Non-standard Preferences

Time preferences

Advanced course in Behavioural and Psychological Economics

Tampere University

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Link to updated version

Bibliography:

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Topics

- Introduction
- Exercise
- Deadlines
- Credit
- Savings
- Default effects

Introduction

Standard theory poses:

$$\max_{x_t^i \in X_t} \sum_{t=0}^{\infty} \delta^t \sum_{s_t \in S_t} p(s_t) U(x_t^i \mid s_t) \tag{1}$$

- $U(x \mid s)$: utility
- x^t: period t payoffs
- $p(s)$: probability of state s
- δ: (time-consistent) discount factor

Introduction

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... but utility discounting is **not just exponential**

Discounted Utility

Suppose:

$x \perp s$ (x is orthogonal to s)

- *Payoffs do not depend on states of the world*

- Individual i maximize $\sum_{t=0}^{\infty} \delta^t U(x_t^i)$

$\sum_{t=0}^{\infty} \delta^t U(x_t^i) = \delta^0 U(x_t^i) + \delta U(x_{t+1}^i) + \delta^2 U(x_{t+2}^i) + \delta^3 U(x_{t+3}^i) + \dots$

- For $\delta = .9$

$\sum_{t=0}^{\infty} \delta^t U(x_t^i) = (1)U(x_t) + (.9)U(x_{t+1}) + (.81)U(x_{t+2}) + (.729)U(x_{t+3}) + \dots$

Time Preferences

Theory

- Standard model assumes a **discount factor** (δ) that:
  - Allows comparing utility in different periods
  - Is independent of when utility is evaluated

    $\rightarrow$ i.e., *time consistency*

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- Discounting is **steeper in the immediate future** than further ahead

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Empirical Evidence

- Discounting is **steeper in the immediate future** than further ahead
  - Thaler (1981) finds people are indifferent between:
    - → \$15 now and \$20 in one month
    - → \$15 now and \$100 in ten years

Discount Rate

We can compute the annualized discount rate $(\delta) = \left(\frac{F}{P}\right)^{\frac{1}{t}} - 1$

1. 15 now versus 20 in one month
   - For $P = 15$ (Present value), $F = 20$ (Future value), and $t = 1$ month ($\frac{1}{12}$ years)

$$\delta_1 = \left(\frac{20}{15}\right)^{\frac{1}{(\frac{1}{12})}} - 1 = 1.333^{12} - 1 \approx 30.57 = \boxed{3{,}057\%}$$

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2. 15 now versus 100 in ten years
   - For $P = 15$ (Present value), $F = 100$ (Future value), $t = 10$ years

     $\delta_2 = \left(\frac{100}{15}\right)^{\frac{1}{10}} - 1 = 6.67^{\frac{1}{10}} - 1 \approx .21 = \boxed{21\%}$

Time Preferences

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Empirical Evidence

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  - Thaler (1981) finds people are indifferent between:
    - → \$15 now and \$20 in one month (3,057% annual discount!)
    - → \$15 now and \$100 in ten years (21% annual discount)

Time Preferences

Theory

- Standard model assumes a **discount factor** (δ) that:
  - Allows comparing utility in different periods
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Empirical Evidence

- Discounting is **steeper in the immediate future** than further ahead
  - Thaler (1981) finds people are indifferent between:
    - $\rightarrow$ \$15 now and \$20 in one month (3,057% annual discount!)
    - $\rightarrow$ \$15 now and \$100 in ten years (21% annual discount)
  - McClure et al. (2004) explores the neural underpinnings:
    - $\rightarrow$ Payoffs in the present activate different neural systems than decisions involving only payoffs in future periods

Self-Control Problems

- When evaluating the **distant future**:
  - More patience
  - People make plans to:
    - → Exercise
    - → Stop smoking
    - → Improve themselves
- When the **future gets near**:
  - Discounting gets steeper
  - People:
    - → Binge-eat
    - → Light (last) cigarette
    - → Stay put

Theoretical Framework

Following Laibson (1997) and O'Donoghue & Rabin (1999)

Suppose that an individual considers her utility throughout many periods:

$$U_t = u_t + \beta \sum_{t=1}^{\infty} \delta^t u_t = u_t + \beta\delta u_{t+1} + \beta\delta^2 u_{t+2} + \beta\delta^3 u_{t+3} + \dots \quad (2)$$

