

## **How are preferences revealed? (Beshears et al., 2008)**

Economists use preferences to model human behavior. A person chooses plan *A* because it is preferred to any other available ones, thus he has certain preferences. Most of the time, the action of choosing *A* reveals their preference. But sometimes humans go for plan *B* even though they prefer plan *A*. The latter is an example when observed choices do not reveal normative preferences economists like to think about.

### **One Sentence Summary**

Actions can reveal normative (theoretical preferences or utility) preferences of an individual. In five situations this might not be the case. But not all is lost, economists can infer normative preferences with six proposed approaches.

### **Main Findings**

There are five situations where actions do not reveal normative preferences: passive choice, complexity of choices, limited experience, marketing influence and intertemporal choice.

When default options are involved, humans reveal procrastination rather than preferences. For example, a company offers 4 savings plans, if no decision is made, the worker will be enrolled in plan 3. Later a worker in plan 3 found out that plan 2 is better. However, he/she procrastinates and never changes their plan. When an economist looks at the data, high participation on plan 3 does not reflect an aggregate preference, just that they procrastinate.

Choosing could be difficult, and complexity of plans does not make it easier. Imagine a worker is offered over 100 options to invest. He doesn't know the best possible combination for his/her needs and preferences. To make the process faster he/she decides intuitively to a portfolio with a 1% return. Which is not the preferred action. The worker would like a plan that has a 5% return on investment rather than a 1%, which is a possible option but hard to find.

Humans discover preferences through trial and error. Buying for the first time a product does not mean you prefer it. It just means you are trying it out. Inexperienced agents reveal exploration and not necessarily their preferences for the product.

People are influenced by marketing. Brand preference is not a violation of revealed preferences. People can prefer Coke even if they prefer the taste of Pepsi. Nonetheless, if the actual preferences are tastes, then the last example clearly does not reveal their preference.

Rational individuals know the best possible actions throughout time. Therefore, planned action for tomorrow should not change. Saving today for retirement is painful but saving tomorrow hurts less. In this example, saving today hurts more because we value the present. Later in time, agents will not save because the present moved. In a sense, when economists observe this behavior, they might capture present preferences rather than lifetime preferences.

## **Concluding Remarks**

To correctly infer normative preferences through actions we can avoid the five situations mentioned above. Using active selection - making the agent chose without a default option – economists can observe revealed preferences. Studying choices of experienced consumer will be more representative of their preferences. Aggregating a group of similar consumers can reveal preference, by avoiding noisy individual choices. Although not a popular opinion in the field, self-reported preferences can approximate normative preferences.

With this insight, governments can produce accurate public policy that people want or prefer. Rather than building park when people really want a shopping mall.

## **References**

- Beshears, J., Choi, J.J., Laibson, D., Madrian, B.C., 2008. How are preferences revealed? J. Public Econ. <https://doi.org/10.1016/j.jpubeco.2008.04.010>.