Self Control, Risk Aversion, and the Allais Paradox

Drew Fudenberg* and David K. Levine**

First Version: May 12, 2006
This Version: January 24, 2009

This paper develops a dual-self model that is compatible with modern dynamic macroeconomic theory and evidence, and calibrates it to make quantitatively accurate predictions in experiments that display a wide range of behavioral anomalies concerning risk, including the Allais paradox. To obtain a quantitative fit, we extend the simpler “nightclub” model of Fudenberg and Levine [2006] by introducing one additional choice (the choice of a “nightclub,” or more generally of anticipated consumption) and one additional parameter that needs to be calibrated. We find that most of the data can be explained with subjective interest rates in the range of 1-7%, short-run relative risk aversion of about 2, and a time horizon of one day for the short-run self.

* Department of Economics, Harvard University
** Department of Economics, Washington University in St. Louis

We thank Daniel Benjamin and Jesse Shapiro for helpful comments and a very careful reading of an early draft, and Eduardo Azevedo and Tao Jin for exceptional research assistance. We are also grateful to Juan Carillo, Ed Glaeser, Glenn Harrison, Yoram Halevy. John Kagel, Stefan Krasa, Drazen Prelec, and seminar participants at Harvard, Ohio State, the University of Illinois Champagne Urbana and the 2006 CEPR conference on Behavioral Economics.