- u_t: period t utility
- δ: discount factor
- β: captures self-control problems, restricted to $\beta \leq 1$

Theoretical Framework

This model (*quasi-hyperbolic preferences*) differs from the *standard model* in β

- if $\beta < 1$ the discounting between present and future is higher
  - e.g., *if* $T = 2$, $\beta = .5$ *and* $\delta = .9$

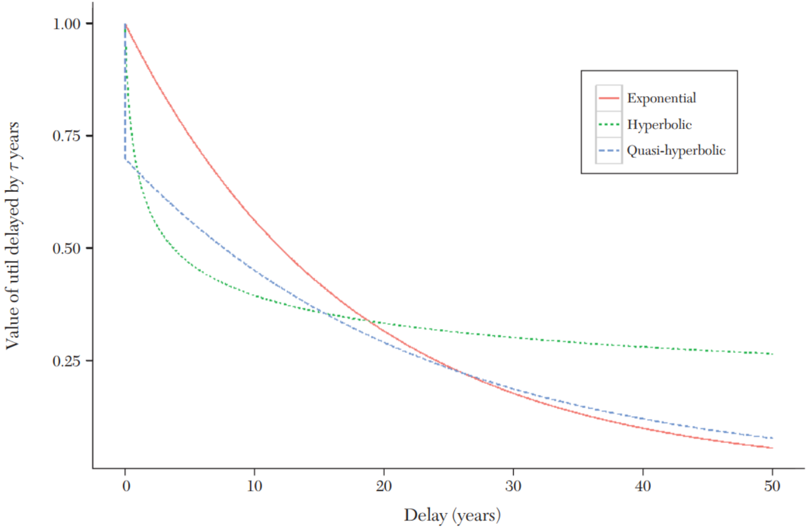
    $$U_t = u_t + \beta\delta u_{t+1} = u_t + (.5) \times (.9)u_{t+1} = u_t + (.45)u_{t+1}$$

    Period 2 utility is weighted at 45% of period 1 utility
- if $\beta = 1$ we have the *standard model*
  - e.g., *if* $T = 2$, $\beta = 1$ *and* $\delta = .9$

    $$U_t = u_t + \beta\delta u_{t+1} = u_t + (1) \times (.9)u_{t+1} = u_t + (.9)u_{t+1}$$

    Period 2 utility is weighted at 90% of period 1 utility

Theoretical Framework



Theoretical Framework

Following O'Donoghue & Rabin (2001)

Suppose that an individual expects her utility to be:

$$\hat{U}_{t+s} = u_{t+s} + \hat{\beta}\delta u_{t+s+1} + \hat{\beta}\delta^2 u_{t+s+2} + \hat{\beta}\delta^3 u_{t+s+3} + \ldots \quad (3)$$

- $\hat{\beta}$: captures expectations about time preferences, restricted to $\hat{\beta} \geq \beta$

Theoretical Framework

- if $\hat{\beta} = 1$ the individual is *fully naive* about self-control problems
  - Will decide without considering that in the future she will have self-control problems
- if $\hat{\beta} > \beta$ the individual is *partially naive* about self-control problems
- if $\hat{\beta} = \beta$ the individual is *sophisticated*
  - Will take into account her self-control problems when deciding

An example

Consider the choice between eating a fruit or a chocolate bar as a dessert

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Consider the choice between eating a fruit or a chocolate bar as a dessert

- **Chocolate bar**
  - Immediate reward: $u_1 > 0$
  - Future cost: $u_2 < 0$
- **Fruit**
  - Immediate cost: $u_1 < 0$
  - Future reward: $u_2 > 0$

An example

Consider the choice between eating a fruit or a chocolate bar as a dessert

- Focusing on the **chocolate bar** $(u_1 > 0, u_2 < 0)$:
  - Planning ahead

    → Consume chocolate bar if $u_1 + \delta u_2 \geq 0$
  - Deciding in the moment

    → Consume chocolate bar if $u_1 + \beta\delta u_2 \geq 0$

    → Remember $\beta \leq 1$, so $|\beta\delta u_2| \leq |\delta u_2|$
  - I would consume more than what I would want to do beforehand!

