Non-standard Decision-making

Cognitive foundations

Advanced course in Behavioural and Psychological Economics

Tampere University

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Link to updated version

Bibliography:

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Topics

Introduction

Noisy Approximations

Comparative Thinking

Reduced Cardinality

Analogies and Categorization

Complexity Aversion

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

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
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. . . but **individuals not always optimize**

Information Processing is Imperfect!

1. **Procedures and Algorithms complexity**
   - Simple problems
     → Behavior can be well-approximated by the standard maximizing model
   - Complex problems
     → People rely on specific procedures or algorithms
     → Arrieta & Nielsen (2023): As problems become more complex, people perform better in describing their decision-making process to others
   - '*Complexity*': refers to the cost of information processing in computer science
     → Oprea (2020): People are willing to pay to avoid implementing certain rules!
     Which ones? Those with higher 'dimensionality'

Information Processing is Imperfect!

2 Decision Maker

- Cognitive resources
  - → Abundant evidence of differential choices and beliefs
    - Hard to reconcile with preferences
    - Natural from a perspective of imperfect information processing
- Experience
  - → Behavioral attenuation weakens as decision makers gather more experience with a specific problem configuration
    - Suggestive of efficient coding
      - Optimal reduction of noise for problems encountered frequently

The Cognitive Turn on Behavioral Economics

Focus on explaining and unifying anomalies

- Shift away from accumulating new deviations from neoclassical predictions
- Explore interrelationships between biases
- Many behaviors reflect imperfections in basic information processing

Replace reduced-form notions of biases

- Focus on cognitive mechanisms underlying choice behavior:
  - → 'Which cognitive limitation generates this choice behavior?'
  - → 'How does it resemble anomalies in other domains?'
- Rather than:
  - → 'Which utility function rationalizes this choice?'

The Cognitive Turn on Behavioral Economics

- **Literature:**
  - Mostly recent: post-2010
  - Classical antecedents:
    - → Bounded rationality (Simon, 1956)
    - → System 1 vs System 2 (Kahneman, 2011)
- **Why so recent?**
  - More complex than previous explanations
    - → Reduced-form approach avoids complexity
    - → Reduced-form approach is more workable in (theory and) practice

The Cognitive Turn on Behavioral Economics

- **(Most) economic decisions are difficult**
  - Intensive information processing requirements
- **People rely on simplification strategies**
  - Strategies play out similarly across contexts:
    1. Noisy Aproximations
    2. Comparative Thinking
    3. Reduced Cardinality
    4. Analogies or Categorization
    5. Complexity Aversion (avoiding options that are difficult-to-assess)
- **Decision problem features affect information-processing imperfections**
- **Still no unified model**

Theoretical Framework

Consider a decision maker taking a decision to maximize overall utility, which is comprised of different problem dimensions i:

$$\max_{a} U(a, \theta) = \sum_{i} u_i(y_i) = \sum_{i} u_i(g_i(a, \theta)) \tag{11}$$

- $u_i(y_i)$: dimension-by-dimension utility
- y_i: outcomes
- $g_i(\cdot)$: outcome production functions
- a: decision
- θ: economic fundamentals

Theoretical Framework

Decision maker would choose the decision that maximizes utility:

$$a^*(\theta) \in \arg\max_a U(a, \theta), \qquad \frac{\partial a^*(\theta)}{\partial \theta_j}|_\theta \equiv \beta_j$$

This maps economic fundamentals in a way the maximizes utility ...

but this is a rather strong assumption!

Some examples:

- How many hours should you work per week to maximize your discounted expected lifetime utility?
- How much of your money should you invest in the stock market?
- Interest rate increases from 0% to 4%. What additional fraction of your income should you save now?
- Do you prefer a 30% chance of getting 120 EUR or a 85% chance of getting 40 EUR ?

Do people know the optimal decision?

