

Reading Assignment 14: Kahneman and Tversky's Prospect Theory

Assigned Reading Read Sections 3 and 4 (i.e., pages 274-289) 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 one, 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. Answer the following questions about Kahneman and Tversky's prospect theory.
 - A. Is it a descriptive or normative theory?
 - B. Does it apply to decisions under uncertainty or under risk only?
 - C. Is it applicable to gambles involving non-monetary outcomes or monetary outcomes only?
2. In no more than a paragraph, summarize the *editing phase* of Kahneman and Tversky's prospect theory.
3. What does the "value function" in Kahneman and Tversky's theory represent? Copy the picture of a typical value function from the bottom of page 279. Which parts of the curve are concave? Which are convex? Which parts of the graph are "steeper" than others, and why?
4. What does the "weighting function" represent, and how does a weighting function differ from a probability function?
5. Define *subcertainty*. In doing so, first copy the equation that is used to define subcertainty. Then, to the best of your ability, explain what "subcertainty" is without the use of mathematical symbols and how it is used to explain typical preferences in the Allais paradox.
6. Kahneman and Tversky claim that prospect theory successfully explains some gambling behavior and some individuals' insurance purchasing behavior. But they also think their theory fails to explain some choices involving insurance. Which phenomena do they think the theory explains well? Which does it explain poorly?
7. What do Kahneman and Tversky typically assume is the "reference point" that is used to distinguish gains from losses? Give an example of a reason that referent point might "shift" and how the shift in reference would influence a decision-maker's choices according to prospect theory.
8. Kahneman and Tversky suggest pursuing several "extensions" to prospect theory. Pick the "extensions" that you find most exciting, and briefly describe it in your own words.