

COMMENT

'A Note on Endogenous Preferences and Adaptive Economizing' by Richard H. Day

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My own reaction to Day's paper tends to confirm his basic assumption — that preferences change as people adapt to experience. Before reading his paper I was not only ignorant but also rather indifferent to the problem of endogenous preferences. After reading it I feel instructed, excited but also somewhat puzzled. I am intrigued both by what Day does not say and by some of his explicit conclusions.

1. Why do preferences change?

Day's paper deals with the consequences of changing preferences and behavior patterns. As for the reasons for changing preferences Day only refers to some 'deep structure' in the beginning and mentions 'bounded rationality' at the end. For a reader, not conversant with the literature, this is not very illuminating.

In the case of an individual consumer, which is what Day mostly deals with, the simplest commonsense reason for changing preferences and consumption pattern is the change in the individuals' biological and social status. Life-cycle development and with that the transformation of the social network of relations can and will usually induce drastic changes in the individual's life pattern and preferences. This is by itself a sufficient reason for not expecting stable long-term demand functions or static utility functions.

This conclusion is furthermore reinforced by the fact that part of our preferences may depend on our experience of what other people consume. In many cases of so-called status goods or fashions and fads the consumer is trying to maintain or improve his relative position in the social pecking order by consuming the fashionable goodies. If this adaptive effort is common enough it will, however, usually prove self-defeating. Fashion leaders and trend-setters will move out first and, after a while, so will the others. In all these cases the 'social adaptation' will thus lead to cycles in consumption. Moreover, these would not be fully anticipated since they depend on other people's behavior.

These kinds of preference changes are, however, not really part of Day's story which is restricted to 'experience-dependent' changes in a more narrow sense.

Economic theory, however, offers several alternative ways of explaining also this kind of instability of short-run preferences.

One obvious possibility is that the observed inconsistencies, preference reversals, cycles etc. are illusory in the sense of being due to an oversimplified treatment of consumption. If our 'innate preferences' refer to the spectrum of social activities, using commodities as inputs, changes in the costs and remunerations of activities, may well result in different commodity choices without commodity prices or total income having changed. Using such an enlarged consumption model you could easily construct examples of, e.g., preference reversals and experience-dependence in terms of commodities.

A perhaps even more intuitively appealing form of explanation could be couched in terms of uncertainty or search strategies. Lack of acquaintance with the varied forms of possible activities, uncertainty about the quality of commodities and their efficacy in different usage, limited knowledge about the prices offered by different sellers and buyers — all this together with a changing economic environment and a limited capacity to learn, calculate and memorize are inescapable conditions in consumption. Part of a mini-max strategy under these conditions could, e.g., be a limited step-size or rate of adaptation, explaining the observed inertia in consumption patterns, which first gave rise to the use of 'experience-related' variables in econometric demand functions. The kind of 'deep structure'-relations used by Day in his examples could often be interpreted in terms of 'reservation prices' used by the consumer during his search, etc.

In these various ways one could probably derive all the 'chaos' needed, without invoking ad-hoc assumptions on 'habit formation' or relying on preset limits to consumer rationality. It would seem to me, that if we want to go beyond considerations of econometric convenience and incorporate the 'chaos' into economic analysis, we would need to find some more solid ground for explaining its occurrence.

2. The examples of 'chaos'

Day presents a long line of ingeniously constructed examples illustrating various possibilities of 'chaotic' behavior. As illustrations they are illuminating but as propositions about real-life behavior they are somewhat less convincing. I therefore get slightly worried when the author starts drawing conclusions about actual behavior from his own examples.

Already the first and simplest of Day's examples (p. 156 ff.) makes me slightly uneasy in this respect. The simplified behavior model used can be described in the following way. The consumer goes into the market with a preset

norm or standard of comparison with regard to the budget share for a certain commodity (the α in Day's 'deep structure'). If this norm is the outcome of conscious deliberations it could be interpreted as a kind of 'reservation price' for the consumer, although measured in terms of budget shares. If the consumer finds that the market price is lower than the preset norm, he will start increasing his purchase of the commodity. Since all other commodity expenditures are residually determined, this will go on until the consumer has used up all his money on the commodity in question. Should the market price be higher than his reservation price, the process will go into reverse, leaving him in the end with a zero purchase of the commodity.

This is a simple and not very convincing story, which, however, serves an illustrative purpose. My worry starts when Day goes on to elaborate his story, drawing conclusions about what rich and poor people respectively will do. Apart from the simplification of the model itself, these conclusions rest on the seemingly far-fetched assumption that the preset norms with regard to budget shares are independent of income. Analogous objections can be raised against the author's later discussion of preference reversal.

In most cases however the author is more cautious and only uses his examples to illustrate possible unstable mechanisms. Personally I find his example of a destabilizing interaction of habit formation and price adjustment particularly instructive. What it illustrates is the fact, too often overlooked, that different but simultaneous adjustment processes, given certain speeds of adjustment, will not only overshoot but result in a destabilized market performance. To the adjustment of preferences and prices could be added tax adjustment as a third potential destabilizer.

Day's examples vividly illustrate various kinds of destabilizing mechanisms. The next step, touched upon by Day at the end of his paper, must be to show, by use of economic theory and later econometric studies, that these kinds of mechanisms are not only possible but probable. It may very well turn out that the real puzzle is not the unstable performance of individual consumers but the apparent stability of aggregate demand.

3. Education as an addiction

Many of Day's behavior models are based on the assumption of an unanticipated positive feedback of consumption on preferences. The only real life example used in the text, however, is the addiction to booze.

I would like to end my comment by suggesting that this kind of unanticipated feedback has a much wider application than that.

For instance, people seem to become, as it were, 'addicted' to education. As many studies have observed, the more educational service you consume, the more eager you get to consume more.

Based on these observations you could construct a scenario, where initial

differences in educational background lead to a cumulatively widening gap both in terms of education and income. Part of these differences could moreover be inherited and carried over to new generations. The process of social segmentation is, however, usually interrupted by collective actions aiming at redistributing educational opportunities or introducing minimum educational standards.

Similar stories of cumulative social segmentation and demand bifurcation can be written for, e.g., many cultural activities and for the health services.

An assumed unanticipated positive feedback could thus be useful in analyzing the demand for a wide variety of social goods and for explaining certain dynamic properties of social allocation and social change.