Indirect evidence of choice uncertainty

- Standard measures of preferences strongly depend on the elicitation format
  - → e.g., *self-reported altruism* vs. *incentivized donation to A* vs. *incentivized donation to B*
- Experimental manipulations have systematic effects on observed choices
  - → Problem complexity (e.g., 1 vs. $\int_0^\infty e^{-x}\,dx$)
  - → Cognitive resources (e.g., *high or low time constraints*)
- Anomalous preferences correlated with behavior in cognitive problems

Measurements of choice uncertainty

- Direct questions to decision makers
- Deliberate randomization strategies
- Willingness to delegate decisions

What makes problems hard?

Cardinality

- The more dimensions a problem has, the harder
  - → Outcomes of interest
  - → Variables to consider
  - → Signals received
- e.g., *'vanilla or chocolate?'* vs. *'small vanilla with sprinkles vs large chocolate with nuts?'*

Aggregation

1. Requires introspection
   - → 'What is my discount/risk factor?'
2. Even with all information available, decision makers still need to process it
   - → Tradeoffs present vs future / risk vs certainty

What do people do?

- They avoid information processing by simplifying!
- Main responses:

Simplify the aggregating process

1. (Noisily) approximate
2. Bracket and compare

Subset to simplify the problem

3. Reduce cardinality

Solve a simpler problem

4. Thinking in analogies and categories
5. Avoiding objects one cannot properly evaluate

Are these responses deliberate?

Sometimes yes, . . . but sometimes no.

Proposed solutions will depend on the source of the response:

- **Deliberate simplifications**
  - In line with procedural choice and bounded rationality
    - → e.g., *noisily approximation*
    - → Possible policy response: simplify procedure
- **Intuitive simplifications**
  - In line with distinction between 'system 1' and 'system 2' thinking
    - → e.g., *salience bias*
    - → Possible policy response: promote time to think

Topics

Introduction

Noisy Approximations

Comparative Thinking

Reduced Cardinality

Analogies and Categorization

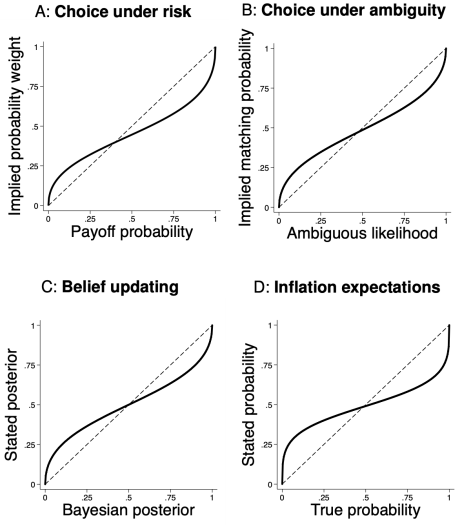
Complexity Aversion

Noisy Approximations

People approximate, rather than solving a problem precisely

- Time: *"about 30 minutes"*
- Risk: *"seems like a low chance"*
- Labor: *"roughly two days to study for the exam"*
- Budget: *"costs around 200 EUR a month"*

‘Weighting functions’ in choices and beliefs



- **A** Risk: people overweight small probabilities and underweight large probabilities
- **B** Ambiguity: people avoid ambiguity for probable gains but seek it for unlikely gains
- **C** Beliefs: people overreact after weak signals but underreact after strong signals
- **D** Expectations: people expect too much when low but too little when high

Theoretical Framework

Suppose that people's average decisions can be described as a convex combination:

$$E[a(\theta)] = (1 - \lambda)a^*(\theta) + \lambda d \tag{12}$$

- a: decision
- θ: economic fundamentals
- λ: degree of attenuation
- d: default decision

Theoretical Framework

This yields an attenuated effect:

$$\frac{\partial E[a(\theta)]}{\partial \theta} = \underbrace{(1-\lambda)}_{\text{Attenuation}} \frac{\partial a^*(\theta)}{\partial \theta}$$

- $\frac{\partial a^*(\theta)}{\partial \theta}$: *normative sensitivity*, that is the optimal sensitivity

Why does attenuation (λ) emerge?

Policy uncertainty

- People know the fundamentals (θ) but do not know how to map them into optimal decision ($a^*(\theta)$)
- In response, people make noisy decisions ($s(\theta) = a^*(\theta) + \epsilon$) to update on true utility-maximizing decision
  - $\rightarrow$ e.g., *dine Ethiopian cuisine on Friday* vs. *dine Bolivian cuisine on Saturday*

Noisy perceptions

- People do not know the fundamentals (θ), but only observe noisy signals ($s = \theta + \epsilon$)
- Implied decisions also show attenuation bias
  - $\rightarrow$ as individuals decide based on prior fundamentals (θ)

What determines default decisions (d)?

