Applications of Psychology and Economics – Econ 219B  
Spring 2007  
Wednesday 12-3, 639 Evans Hall

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Office Hours:

Syllabus

Features of this course

This course is the continuation of the 219A class in Psychology and Economics – Theory, taught by Mathew Rabin. As in 219A, we will keep emphasizing the psychological evidence as the basis for sound economic analysis. This should surprise nobody, given the name by which the course (and the field) goes. We will also insist on the importance of neoclassical theory as a very successful benchmark that you are required to know. Finally, several topics of this course are designed to be the empirical counterpart of the theory covered in 219A. This is in particular true for the sections on Present Bias, Reference Dependent Preferences, and Social Preferences.

There are two main differences between 219A and 219B. First, this class has largely an empirical orientation, as opposed to the theoretical orientation of 219B. The emphasis on data just reflects the empirical status of economics. In particular, the success of the Psychology and Economics approach will depend on the empirical explanatory power of its theories. Can this approach explain evidence that the neoclassical model struggles with? Can it do so using parsimonious models? In 219B I will present empirical papers drawn from a variety of fields to try to address these questions. We will study papers in the fields of asset pricing, consumption, development economics, environmental economics, industrial organization, labor economics, political economy, public economics, and corporate finance.

The second main feature of the course will be its emphasis on dissertation writing. This will be apparent in the exposition of the topics. More often than not, we will note that the available empirical evidence barely scratches the surface. While this is a drawback for the field, it is a great opportunity for students planning to work in the area. In very few other fields there are so many important questions that still go unanswered. Throughout the course I will do my best to point out what seem to me like good directions for empirical research. In addition, as an incentive to get you started, one of the requirements of the course is a paper on an applied topic using field data.
**Rules of the game**

As a general rule, you should have taken the 219A course before you take this course. If you have not, but are interested in taking this course, please come and talk to me. The prerequisites of the 219A course, that is, an understanding of the economics of uncertainty and game theory at the level of 201B, apply to this course as well. In addition, it is important that you have had exposure to econometrics and empirical research. You should be familiar with OLS estimation, panel data models, and discrete choice models. For example, you should have no uncertainty as to what fixed effects do in a regression. Although it is not a requirement for this course, I recommend taking at least one labor economics, public economics, or applied econometrics course to anyone contemplating doing empirical research.

Throughout the course, I will assign a few required readings each week. The required readings are starred in the reading list below. The non-starred readings are optional, but I suggest that you at least read the abstract. So much of a paper is in the abstract (if the abstract is well-written).

There are four requirements for the course: three problem sets, a final exam, an empirical problem set, and an empirical paper. The last two requirements are either/or, that is, you can do either the empirical problem set or the paper. (Notice: The requirements have changed from the last time the class was taught, in Spring 2005)

I encourage everyone to try to write an empirical paper on a Psychology and Economics topic. This will help you to get started on your research, which is the real purpose of taking a PhD (as opposed to doing class-work). The paper can be written with up to two other students in the class. I encourage every one that is thinking about writing the paper to come and see me by February 18. You should feel free to either come during office hours or to schedule an appointment via email. A two-page written proposal is due by March 17. The final 10-15 page paper is due on May 20. The ideal paper contains a novel idea, the empirical strategy, and preliminary empirical results. However, I will accept significantly less as long as you show significant effort. Two things are key: (i) that you do at least some preliminary analysis with data, since one purpose of the requirement is to make sure that you learn to use Stata or another statistical package; (ii) that you use field data, as opposed to experimental data. (This is by no means meant as a negative on doing lab experiments. Laboratory experiments are great. However, this class focuses on field data) Replication of existing studies is perfectly fine, and encouraged. Replication, in fact, is a good way to start original research, and more and more replication data sets are available on the AER and JPE websites. Some of the papers prepared for this class in past year have turned into publishable papers and, in one case, even into a job market paper. I encourage you therefore to think of presenting the paper that comes out of this class in the Psychology and Economics Lunch.

In any case, you are strongly encouraged to attend the Psychology and Economics lunch (meeting most Fridays 1.30-2.30) if you are interested in making Psychology and Economics one of your fields. In addition, you should attend the Psychology and Economics Seminar (Tu 2-4) as much as you can. Spots to go for lunch with outside speakers are available for sign-up.

The alternative assignment is a one-time, significant empirical problem set that is meant to familiarize you with empirical research in Psychology and Economics. This year, the problem set will focus on earning announcements and the response of stock prices to the new information contained in the announcements. We may also have, in alternative, another empirical problem set on the effect of the media. You can work on the assignment in groups of up to three people, but
each one should hand in a solution. I will distribute the problem set at the beginning of March. The data will be in Stata format. I will assume that you have a working knowledge of Stata.

