

Chapter 7

Back to the Present Bias

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ABSTRACT

Much of the economic theory in the beginning of the 20th century assumes that people's tastes and preferences are invariant throughout time. However, recent studies show that this assumption cannot be supported by experiments. Humans are more inclined to present outcomes than future ones. Economists name this as present bias, which can formally be defined as the undervaluing of a larger, later reward and the preference for a smaller, sooner reward. Present bias has been considered a crucial element of economic/financial decision-making processes and it is shown to be related to various suboptimal outcomes. Here, the chapter per the authors summarizes several definitions of present bias, reviews the literature on present bias and behavioral based interventions. The chapter points out the importance and the relevance of some recent studies that stand out, as well as their implications for our day-to-day lives and how we can combat present bias.

INTRODUCTION

For years, especially after World War II, economists have approached individual decision-making as rational, level-headed, and that all consumers take the time necessary to weigh all potential options and make the most educated decision that benefits them (Thaler, 2016). However, in situations ranging from our daily lives to studies done by all sorts of disciplines beyond economics, this has consistently been shown to not be the case. Why do we choose to stay up late watching movies when we know we have to go to school or work the next day? Why is it that we consistently continue to smoke or consume copious amounts of fast food, knowing it is bad for our health? Why is it that we know that we should save for retirement, yet fail to set aside the necessary money every month? In the Platonic dialogue of Phaedrus, Socrates creates an analogy to describe human behavior: the soul is as a charioteer with a pair of these horses. Both gods and humans have this pair of horses, but while gods have two noble horses, humans

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Back to the Present Bias

have one horse that is wild and unruly. More colloquially, this horse corresponds to our impulsive side, the one that represents our inner passions and our desire to satisfy our needs immediately. Behavioral economics acknowledged the existence of this horse where earlier economic studies mostly refused to.

The argument on behalf of behavioral economists of what to name this phenomenon, the bowing to the will of the unruly horse, knows no bounds. Present-bias, present-focused behavior, inconsistent time preferences or something else-- which is it? Present-focused models, according to Ericson & Laibson (2019) are “temptation models or competing sets of interests simultaneously pull[ing] the decision maker in different directions.” Such a definition ties back to the Socratic reasoning about the soul described above-- the competing sets of interests are our passions and the internal spectator who attempts to rein in the unruly horse that is the free expression of our inner passions. Direr (2020) describes a present biased individual as someone who “values more an immediate outcome than one postponed in the near future, where the near future can be arbitrarily soon.” Building off of these definitions and various other formal definitions, this chapter will address our phenomenon as present bias and define it as the *undervaluing of a larger, later reward and the preference for a smaller, sooner reward*. In other words, “this amounts to people choosing more impatiently for the present than they do for the future”. There is an overwhelming literature supporting the argument that people tend to have present biased preferences (see O’Donoghue & Rabin (1999)). From the above definition, we review the literature on present bias and focus our attention to behavioral-based interventions tied to it.

PRESENT BIAS THEORIES AND MODELS

The study of present bias in formalized research stretches back to Samuelson’s seminal paper in (1937). He proposes ways to measure individual utility, in which individual tastes are assumed to be invariant throughout time. This model, commonly referred to as the exponential discounted utility model, discounts all the utilities in time by the same discount factor δ .¹ Strotz (1955) begins to explore time inconsistent preferences and concludes the following-- individuals can make a plan for the future, and follow it with certainty. This is called the harmony case, and represents no present biased decision making in an individual-- they make their decisions in the present and stick to it in the future with no changes in time preferences or any similar changes. The present bias counterpart of the harmony case, which he describes as the intertemporal tussle, which

May be inconsistent with the optimizing future behavior of the individual. In this later case, the conflict may not be recognized and... his behavior being inconsistent with his plans, or the conflict may be recognized and solved either by a strategy of precommitment or a strategy of consistent planning.

As we can see, Strotz (1955) even takes the first steps into behavioral interventions to solve what he calls the intertemporal tussle and we now know as present bias. A later section in this chapter will address commitment mechanisms, as well as other behavioral interventions tested in a more modern setting to help reduce present biased behaviors.²

It is worth mentioning Thaler & Shefrin’s (1981) dual-self model, which relies heavily on the principle-agent model of economic theory. This model proposes two selves for people:

1. First, the long sighted planner, who cares both the future and the present

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