PHPE 400
Individual and Group Decision Making

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Summary

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    - The principles of stability or invariance are not satisfied.
    - Outcomes can be *reframed* or *redescribed* to address the apparent inconsistencies.

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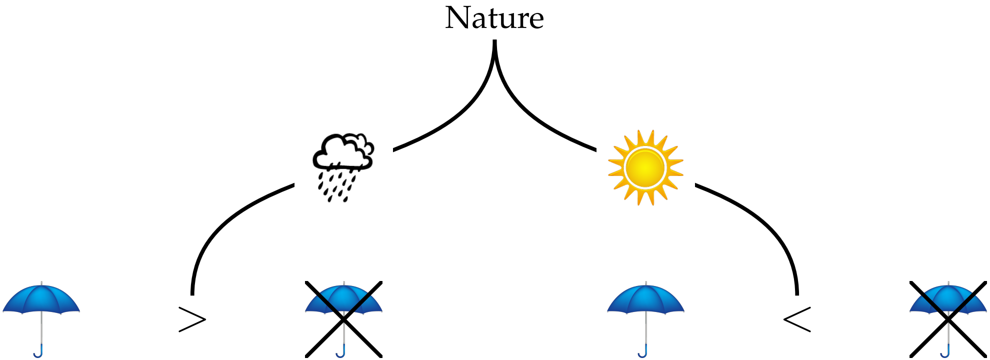
- Violations of expected utility theory can be understood in two key ways:
  - The principles of stability or invariance are not satisfied.
  - Outcomes can be *reframed* or *redescribed* to address the apparent inconsistencies.

- Rational choice theory faces a fundamental dilemma: Only assume the formal axioms of transitivity, independence, etc. OR transform rational choice theory into a substantive framework shaped by assumptions that reflect *the economist's* perspective.

Decision problems


Nature
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	encumbered, dry	encumbered, dry
	wet	free, dry

States: it rains; it does not rain

Outcomes: encumbered, dry; wet; free, dry

Actions: take umbrella; leave umbrella

		
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	Rain (s_1)	No rain (s_2)
Take umbrella (A)	encumbered, dry (o_1)	encumbered, dry (o_1)
Leave umbrella (B)	free, wet (o_2)	free, dry (o_3)

$$A(s_1) = A(s_2) = o_1$$

$$B(s_1) = o_2, B(s_2) = o_3$$

	Rain (s_1)	No rain (s_2)
Take umbrella (A)	encumbered, dry (o_1)	encumbered, dry (o_1)
Leave umbrella (B)	free, wet (o_2)	free, dry (o_3)

Suppose that $P(s_1) = 0.6$ and $P(s_2) = 0.4$
(the decision maker believes that there is a 60% chance that it will rain).

	Rain (s_1)	No rain (s_2)
Take umbrella (A)	encumbered, dry (o_1)	encumbered, dry (o_1)
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Suppose that $P(s_1) = 0.6$ and $P(s_2) = 0.4$
(the decision maker believes that there is a 60% chance that it will rain).

Suppose that the decision maker's utility for the outcomes is:
$u(o_1) = 5$, $u(o_2) = 0$ and $u(o_3) = 10$.

	Rain (s_1) $P(s_1) = 0.6$	No rain (s_2) $P(s_2) = 0.4$
Take umbrella (A)	encumbered, dry (o_1) $u(o_1) = 5$	encumbered, dry (o_1) $u(o_1) = 5$
Leave umbrella (B)	free, wet (o_2) $u(o_2) = 0$	free, dry (o_3) $u(o_3) = 10$

$$
\begin{aligned}
EU(A, u) &= P(s_1) \times u(A(s_1)) + P(s_2) \times u(A(s_2)) \\
EU(B, u) &= P(s_1) \times u(B(s_1)) + P(s_2) \times u(B(s_2))
\end{aligned}
$$

	Rain (s_1) $P(s_1) = 0.6$	No rain (s_2) $P(s_2) = 0.4$
Take umbrella (A)	encumbered, dry (o_1) $u(o_1) = 5$	encumbered, dry (o_1) $u(o_1) = 5$
Leave umbrella (B)	free, wet (o_2) $u(o_2) = 0$	free, dry (o_3) $u(o_3) = 10$

$$\begin{aligned} EU(A, u) &= 0.6 \times 5 + 0.4 \times 5 &= 5 \\ EU(B, u) &= 0.6 \times 0 + 0.4 \times 10 &= 4 \end{aligned}$$

$EU(A, u) > EU(B, u)$, so the decision maker strictly prefers A to B.

