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A parameter-free analysis of the utility of money for the general population under prospect theory

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Abstract

Extensive data has convincingly demonstrated that expected utility, the reigning economic theory of rational decision making, fails descriptively. This descriptive failure casts doubt on the validity of classical utility measurements. Prospect theory can better explain choice behaviour because it makes the plausible assumption that risk attitudes are not only driven by sensitivity towards outcomes (utility curvature), but also by sensitivity towards probabilities (probability weighting), and by sensitivity towards whether outcomes are above or below a reference point (loss aversion). This paper presents an experiment that completely measures the utility- and loss aversion component of risk attitudes, using a representative sample of NÂ =Â 1935 respondents from the general public, in a parameter-free way. This study thereby provides the first measurement of the utility of money for the general population that is valid under (cumulative) prospect theory, does not depend on prior assumptions about the underlying functional form of utility, is externally valid, and does not rule out heterogeneity of individual preferences. The results confirm the concaveâ€“convex pattern of utility as predicted by prospect theory, suggest that utility curvature is less pronounced than suggested by classical utility measurements, and show that women are significantly more loss averse than men.

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Keywords

Prospect theory; Utility measurement; Loss aversion; Gender differences

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