Reading Response #2 Feedback and Comments

TLDR: Key Takeaways

- **Do not summarize. Do not summarize. Do not summarize.** (So important that it needs to be stated three times)
  - If you are using more than one or two sentences to describe the background, you're probably summarizing too much (and the opportunity cost of summarizing is that you are not offering your unique insights and perspectives, i.e., the things that can add value to your paper)
  - If you must, it's better to insert a reference (e.g., "Problem 5") or a screenshot of the problem you're referring to and just focus on your analysis and insights in your essay
- **Establish Motivation**. Why should someone be interested in your paper? Who is your target audience (either stated or implied)? What specific actions would you recommend?
  - Is your essay saying something new that isn't generally accepted or considered?
    - *Thesis 1*: Economics and psychology have a lot of overlaps, and economists and psychologists should continue to learn from one another.
    - *Thesis 2*: Financial advisors should take into account the learnings from the prospect theory to issue more client-centered decisions informed by a research-driven understanding of risk and how people respond to risk. They can achieve this by <initiative-a>, <initiative-b>, and <initiative-c>.
    - Which one do you think is a more compelling thesis?
- **Consider unconventional connections and real-world examples** (see below for examples)

As this is not a writing class, I will not go into much more detail about specific writing strategies. Additional writing support are available if you come talk to me during office hours, utilize the Student Learning Center's Writing Program, or reference books such as this one which I highly recommend: The Craft of Research 4e [Wayne C. Booth, Gregory G. Colomb, Joseph M. Williams, Joseph Bizup, William T. Fitzgerald].

General remarks

We are constantly dealing with risk and uncertainty as we live our lives, whether it's buying a lottery, driving a car, accepting a new job, etc. We use insurance to manage and mitigate risks, negotiate and communicate to narrow our options, and criminal plea bargains help reduce uncertainty surrounding outcomes. Moreover, we are fascinated by risk-taking and courage as fictional characters approach new and unfamiliar situations, seeking new ideas, making good decisions, communicating their opinions, and standing up for their beliefs. This is Harry Potter accepting his expedition at Hogwarts, Alice in Wonderland exploring the unknown, and Woodie's chivalrous adventure while finding his belonging in Toy Story. The Expected Utility Theory and the Prospect Theory help us understand the intricacies surrounding risk tolerance and risk aversion.

Consider the following essay

Prospect theory is a psychological theory that describes how people choose between different options when faced with uncertainty. The theory was first proposed by Daniel Kahneman and Amos Tversky in 1979 and has since been used to explain a wide range of human decision-making behavior.

Prospect theory posits that people are risk-averse when it comes to gains and risk-seeking when it comes to losses. This means that people are more likely to choose an option that will give them a sure gain, even if it is smaller than the potential gain from another option with more uncertainty. Similarly, people are more likely to take a chance on an option that could result in a loss to avoid the certain loss associated with the other option.

The prospect theory is useful in explaining everything from investment decisions to medical choices. It can help us understand why someone might choose a less risky investment even though it offers lower returns or

why someone might opt for surgery even though there is no guarantee it will be successful. In many cases, prospect theory can help us make better decisions by considering our natural tendencies towards risk aversion and risk seeking.

This essay was generated by a personal AI writer based on OpenAI's GPT-3 model. In other words, it is very easy to get an elegant summary of virtually any topic that includes broad connections. A paper like the above will not score very high as it does not demonstrate deeper critical thinking. Where you, as a discerning economist, can add the most value, therefore, is by going beyond a mere summary of the paper and instead exploring unconventional connections and applying a critical analysis to the paper.