	Rain (s_1) $P(s_1) = 0.6$	No rain (s_2) $P(s_2) = 0.4$
Take umbrella (A)	encumbered, dry (o_1) $u'(o_1) = 4$	encumbered, dry (o_1) $u'(o_1) = 4$
Leave umbrella (B)	free, wet (o_2) $u'(o_2) = 2$	free, dry (o_3) $u'(o_3) = 8$

$$
\begin{aligned}
EU(A, u') &= 0.6 \times 4 + 0.4 \times 4 &= 4 \\
EU(B, u') &= 0.6 \times 2 + 0.4 \times 8 &= 4.4
\end{aligned}
$$

$EU(A, u') < EU(B, u')$, so the decision maker strictly prefers B to A.

	Rain (s_1) $P(s_1) = 0.6$	No rain (s_2) $P(s_2) = 0.4$
Take umbrella (A)	encumbered, dry (o_1)	encumbered, dry (o_1)
Leave umbrella (B)	free, wet (o_2)	free, dry (o_3)

$$u(o_3) = 10 > u(o_1) = 5 > u(o_2) = 0$$
$$EU(A, u) = 0.6 \times 5 + 0.4 \times 5 = 5 > EU(B, u) = 0.6 \times 0 + 0.4 \times 10 = 4$$

$$u'(o_3) = 8 > u'(o_1) = 4 > u'(o_2) = 2$$
$$EU(A, u') = 0.6 \times 4 + 0.4 \times 4 = 4 < EU(B, u') = 0.6 \times 2 + 0.4 \times 8 = 1.2 + 3.2 = 4.4$$

Strict Dominance

	s_1	s_2	s_3
A	2	3	1
B	1	2	0
C	1	4	0

Is there a way of assigning probabilities to the states s_1, s_2, and s_3 such that the decision maker strictly prefers B to A?

Is there a way of assigning probabilities to the states s_1, s_2, and s_3 such that the decision maker strictly prefers C to A?

Strict Dominance

	s_1	s_2	s_3
A	2	3	1
B	1	2	0
C	1	4	0

Is there a way of assigning probabilities to the states s_1, s_2, and s_3 such that the decision maker strictly prefers B to A? No!

Is there a way of assigning probabilities to the states s_1, s_2, and s_3 such that the decision maker strictly prefers C to A? Yes!

Strict Dominance

	s_1	s_2	s_3
A	2	3	1
B	1	2	0
C	1	4	0

Is there a way of assigning probabilities to the states s_1, s_2, and s_3 such that the decision maker strictly prefers B to A? No!

Is there a way of assigning probabilities to the states s_1, s_2, and s_3 such that the decision maker strictly prefers C to A? Yes!

X **strictly dominates** Y when for all states s, $u(X(s)) > u(Y(s))$.

- A strictly dominates B

Strict Dominance

	s_1	s_2	s_3
A	2	3	1
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Is there a way of assigning probabilities to the states s_1, s_2, and s_3 such that the decision maker strictly prefers C to A? Yes!

X **strictly dominates** Y when for all states s, $u(X(s)) > u(Y(s))$.

- A strictly dominates B
- A does not strictly dominate C

Newcomb's Paradox

R. Nozick. *Newcomb's Problem and Two Principles of Choice*. 1969.

There are two boxes in front of us:

- box A, which contains \$1,000;
- box B, which contains either \$1,000,000 or nothing.

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We have two choices:

- we open only box B.
- we open both box A and box B;

There are two boxes in front of us:

- box A, which contains \$1,000;
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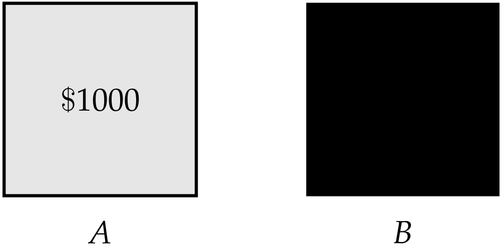
We have two choices:

- we open only box B.
- we open both box A and box B;

You can see inside box A, but not inside box B. We can keep whatever is inside any box we open, but we may not keep what is inside a box that we do not open.



Choice:

- one-box: choose box B
- two-box: choose box A and B

A famous example: Newcomb’s paradox

A very powerful being, who has been invariably accurate in his predictions about our behavior in the past, has already acted in the following way:

1. If he has predicted we will open just box B, he has put \$1,000,000 in box B.
2. If he has predicted we open both boxes, he has put nothing in box B.

What should we do?