An example

Consider the choice between eating a fruit or a chocolate bar as a dessert

- Focusing on the **fruit** $(u_1 < 0, u_2 > 0)$:
  - Planning ahead
    - $\rightarrow$ Consume fruit if $u_1 + \delta u_2 \geq 0$
  - Deciding in the moment
    - $\rightarrow$ Consume fruit if $u_1 + \beta\delta u_2 \geq 0$
    - $\rightarrow$ Remember $\beta \leq 1$, so $|\beta\delta u_2| \leq |\delta u_2|$
  - I would consume less than what I would want to do beforehand!

An example

Consider the choice between eating a fruit or a chocolate bar as a dessert

- How can *sophisticated* agents solve this?
  - Look for **commitment devices** to:
    - → Increase investments
    - → Reduce present consumption
- Partially *naive* agents would still mispredict their consumption/investment decisions
  - Planning ahead (and focusing on fruit)
    - → Consume fruit if $u_1 + \hat{\beta}\delta u_2 \geq 0$
  - Deciding in the moment
    - → Consume fruit if $u_1 + \beta\delta u_2 \geq 0$
    - → With $\beta \leq \hat{\beta}$, then $|\beta\delta u_2| \leq \left|\hat{\beta}\delta u_2\right|$
  - Would still consume less than what wanted to do beforehand!

Cases

1. Exercise
2. Deadlines
3. Credit
4. Savings
5. Default effects

Topics

Introduction

Exercise

Deadlines

Credit

Savings

Default effects

Exercise

DellaVigna & Malmendier (2006): Health clubs in the US

Exercise

DellaVigna & Malmendier (2006): Health clubs in the US

- Setup:
  - X_M: Monthly membership for $L = \$80$
  - X_P: Pay-per-visit membership with $\$10$ per visit

- Optimal choice:
  - Choose monthly membership $\Leftrightarrow p \times E(x_M | X_M) \geq L$

    $\rightarrow$ Expected price per attendance (x_M) under X_M is lower than X_P

Exercise

DellaVigna & Malmendier (2006): Health clubs in the US

- Evidence:
  - Users choosing the monthly membership visit 4.4 times per month
  - This implies a cost of $\sim \$17$ per visit

    $\rightarrow$ Choosing X_M is more expensive than choosing X_P ($\$10$ per visit)

- Explanation:
  - Users are purchasing a **commitment device** to exercise more:

    $\rightarrow$ Marginal cost of each visit is $\$0$ under the monthly membership
  - **Overestimation of attendance**

    $\rightarrow$ Most consistent with post-intervention survey

Topics

Introduction

Exercise

Deadlines

Credit

Savings

Default effects

Deadlines

Ariely & Wertenbroch (2002): Professionals enrolled in executive education at MIT

Deadlines

Ariely & Wertenbroch (2002): Professionals enrolled in executive education at MIT

- Setup:
  - Course with 3 homework assignments required
  - Possibility to set binding deadlines:
    - → Delays imply lower grades
    - → No feedback until the end of the course
- Evidence:
  - 68% of deadlines were set before the end of the semester

Deadlines

Ariely & Wertenbroch (2002): Professionals enrolled in executive education at MIT

- Theory:
  - *Standard Model*:
    - → Incentive to set the last day of the semester as the deadline
    - → No constraints are better than constraints
  - *Self-Control:*
    - → Homework is an investment
    - → People spend less time than wished *ex ante*
    - → Deadlines force future self to spend more time

Deadlines

Ariely & Wertenbroch (2002): Professionals enrolled in executive education at MIT

- Open questions:
  - Does self-control improve performance?
  - Are chosen deadlines optimal?
- Experiment:
  - 3 error-detection homework assignments with 3 treatment conditions:
    - → `T0`: No deadlines (all due after 3 weeks)
    - → `T1`: Possibility to set binding deadlines
    - → `T2`: Equal-spaced deadlines (one every week)
  - Evidence:
    - → Self-set **deadlines improve performance**: score of 105 in `T1` vs. 70 in `T0`
    - → Self-set deadlines are not optimal (**partial naïveté in self-control**): 105 in `T1` vs. 130 in `T2`