As for the other two requirements, the three problem sets will test your knowledge of modelling and of empirical specifications in some of the papers we cover. The problem sets this year will be on Present-Biased Preferences, on Reference Dependence, and on Menu Effects.

Finally, the exam will cover the material of the whole class and will be modeled on the type of questions that I ask in the problem sets.

The course webpage is an important instrument for this course (http://emlab.berkeley.edu/users/webfac/dellavigna/e219b_sp07/e219b_07.shtml is the address of this year’s). On the website you will find updated lists of readings, the assignments, and the revised lecture notes in pdf format.

After class, I invite you to join me to chat about any favorite topic of yours in the Peixotto room during tea time.
Grading

The final grade will be an average with weight 30% on the three problem sets, 40% on the final (in-class) exam, and the remaining 30% on either the paper or empirical problem set.

Tentative schedule of classes

The schedule will vary somewhat as the class unfolds. The syllabus will be updated on the web and will be available on the course webpage at http://emlab.berkeley.edu/users/webfac/dellavigna/e219b_sp07/e219b_07.shtml. (the course webpage)

Part I -- Non-Standard Preferences

January 17 – Lecture 1
   Introduction
   Psychology and Economics: The Methodology
   Psychology and Economics: The Fields
   Present-Biased Preferences, Part 1
   Problem Set 1 assigned

January 24 – No Lecture

January 31 – Lecture 2
   Present-Biased Preferences, Part 2
      Status-Quo in Financial Decisions
   Problem Set 1 due

February 7 – Lecture 3
   Behavioral Economics and Economic Demography – Special Session with Daniel Kahneman and Ronald Lee
   Present-Biased Preferences, Part 3
      Consumption Choices

February 14 – Lecture 4
   Present-Biased Preferences, Part 4
   Reference Dependence, Part 1
      Effect of Experience
   Problem Set 2 assigned

February 21 – Lecture 5
   Reference Dependence, Part 2
      Daily Labor Supply
      Risk Aversion
   Problem Set 2 due

February 28 – Lecture 6
   Reference Dependence, Part 3
Financial Decisions
Effort on the Job
Social Preferences, Part 1
Charitable Giving Overview

**Part II -- Non-Standard Information Processing**
March 7 – Lecture 7
- Social Preferences, Part 2 (from Non-Standard Preferences Section)
- Field Evidence of Gift Exchange
- Limited Attention, Part 1
- eBay Auctions
- Problem Set 3 assigned

March 14 – No Lecture

March 21 – Lecture 8
- Limited Attention, Part 2
- Financial Market Evidence
- Voter Behavior
- Menu Effects
- 1/n Heuristic
- Use of Irrelevant Information
- Problem Set 3 due

March 23 – 2-page Paper proposals due

March 28 – Spring Break – No Lecture

April 4 – Lecture 9
- Menu Effects
- Choice Overload
- Social Pressure
- Persuasion

**Part III -- Non-Standard Beliefs**
April 11 – Lecture 10
- Overoptimism
- Overconfidence
- Projection Bias

**Part IV – Market Response to Biases**
April 18 – Lecture 11
- Market Reaction to Biases, Part 1
- Introduction to Behavioral Asset Pricing
- Limits to Arbitrage
- Behavioral IO

April 25 – Lecture 12
Market Reaction to Biases, Part 2
  Behavioral Corporate Finance
  Behavioral Political Economy
  Behavioral Welfare Economics
  Empirical Methodologies in Psychology and Economics
  Choosing Topics for Dissertation
  Conclusion
  Empirical Problem Set Handed Out (Earnings Announcement)

May 2 – Final (in-class) Exam

May 20 (midnight) – Due date for Paper and Empirical Problem Set
Readings

*designates required readings.

Some of the readings will be taken from the textbook used in the previous semester of 219A, that is, from *Choice, Values and Frames*:
Kahneman and Tversky *Choices, values and frames*, (henceforth CVF).

The following paper in preparation for the *Journal of Economic Literature* will cover, in a dense manner, the topics covered in the class. It is still a preliminary version:

For those of you who are looking for a background book in social psychology to complement the content of the Psychology and Economics sequence, I recommend:

Part I -- Non-Standard Preferences

January 17 – Lecture 1

*Six Examples of Psychology and Economics*


* Present-Biased Preferences: Status-Quo Bias in Financial Decisions I*

January 24 – No Lecture

January 31 – Lecture 2

Present-Biased Preferences: Status-Quo Bias in Financial Decisions II


Present-Biased Preferences: Consumer Behavior I

* Ariely, Dan and Wertenbroch, Klaus (2002), “Procrastination, Deadlines, and Performance: Self-Control by Precommitment, Psychological Science, 13 (May), 219-224

February 7 – Lecture 3

12pm-1pm: Meet at 2232 Piedmont for Brownbag Seminar with Daniele Kahneman on “Behavioral Economics and Demography”.

