Advanced Behavioral Economics Principles

Behavioral Economics · Answer Key · 12 Questions

1. In the context of Prospect Theory, what is the mathematical term for the phenomenon where individuals assign higher value to the prevention of a loss than to an equivalent gain?

A) Loss aversion coefficient
B) Diminishing sensitivity parameter
C) Probability weighting function
D) Reference point shift

2. The 'Allais Paradox' fundamentally challenges which traditional economic axiom regarding rational choice under uncertainty?

A) Independence Axiom
B) Transitivity Axiom
C) Completeness Axiom
D) Monotonicity Axiom

3. What does the 'reflection effect' in Prospect Theory specifically describe regarding risk attitudes?

A) Risk aversion in gains and risk seeking in losses
B) Risk seeking in gains and risk aversion in losses
C) Increased risk aversion in both domains
D) Increased risk seeking in both domains

4. Which phenomenon explains why subjects often exhibit a higher willingness to pay (WTP) to prevent the loss of an item than the willingness to accept (WTA) to part with the same item?

A) Endowment effect
B) Anchoring bias
C) Availability heuristic
D) Hindsight bias

5. According to the 'Law of Small Numbers' as defined by Tversky and Kahneman, what cognitive error do individuals consistently make?

A) Overestimating the replicability of small-sample results
B) Underestimating the variance of large populations
C) Ignoring base rates in Bayesian updates
D) Overweighting extreme outliers

6. In intertemporal choice, what does the 'hyperbolic discounting' model suggest about human discount rates?

A) They decline over time as the delay increases
B) They remain constant regardless of the time delay
C) They increase exponentially as the delay increases
D) They are independent of the magnitude of the reward

7. The 'Ellsberg Paradox' provides empirical evidence that individuals demonstrate a preference for known risks over ambiguous risks, a concept known as what?

A) Ambiguity aversion
B) Risk neutrality
C) Probability matching
D) Certainty effect

8. What is the core function of the 'Probability Weighting Function' in Cumulative Prospect Theory?

A) To account for the systematic overestimation of low probabilities
B) To linearize the relationship between objective and subjective utility
C) To adjust for the inflation rate over time
D) To measure the standard deviation of risky outcomes

9. Which concept, introduced by Thaler, describes the psychological tendency to treat money differently depending on its source or intended use, violating the principle of fungibility?

A) Mental accounting
B) Hedonic framing
C) Choice architecture
D) Preference reversal

10. The 'Isolation Effect' (or framing effect) in choice theory posits that individuals tend to simplify complex decisions by doing what?

A) Discarding common components of alternatives to focus on unique differences
B) Aggregating all outcomes into a single utility score
C) Focusing exclusively on the first attribute presented
D) Selecting the default option regardless of utility

11. In the context of social preferences, what does the 'Fehr-Schmidt model' of inequity aversion formally measure?

A) The disutility derived from unequal payoff distributions
B) The gain in utility from absolute wealth maximization
C) The impact of altruism on social welfare functions
D) The influence of peer pressure on consumption

12. Which cognitive bias, often cited in behavioral finance, refers to the tendency for investors to hold onto losing stocks for too long while selling winners too soon?

- **A) Disposition effect**
- B) Momentum effect
- C) Mean reversion
- D) Overconfidence bias