

Reading Assignment 13: Kahneman and Tversky on Certainty, Reflection, and Isolation Effects

Assigned Reading Read Sections 1 and 2 (i.e., pages 263-273) of D. Kahneman and A. Tversky. “Prospect Theory: An Analysis of Decision under Risk”. In: *Econometrica* 47.2 (1979), pp. 263–291

Technical Requirements

Answer questions three, four, and six. Together, your answers should not be longer than a single typed page. Remember to provide page numbers indicating which passages you are paraphrasing. For the remaining optional questions, please write down the page numbers on which the authors address the question.

1. In Kahneman and Tversky’s experiments, subjects are offered *hypothetical* choices, which they acknowledge has a number of methodological limitations for studying human decision-making. Briefly describe two alternative methodologies that they discuss and the limitations of those methodologies.
2. Kahneman and Tversky claim that, in expected utility theory, “risk aversion” is equivalent to *concavity* of the utility function. Run a Google search if necessary, but draw examples of concave and convex functions.
3. According to Kahneman and Tversky, the method of hypothetical choices relies on what two assumptions? Give your own examples of hypothetical choices that might be offered to subjects in labs in which those two assumptions might be violated.
4. Describe the *certainty effect* in your own words. Is the certainty effect observed in hypothetical choices involving non-monetary outcomes? If so, give an example of hypothetical choices that (i) Kahneman and Tversky gave to experimental subjects, (ii) involve non-monetary prizes, and (iii) illustrate the certainty effect. If no such experiments exist, briefly explain why not.
5. Is the certainty effect observed in choices involving monetary *losses*? If so, give an example of hypothetical choices that (i) Kahneman and Tversky gave to experimental subjects, (ii) involve monetary losses, and (iii) illustrate the certainty effect. If no such experimental exist, briefly explain why not.
6. Describe the *reflection effect* in your own words. Give an example of one of Kahneman and Tversky’s experiments illustrating the reflection effect.
7. What is *probabilistic insurance*? Give an example of a type of “probabilistic insurance” that many people possess, according to Kahneman and Tversky. Then try to give *your own* example of a type of “probabilistic insurance” that many people possess (i.e., your example should not be one in Kahneman and Tversky’s papers).
8. Describe the *isolation effect* in your own words. Give an example of one of Kahneman and Tversky’s experiments illustrating the reflection effect.