarded as useful in labor economics for theoretical and practical purposes. Income is also a well discussed parameter in the context of policy.

Preferences, at last, are taboo. Theorists readily admit the co-necessity of preferences to an equal footing with income and prices as a prerequisite to solving any economic problem, but over time it became a mainstream assertion that preferences do not change.

I argue that this assertion that preferences do not change was not in the original thought of Smith and the Classicals. I argue also that it has been defeated on empirical grounds by modern Bayesians, Experimentalists, and Behavioralists. I hypothesize tangentially that the stickiness of the Becker-Stigler approach of the exemption of preferences from explanation per *De Gustibus* is due to the fact that it is in fact a very useful applied simplification, although from their exposition it seems to have been their genuine view as opposed to a mere methodological point.

I note that the Austrians allowed for genuine heterogeneity of goals and preferences. It is both fully consistent with the Austrian focus on heterogeneity per se and also an implicit quality in particular of the heterogeneity of goals, which is recognized by that school.

necessary existence of preferences and the need for calculable operationalizations including willingness to pay, but preferences are treated historically as things which do not or cannot change.

Approaches:

1. Experiment / Natural experiment
2. Survey-as-experiment, since the treatment is information.
3. Discontinuous treatment

One possible explanation is that preference elasticity is usually non-numeric. It is usually a function. This makes it more difficult to use in a general way because comparisons are sensitive to the expression of the utility curve and a number of variations exist. In particular, for a comparison of coefficients to be valid there must be a similar treatment of the exponents in each utility curve. It is the non-linear nature of preference curves which makes estimation a bit more difficult in the first place, and comparison additionally difficult in the second place.

Criticisms:

1. Preferences explain everything and therefore they explain nothing.
   1. False.
   2. First this is a technically absurd statement and it seems difficult to explain how it ever became a recognizably common phrase. If preferences did explain everything then clearly they would still need to be studied. In fact, it would be the only subject worthy of study.
   3. Second, preferences don’t explain everything. As both theory and empirical evidence including experimental evidence show, a pure change in preference has a limited effect which is separable in theory and less so but still partly separable in practice from the other effects which necessarily exist to solve any economic problem: Income and price.
2. Preferences are the same for everyone
   1. De Gustibus
   2. False; per Caplan, identical twin studies
   3. Further critique from Cowen <http://www.sciencedirect.com/science/article/pii/016726818990067X>
3. Preferences are unobservable
   1. Landsburg’s price theory <https://mises.org/library/de-gustibus-non-est-disputandum>
   2. Simple preferences are not unobservable; the tangent is revealed through transaction. The broader curve can be estimated by simple survey or perhaps more precisely established with experiment.
   3. Statistics deal with unobservable all the time
   4. Mises specifically rules out the scientistic view that only observables matter
4. Preferences are the realm of psychology
   1. True, but that doesn’t exclude it from economics. There is some overlap between fields.

Is it just a framing effect? No. <https://en.wikipedia.org/wiki/Framing_effect_(psychology)>

Proposal: An Experimental Survey on the Preference Elasticity of Demand

John Vandivier

**Research Question**

The paper will test the hypothesis that the preference elasticity of demand is an important determinant of demand at the individual level.

**Importance**

Theorists readily acknowledge the importance of preferences as a determinant of demand. Indeed, preferences are co-equal with income and prices in that no microeconomic system is solvable without all three components of information. Despite consensus on theoretical centrality, empirical work on the preference elasticity of demand is nowhere to be found.

There are several reasons for the lack of empirical research on preferences. Influential thinkers in the transition of mainstream economics toward a focus on microfoundations [Stigler and Becker 1977] argued that preferences are fundamentally homogenous. While other scholars have since provided theoretical and empirical work suggesting otherwise [Caplan 2003], mainstream models present technical difficulty in the separation of effects and best practices for empirical measurement do not seem to be established.

This article contributes to the literature through advancing theoretical means of separating certain effects, noting the limits of the possible separation of effects, the presentation of an experimental design which may measure such parameters, and the realization of some measurement of those parameters.

**Data Source and Design**

The model uses a survey-as-experiment design which involves a treatment of pure information in order to shift preferences in an expected direction. The survey will be an own-procured data set which will be included in a table attached to the final paper as an appendix. The survey will be conducted through Survey Monkey and the expected sample size is between 70 and 100.

Respondents are queried for a total of 10 questions including personal factors for control purposes, hypothetical demand before treatment, and hypothetical demand after treatment. A difference-in-difference effect is measured prior and post treatment.