Topics

Introduction

Exercise

Deadlines

Credit

Savings

Default effects

Credit

Ausubel (1999): Credit card offers

Credit

Ausubel (1999): Credit card offers

- Setup:
  - Credit card company randomly mailed offers:
    - → `T0`: 6.9% interest for first 6 months, 16% afterwards
    - → `T1`: 4.9% interest for first 6 months, 16% afterwards
    - → `T2`: 6.9% interest for first 6 months, 14% afterwards
- Evidence:
  - Average borrowings:
    - → $2000 during the first 6 months
    - → $1000 afterwards (up to 15 months after change of rate)

Credit

Ausubel (1999): Credit card offers

- Theory:
  - *Standard Model:*

    → In **T1** the offer is 2% rate for first 6 months

    → In **T2** the offer is 2% rate for last 15 months

    → Response to **T1** should be smaller than to **T2**

    → Calculation:

    in **T1**: $2000 \times \left(\frac{6}{12}\right) \times 2\% = 20$

    in **T2**: $1000 \times \left(\frac{15}{12}\right) \times 2\% = 25$

Credit

Ausubel (1999): Credit card offers

- Evidence:
  - Increase in take-up for `T1`: 386 per 100k
  - Increase in take-up for `T2`: 154 per 100k
  - `T1` vs. `T0` is 2.5 times larger than for `T2` vs. `T0`
  - Individuals over-respond to the first six-months discount
- Interpretation:
  - Individuals **naively believe** they will not borrow much after the discount period ends

Topics

Introduction

Exercise

Deadlines

Credit

Savings

Default effects

Savings

Ashraf, Karlan, & Wesley (2006): Savings behavior in the Philippines

Savings

Ashraf, Karlan, & Wesley (2006): Savings behavior in the Philippines

- Motivation:
  - How to reconcile?
    - → Liquid debt: ~12% of annual income, implies high impatience
    - → Illiquid wealth accumulation: >200% of annual income towards retirement, implies high patience
  - Proposed solution: **Commitment device**

- Setup:
  - Philippine bank randomly assigned customers to:
    - → `T0`: Verbal encouragement to save
    - → `T1`: Commitment device

      Customers could not access savings until reaching a self-specified goal

Savings

Ashraf, Karlan, & Wesley (2006): Savings behavior in the Philippines

- Evidence:
  - High demand for commitment: $\sim$25% of customers accepted the commitment device
  - Savings increased:
    - $\rightarrow$ `T1`: 33.3% increase
    - $\rightarrow$ `T0`: 27.7% increase

Topics

Introduction

Exercise

Deadlines

Credit

Savings

Default effects

Default effects

Default effects

- Tendency for an agent to generally accept the default option
- One of the most robust findings in applied economics since 2000!
- Observed in contexts such as:
  - Health clubs
  - Organ donation
  - Insurance plan choice
  - Retirement plan choice
- Widely applied in public (and private) policy

Default effects

Madrian & Shea (2001): Company-offered 401(k) plans in the US

- Setup:
  - `T0`: Default is non-participation
    - → Employer match-up: 50% of contributions
  - `T1`: Default is participation at 3%
    - → Employer match-up: 50% of contributions
  - Employees can override default via phone call or form submission

- Evidence:
  - Participation rate:
    - → `T0`: 49%
    - → `T1`: 86%

Default effects

Madrian & Shea (2001): Company-offered 401(k) plans in the US

- Explanation:
  - **Transaction costs?**
    - → Unlikely: Costs are too low compared to benefits
    - → e.g., *Average match-up provides $1.2k in annual benefits*
  - **Self-control and naïveté?**
    - → Decisions involves:
      - Immediate disutility (i.e., *transaction cost*)
      - Delayed benefit
    - → Agent behavior:
      - Postpones decision (i.e., *self-control problem*)
      - Believes they will act tomorrow (i.e., *naïveté*)
    - → Can result in infinite procrastination

Default effects

Carroll et al. (2009): Forcing Choice as a Solution

- Setup:
  - New hires at a company:
    - → `T0`: Free to choose a retirement plan
    - → `T1`: Required to choose a retirement plan
- Evidence:
  - Participation rate:
    - → `T0`: 50% choose a 401(k) plan
    - → `T1`: 80% choose a 401(k) plan