When people have prior experience

- Default is shaped by memory: what one usually experiences
  - → e.g., *maintaining status quo*

When people have no prior experience

- Less clear
- Probably, related to simple heuristics that 'usually work'
  - → e.g., *choosing the middle-ground*

When is noisy approximation stronger?

When aggregating trade-offs is difficult

- More noise when far from dominance
  - → e.g., *providing additional labour hour when payoff is 2 EUR than when it is 200 EUR*
- More noise when more dimensions to consider and dimension-by-dimension dissimilarity
  - → e.g., *A arrives later, is superior, is costlier, is more econ-friendly than B*

When the problem is less important

- More noise when people incur in less thinking about a problem (e.g., rational inattention)
  - → e.g., *snack vs mobile phone purchase*
  - → Determinants: relevance of decision, frequence of decision

Topics

Introduction

Noisy Approximations

Comparative Thinking

Reduced Cardinality

Analogies and Categorization

Complexity Aversion

Comparative Thinking

People avoid aggregating across dimensions and compare within-dimensions

- e.g., '*I prefer mobile A because it has better camera and battery-life, while B only is cheaper*'
- e.g., '*I will buy car C because it looks nicer and is cheaper, while D only is more efficient*'
- e.g., '*I study E because it is easier and more interesting, while F only pays more*'

Why do people do this?

- Assessments are typically **relative** rather than absolute
  - Compare relevant quantities with (relevant or irrelevant) reference points
- Interpretations:
  - Reference-dependent utility functions (*leading interpretation*)
  - Simplification strategy (*alternative interpretation*)
    - → Helps dealing with the difficulty of information processing across dimensions
    - → Difficult to translate different dimensions into a 'common currency'
    - → Relative assessments are easier than absolute assessments

      e.g., *'How much is this wine worth to me?' vs.*

      'Is this wine better than the one I had yesterday?'

Pairwise Comparison

- Consider two goods with two dimensions
  - e.g., *expensive high-quality wine and a cheap low-quality wine*
- Under neoclassical theory, equivalence between:
  1. Compare Aggregations
     → 1. Aggregate components within each option → 2. Compare aggregated values across options
  2. Aggregate Comparisons
     → 1. Compare component-by-component → 2. Aggregate these comparisons
- But people tend to follow (ii)
  - Ariely (2011): Eye-tracking in decision making
    → Frequency of within-dimension comparisons is higher and increases when the number of dimensions increases

Reference points

- People compare utility-relevant outcomes with normatively irrelevant reference points
  - e.g., *status quo, what they usually get, what they expect to get*

Why decisions are particularly sensitive around reference points?

1. Difficulty of aggregating tradeoffs across dimensions
   - People understand whether an outcome is better or worse than a comparison point, but not necessarily by how much
     → e.g., *Person's references for product A is mid-quality and very high-price. Prefers high-quality and high-price (gains in both) over low-quality and low-price (gains in one)*

Why decisions are particularly sensitive around reference points?

2. Efficient coding
   - People have much experience around these points, and values are more precisely
     → However, this is not *per se* a reference-point comparison nor comparative thinking

Why decisions are particularly sensitive around reference points?

3. Normalization
   - Within-dimension differences matter more when relatively larger

     Average-based

     → e.g., *difference between 30 and 20 is larger than between 130 and 120*

     Range-based

     → e.g., *difference between 30 and 20 is larger when third item is 19 than when it is 0*

   - People extrapolate relative difference to utility gains, overweighting dimensions

Sequential contrast effects

- People hold quantities (or qualities) as larger if preceding one is smaller
  - e.g., *30 looks larger in (2,30) than in (29,30)*
  - Proven to have an impact in candidate assessment (Radbruch & Schiprowski, 2022), stock evaluations (Hartzmark & Shue, 2018)
  - Sequential contrast effects increase as tradeoffs become difficult (Enke & Graber, 2024)
- Prove-of-concept that reference point effects can be ultimately cognitive

Topics

Introduction

Noisy Approximations

Comparative Thinking

Reduced Cardinality

Analogies and Categorization

Complexity Aversion

Reduced Cardinality

- **People don’t use all of the available information**
  - In many problems, the dimension size is too large
  - Simplification strategy: use a subset of information and decide with what is top of mind

    → e.g., *selective attention or memory*

Why they do this?