**Limitations**

There are several potential limitations to the paper. First, there may be selection bias into the survey which exceeds the ability to control. Second, there may be low significance due to the relatively small expected sample size. Third, the paper will only be able to establish an effect on self-reported demand, which has known deviations compared to revealed demand. Fortunately, however, there are also known corrective practices for self-reported demand.

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**Appendix A – List of SurveyMonkey Survey Question**

1. What is your gender
2. What is your age group
3. What is your income group
4. Which race/ethnicity best describes you? (Please choose only one.)\*
5. You must spend $10 on chocolate or almond croissants at a new cafe. They each cost $1. How many chocolate croissants would you purchase?
6. You must spend $10 on chocolate or almond croissants at a new cafe. Chocolate costs $1.50 and almond costs $1. How many chocolate croissants would you purchase?
7. You eat a chocolate croissant from the new shop. It's not as good as you expected, but you've had worse. The next day, you must spend $10 on chocolate or almond croissants again. They each cost $1. How many chocolate croissants would you purchase?
8. You eat a chocolate croissant from the new shop. It's not as good as you expected, but you've had worse. The next day, you must spend $10 on chocolate or almond croissants again. Chocolate costs $1.50 and almond costs $1. How many chocolate croissants would you purchase?
9. On a scale from 1 to 10, how confident are you that your previous numerical answers reflect what your real behavior would be in the real world?

\*Only on SurveyMonkey, not my own website.

Conclusions so far:

1. Aggregate movements as expected
   1. 1>2>3>4, 1>3, 2>4, 1-3 > 2-4
2. Distinguishable aggregate price and taste shifters
3. Illegal values (perhaps an instrument? Not that I need one.)
4. Small sample size prevents real microanalysis. No deep micro analysis, but I have the microdata.
5. Design flaws: SurveyMonkey has an input box next to the slider which allowed illegal values
6. Demographic info uncorrelated to findings (gender, race, age, income group)
7. Some demographic covariance
8. Some RHS covariance with illegal values
9. Want to do diff in mean comparison with own-website and see get more significance

notes

1. Whole response yields expected results
2. Difference in means test, q1 vs q3 and q2 vs q4
3. More likely than not, q3-q4 !=0, although any estimate has low confidence
4. Q5 increases variance or attenuate swings or increase swings
5. Hypothesis that illegal values are bad noise, so removing them should reduce variance
   1. Confirmed
6. Method is means tests and diff in diff
7. Consider if baseline was 0. In real world they aren’t a consumer at all.
8. Show theoretical and empirical approach. The indifference curve captures many factors which will show up separate from a pure preference effect in an econometric model. For example, if women tend to consume particular products more frequently than men this will show as a coefficient for a gender variable on an econometric model, but in theory this is still a preference effect.
   1. In practice many variables will move with price and preference simultaneously. This is an important practical issue, but in our experimental context this consideration is not needed because we control the only source of treatment. In practice there may be regional differences in both price and tastes, for example. In such a situation it remains possible to extract distinct price and preference effects by including proper interaction terms and examining the cross-correlation between the independent variables.
   2. The fact that B explains C does not undermine that A mutually explains C if it is the case that A explains B. It may be the case that an individual consumes a particular product more frequently because that individual has a property called gender which takes a particular value. From an econometric point of view we rightly claim that it is the gender which has explanatory power, but we are equally right to say based on theory: “True, preference is influenced by gender, but it is still her preference.”
   3. An interesting specification puzzle arises. If the economist truly believes that preferences are the causal element in the selection of quantities, why don’t we model preference directly as an independent variable? The answer is that such a specification is expected to be fraught with variance and error due to behavioral considerations.
      1. Would could construct a two-stage model where various factors predict preference level and preference level in turn predicts quantity consumed. That approach is worth exploring but it is not taken up in this paper and it will also involve an interesting issue. From behavioral science we have evidence that people are better at giving answers to concrete problems, such as the number of croissants they would buy, compared to abstract problems, such as their level of preference for croissants. If I had implemented such a two-stage model I would expect larger variance and error. As a result, the two-stage approach is not expected to be a good applied model, although it is the proper theoretical model. In practice I have adopted a more concrete model where the value of preference is “backed out” rather than fed in. This occurs plenty in the theoretical work as well.
   4. Todo: weighted regression, maybe chi-squared (given non-treatment, odds treatment would have same distribution)
   5. Demonstrate economic importance: 1) compare coefficient of price and preference. 2) given sample A, predict sample B with and without treatment on rhs
   6. Clean up tables to use labels