1.10pm-3pm: Meet back in 639 Evans

Present-Biased Preferences: Consumer Behavior II


Present-Biased Preferences: Life-Cycle Consumption and Savings Decisions


Additional Readings on Present-Biased Preferences

Experimental and Neural Evidence


Samuel M. McClure, David Laibson, George Loewenstein and Jonathan D. Cohen) Separate Neural Systems Value Immediate and Delayed Monetary Rewards. Science 306, October 15 2004


Consumer Behavior
Wertenbroch, Klaus, “Consumption Self-Control by Rationing Purchase Quantities of Virtue and Vice,” Marketing Science, 17 (4), 317-337


Payday effect


Barenstein and Huffman “Beer, Steak and Whisky: Evidence of a Payday Spending-Spree”

Duflo and Kremer

Labor Economics

Public Economics


Corporate Finance

February 14 – Lecture 4

Present-Biased Preferences: Life-Cycle Consumption and Savings Decisions II

Reference Dependence and the Endowment Effect


February 21 – Lecture 5

Reference Dependence and Labor supply


Goette, Lorenz and Huffman, David “Reference-Dependent Preferences and the Allocation of Effort Over Time”, 2004.


Reference Dependence and Risk Aversion


February 28 – Lecture 6

Reference Dependence and Asset Pricing


Reference Dependence and Pay-Setting
Social Preferences: Charitable Giving

Additional Readings on Reference Dependence

Markets


Camerer, Colin. “Prospect theory in the wild: Evidence from the field” (CVF 16)

Time preferences

Neural evidence

March 7 – Lecture 7

Social Preferences: Gift Exchange in The Field


Limited Attention: eBay Auctions

**Additional Readings on Social Preferences**


*Field experiments*


**March 14 – No Lecture**
Part II -- Non-Standard Information Processing

March 21 – Lecture 8

Limited Attention: Financial Market Evidence


DellaVigna, Stefano and Pollet, Josh. 2004 “Attention, Demographic Changes and the Stock Market”


Limited Attention: Consumption Behavior

Menu Effects: 1/n Heuristic


Menu Effects: Use of Irrelevant Information
*Ho, Daniel E., and Kosuke Imai.``

Additional Readings on Limited Attention

Theory and Experiments

Gabaix, Xavier and David Laibson “Bounded rationality and directed cognition”, Mimeo.


Financial Markets


Voters

March 23 – 2-page Paper proposals due

March 28 – Spring Break – No Lecture

April 4 – Lecture 9
Menu Effects: Choice Overload and Other


Social Pressure


Persuasion


Additional Readings on Social Pressure and Persuasion
Model

DeMarzo, Peter, Vayanos, Dimitry, and Zwiebel, Jeff. “Persuasion Bias, Social Influence, and Uni-Dimensional Opinions”, July 2002

Evidence


Bernardo A. Huberman, Christoph H. Loch, and Ayse Öncüler “Status as a Valued Resource”, mimeo.
Part III -- Non-Standard Beliefs

April 11 – Lecture 10

Overoptimism

CVF 23


Overconfidence


Projection Bias

Part IV -- Market Response to Biases

April 18 – Lecture 11


April 25 – Lecture 12


Market Response to Biases: Corporate Decisions


Market Response to Biases: Politicians


Market Response to Biases: Welfare Maximization

Empirical Methodologies in Psychology and Economics

May 2 – Final Exam

Additional Readings on Market Response to Biases
Market Response to Bias: Pricing


Do biases matter?
Becker, 1962


Betting

Corporate Decisions


Empirical and Behavioral Corporate Finance: CEOs
Jensen and Murphy (1990): "Are CEOs paid like Bureaucrats?"


*Behavioral Finance and Event Studies*


Additional Topics

Framing and Narrow Framing

*Constructed Preferences*

Loewenstein, George and Simonsohn, Uri. "Mistake #37: The Effect of Previously Faced Prices on Current Housing Demand".

*Framing / Anchoring*

*Bargaining*


*Flypaper effect*
Singhal, Monica. Special Interest Groups and the Allocation of Public Funds, mimeo.

Neuroeconomics

Camerer, Colin; Loewenstein, George; Prelec, Drazen. “Neuroeconomics: How Neuroscience Can Inform Economics”