1. **Goal-driven process**
   - People attend/remember the **most important** elements
   - Literature on rational inattention, sparsity, optimal bounded memory
   - Focus on specific problem at hand
2. **Stimuli-driven process**
   - People attend/remember elements **cued by the environment**
   - Can be optimal *on average*
     - → Maybe a response to constraints in attention/memory
     - → Focus on variance/similarity broadly makes sense

Incomplete Representations

System Neglect

- People excessively **focus on the visible 'output' rather than on the underlying data-generating process** (DGP)
  - Example: Belief updating with bimodal response
    - → Rational agents: Focus on the DGP
    - → Simplifiers: Equate observed signals with the underlying process
  - Drawing people's attention to the neglected aspect of the DGP impacts behavior
    - → i.e., *selective attention*
- Extends to indirect effects:
  - People do not pay sufficient attention to how others' behavior is driven by fundamentals
  - People do not pay sufficient attention to how behavioral responses impact aggregates

Incomplete Representations

Data Neglect

- People simplify by **entirely ignoring certain problem aspects**
  - Example: Belief updating with multi-modal response
    - → Rational agents: Focus on the DGP
    - → Signal-neglect agents: Only focus on the base rate
    - → Base-neglect agents: Only focus on the signal
  - Non-rational agents only pay attention to one statistic
  - Drawing people's attention to the neglected aspect of the DGP impacts behavior
    - → e.g., *selective attention*

Topics

Introduction

Noisy Approximations

Comparative Thinking

Reduced Cardinality

Analogies and Categorization

Complexity Aversion

Analogies and Categorization

People repeat previous solutions rather than solving the actual problem

- e.g., '*I will take route A because I took it last time and worked well*'
- e.g., '*I will buy car B because I have always bought cars from that company*'
- e.g., '*I will buy a Japanese mobile because I like Japanese films*'

Why people do this?

Model-free learning

- People don't form a mental model of the problem, they just learn purely by experience
  - → e.g., 'I don't know why, but this works'
- People choose previously successful decisions for the same task
  - → Main mechanism: reinforcement
  - → **Problem 1:** most problems differ from each other
  - → **Problem 2:** people do rely on model-based reasoning
- Extensions
  - → Case-based reasoning, weighting past decisions by similarity to current environment
  - → Dual-decision process, combining model-free with model-based learning

Why people do this?

Categorization

- People lump together current situations that are similar but differ
  - → e.g., 'all Nordics speak North Germanic languages'
- People lump together observations into categories and then analyze categories as one
  - → e.g., investors categorize as similar companies just because they report earnings same day or appear next to each other on reports, which makes stock move jointly (Charles, 2022).

Topics

Introduction

Noisy Approximations

Comparative Thinking

Reduced Cardinality

Analogies and Categorization

Complexity Aversion

Complexity Aversion

People undervalue what requires much information processing to evaluate

- Similar to risk aversion to uncertainty resulting from imperfect information processing
  - → e.g., 'picking which stock to investment in is too hard, so I avoid it'
  - → e.g., 'economic news are difficult to understand, so I don't incorporate them to update my beliefs'
  - → e.g., 'option A has too many caveats, so I prefer option B because is simpler'

Source of complexity

Cardinality

- Different states increase the complexity of assessing a decision
  - → e.g., 'people shy away from products with many add-ons due to obfuscation' (Fehr & Wu, 2023)
  - → e.g., 'financial assets with many distinct payouts tend to be avoided'

Tradeoffs

- People act cautiously
  - → Uncertainty about derived utility makes for conservative assessments
    concave transformation of utils due to risk aversion
  - → Can explain endownment effect, certainty effect, and present bias