Foundations of Economic Preferences

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Outline of presentation

The „stable preference assumption“
- Economists view
- Sociologists view
- How sound is the economists viewpoint?

Understanding endogenous preferences – what can we gain?

Two examples
- The impact of stock prices on risk preferences
- The impact of business culture on honesty in banking industry
The role of preferences in economics

- **Economics deals with the allocation of goods among alternative uses**
  - "Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses." (Lionel Robbins)
  - Individual preferences as the decisive determinant of the "ends"
  - In positive and normative economics individuals’ preferences are typically taken as exogenously given
  - Preferences are the “unmoved movers” of economic behavior
De Gustibus non est disputandum (Stigler & Becker)

... tastes neither change capriciously nor differ importantly between people. On this interpretation one does not argue about tastes for the same reason that one does not argue over the Rocky Mountains – both are there, will be there next year, too, and are the same to all men.“

Not just stable preferences but also no heterogeneity
Stigler & Becker cont’d

- Assuming unstable and heterogeneous preferences leads to intellectual laziness
  - “We also claim that no significant behavior has been illuminated by assumptions of differences in tastes. Instead, they, along with assumptions of unstable tastes have been a convenient crutch to lean on when the analysis has bogged down. They give the appearance of considered judgement, yet really have only been ad hoc arguments that disguise analytical failures”
Not all economists subscribe to this extreme view but ... 

- Compelling evidence that preference heterogeneity matters and interacts in important ways with the institutional environment
  - Social preference research (e.g., Fehr & Schmidt 1999)
  - Risk preference research (e.g., Bruhin et al. 2010)

- But: almost all economic research examines the changes in individual behavior and aggregate outcomes that follow from changes in constraints
  - Tax, cost, price and information changes
  - Changes in property rights & the contractual environment

- Implicit assumption:
  - Strong preference stability: changes in constraints ("the environment") leave preferences unaffected
  - Weak preference stability: for the problem under consideration preferences are more stable than constraints
Are preferences stable or are they shaped by „society“?

A sociologist’s view

The assumption that society shapes individuals’ preferences „clearly concerns one of the core pillars of sociology but it is not easy to suggest any literature to you. It is almost too fundamental for that - like asking economists to suggest some tests on the importance of choice. Almost all sociologists take it as obvious that individuals’ preferences are formed by society and that society, so to speak, exists within persons.“ (Peter Hedstrom, Oxford)
Remarks on the assumption of preference stability

- Important to recognize
  - It is **NOT a fact** that changes in the environment leave preferences unaffected
  - It is merely a useful assumption that took on the nature of a social convention
  - It is considered bad practice to invoke changes in preferences as explanations

- „*One can explain everything if one invokes changes in preferences as an explanation*“
- „*It is too easy to explain changes in behavior by changes in preferences*“
Problems with the economists’ argument

- „One can explain everything if one invokes changes in preferences as an explanation“
- „One can explain everything if one invokes changes in the environment (constraints) as an explanation“
  - „Give me a real world contract and I will find an extensive form game that rationalizes this contract as an equilibrium of the game“
  - Clever contract theorists can rationalize „everything“ in terms of changes in the environment
My View

- The methodological arguments against invoking „preference changes“ are not very convincing.
- They rest on conventions, social norms and (unproven) beliefs about the empirical validity of the assumption that one can neglect changes in preferences for the problem at hand.
- Deep down, most of us believe that preferences are shaped by teaching, role models, the behaviors we observe around us and our social interactions with other people.
  - Educating one’s children is not just about skill formation – it’s also about teaching the „right“ preferences.
Studying the production of personality (preferences) - A research program

- What are the social and cultural determinants of preferences (cultural economics)?

- How do aggregate economic events feedback on individuals’ preferences («sociological economics»)?

- What are the biological and neural determinants of human preferences (Neuroeconomics)?
Two programmatic papers

- Tastes, Castes and Culture (Fehr & Hoff, Economic Journal 2011)

Why should we study the «production of people»?

- It is per se interesting
- Helps us to better understand real world phenomena

Social inequality may be perpetuated because social status differences produce preferences that facilitate the reproduction of inequality

- Hoff-Fehr-Kshetramade (EJ 2011): low castes are less willing to altruistically punish norm violations leading to lower ability for collective action.
- Haushofer-Fehr (Science 2014): poverty causes higher risk aversion and impatience making it more difficult to escape poverty
Group conflict (wars) seem to induce risk-seeking, impatience, and prosociality towards ingroup members – all of which tends to make peace more difficult (Voors et al., AER 2013)

Social (labor market) policy creates entitlement effects that change preferences
  - Legal minimum wages increase reservation wages (Falk-Fehr-Zehnder, QJE 2006)

Impact of legal defaults strongly influences savings and organ donations
Welfare state may affect preferences for leisure and work (Lindbeck & Weibull, QJE 2006)

- Altruistic parents have an incentive to instill strong «work norms» in their children because that reduces the probability that they need help when grown up.
- Welfare state diminishes this incentive and leads to weaker work norms.
The impact of «society» on preferences
Two examples

- The impact of aggregate stock market trends on people’s risk preferences
  - Cohn-Fehr-Marechal (forthcoming AER)

- The impact of business culture on honesty
  - Cohn-Fehr-Marechal (Nature 2014)