Examples of Unconventional Connections

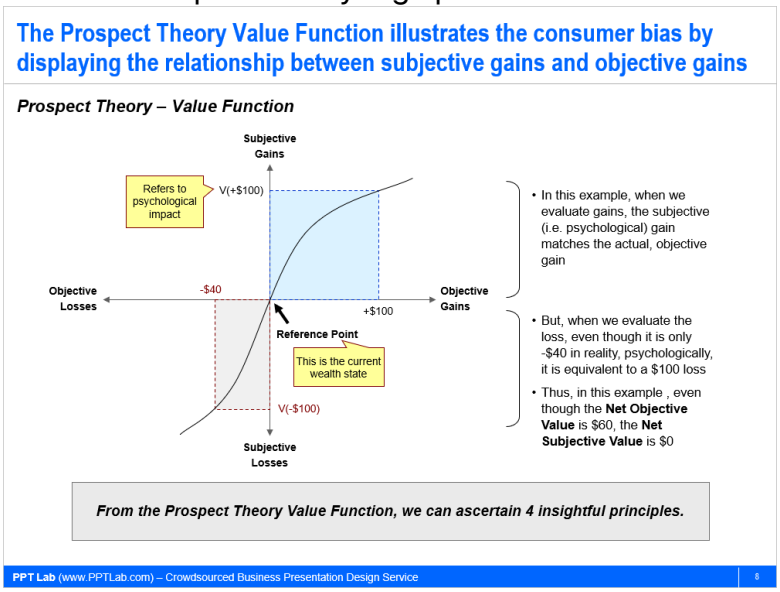
- A discussion of how user experience (UX) should be focused on eliminating negative experiences (such as 404 page not found errors, website maintenance, etc.), see more here: https://www.nngroup.com/articles/prospect-theory/
- Implications for political science, international relations, and law, see https://fas-polisci.rutgers.edu/levy/articles/2003%20Prospect%20Theory%20-%20Synthese.pdf
- Strategic management and organizational behavior / human resource management, see https://journals.sagepub.com/doi/pdf/10.1177/0149206310394863
- Relationship to specific products or sectors, e.g. https://www.sciencedirect.com/science/article/pii/S2212827114001425
- Coupon Collector Problem in statistics and probability; some products feature unpredictability in what's inside, e.g. Happy Meal with a (random) free toy. Consider how this relates to (or contradicts) the prospect theory. What deeper truths might this reveal about consumer preferences, and how might we reconcile these frameworks?
- Connections to academia: Bounded Rationality (Herbert Simon), read more here https://thedecisionlab.com/biases/bounded-rationality; Maximizers vs. Satisficers (Barry Schwartz), read more here: https://www.psychologistworld.com/cognitive/maximizers-satisficers-decision-making
- Network routing and signal processing as inherent random processes. How can we design those with user experience in mind?
- Do the theories relate to the Net Present Value rule in finance?
- How does people's risk preference (and perception) affect political outcomes? Example: American Revolution involved a lot of risks but also a lot of rewards — how might the Prospect Theory inform our understanding of political and democratic decisions? Expressions of political discontent? One paper this reminds me of is "From the Elites to the Streets: The Psychology of Democracy and Economic Inequality" by Seamus A Power. See https://knowledge.uchicago.edu/record/937?ln=en

Examples of Real-World Examples

- Consider where some CEO's receive salary as well as stock options, introducing uncertainty in the payoff
- How does probabilistic insurance play into the real world: consider car insurance with specific exclusions such as towing, damaged wheels, etc.
- Marriage and other long-term partnerships/relationships — how do we choose under uncertainty?
- Do people prefer long-term employment security? Think tenured professors, long-term athletes, supreme court justices, etc. What might be some unintended consequences (both positive and negative) from this?
- How often do people use self-insurance (e.g., pay $35,000 to the DMV in lieu of commercial insurance)?
- How might companies offering a generous return policy (Costco, Amazon) and companies making up for bad experiences (Starbucks "always say yes" policy, making your coffee over again until you are satisfied) be related to the prospect theory? What further company-wide policies or industry-wide policies do you think relate to the prospect theory or should be implemented based on the prospect theory?

Critical Analysis Prompts

- In which kinds of scenarios are the prospect theory most applicable? In which kinds of scenarios are the expected utility theory most applicable?
- Considering the analogy of a map: a map that is just a circle to represent the world is probably not very useful, and a map that contains every detail is too big to be useful. Does the expected utility theory contain the optimal balance between the amount of detail and the degree of abstraction? What about the prospect theory?
- Is there a way to combine the two theories to yield a more comprehensive model? If so, how? If not, what are some challenges?
- Is there a way to model risk preference and risk aversion using utility functions, and how might this inform our understanding of risk preference?
    - If you want to model different risk preferences (e.g. risk-aversion for gains and risk-seeking in the losses, how would you express this using a utility function)?
- We have seen the EUT expressed numerically, but what about the prospect theory? How can we numerically express the relationships described in the paper?
- Inspired by the Russian Roulette example, let's consider risk and uncertainty in life-and-death scenarios. How would you view our current policies intended to save lives (e.g., speed limits, seat belt legislation, driving under influence enforcement) in light of the prospect theory? Do you think how we value reducing fatalities, whether it's TSA in air travel safety, emergency medical response, disaster relief, etc., is reasonable, given what we know about the prospect theory?
- One potential way to reconcile the prospect model is for people to value their cognitive energies — people want to avoid thinking as much as possible. How this plays out might be that people select the option that seems to yield the higher benefit (if the optimal choice is obvious, choose the option that maximizes the utility), and people rely on their intuition when the two option appears to be similar (when the optimal choice is not obvious, people resort to laziness, preserving their cognitive energies)
- One way to understand why people prefer certainty: A certain outcome is easy to think about and plan for, whereas an uncertain outcome leads to excessive planning as you want to prepare your response to every possible scenario. The former is cognitively cheaper, so we prefer certainty.
- An interesting illustration of the Prospect Theory in graph form is attached:



A critical reflection should go beyond a mere summary and transcend mere personal examples that confirm the Prospect Theory. The critical reflection could involve a discussion of the applications (as above), so you are encouraged to pick a unique connection to share your insights. I look forward to continue exploring microeconomics, learning from and growing with you all. I particularly look forward your refreshing thoughts on the future reading responses, good luck!