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Abstract

This paper models an agent in a three-period setting who does not update according to Bayes' Rule, and who is self-aware and anticipates her updating behavior when formulating plans. Gul and Pesendorfer's theory of temptation and self-control is a key building block. The main result is a representation theorem that generalizes (the dynamic version of) Anscombe-Aumann's theorem so that *both* the prior *and* the way in which it is updated are subjective. The model can accommodate updating biases analogous to those observed by psychologists.

Keywords: Temptation, self-control, non-Bayesian updating, underreaction, overreaction

JEL Classification: D80, D81

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1. INTRODUCTION

1.1. Motivation and Outline

This paper models an agent in a three-period setting who does not update according to Bayes' Rule, and who is self-aware and anticipates her updating behavior when formulating plans. The major contribution is a representation theorem for a suitably defined preference that provides (in a sense qualified in the concluding section) axiomatic foundations for non-Bayesian updating. One perspective on the theorem is obtained through its relation to a dynamic version of the Anscombe-Aumann theorem which provides foundations for reliance on a probability measure representing subjective prior beliefs and for subsequent Bayesian updating of the prior.[1] Thus, while beliefs are subjective and can vary with the agent, updating behavior cannot - everyone must update by Bayes' Rule. This Anscombe-Aumann theorem is generalized here so as to render it more fully subjective - *both* the prior *and* the way in which it is updated are subjective.

Non-Bayesian updating leads to changing beliefs and hence to changing preferences over alternatives (Anscombe-Aumann acts). This in turn leads to the temptation to deviate from previously formulated plans. Thus we are led to adapt the Gul and Pesendorfer (2001, 2004) model of temptation and self-control. While these authors (henceforth GP) strive to explain behavior associated with non-geometric discounting, we adapt their approach to model non-Bayesian updating.

More specifically, GP show that temptation and self-control are revealed through the ranking of menus of lotteries;[2] see the next subsection for an outline of their model. Temptation arises because the ranking of lotteries which prevails when menus are chosen (period 0), changes in period 1 when a lottery must be selected from the previously chosen menu. Adapt their model first so that menus consist of (Anscombe-Aumann) acts over a state space S_2. In this setting, since preference

[1] A rough statement is as follows: if conditional preference at every decision node conforms to subjective expected utility theory and is independent of unrealized parts of the tree, then preferences are dynamically consistent if and only if they have a common vNM index and conditional beliefs at each node are derived by Bayesian updating of the initial prior. For a recent formalization in a Savage-style setting see Ghirardato (2002). For an Anscombe-Aumann setting, which is more relevant to this paper, the assertion is a special case of the main result in Epstein and Schneider (2003) regarding the updating of sets of priors.

[2] Kreps (1979, 1992) was the first to point out the advantage of modeling preference over menus. See Dekel, Lipman and Rustichini (2001) and Nehring (1999) for more recent refinements and variations.

over acts admits two distinct components - risk attitude and beliefs - one can consider temptations that arise due to changes in only one of these components. We do this here and focus on the effects of changes in beliefs.[3] Finally, we introduce another state space S_1, which can be thought of (roughly) as a set of possible signals, one of which is realized after a menu is chosen but before choice of an act. Then the above noted change in beliefs about S_2 presumably depends on the realized signal, and this dependence provides a way to capture non-Bayesian updating. To illustrate the resulting connection between temptation and updating, the model admits the following interpretation: at period 0, the agent has a prior view of the relationship between the next observation s_1 and the future uncertainty s_2. But after observing a particular realization s_1, she changes her view on the noted relationship. For example, she may respond exuberantly to a good signal after it is realized and decide that it is an even better signal about future states than she had thought ex ante. Or the realization of a bad signal may lead her to panic, that is, to interpret the signal as an even worse omen for the future than she had thought ex ante. In either case, it is as though she retroactively changes her prior and then applies Bayes' Rule to the new prior. The resulting posterior belief differs from what would be implied by Bayesian updating of the original prior and in that sense reflects non-Bayesian updating; for example, the exuberant agent described above would appear to an outside observer as someone who overreacts to data. The implication for behavior is the urge to make choices so as to maximize expected utility using the conditional of the new prior as opposed to the initial prior. Temptation refers to experiencing these urges, which here stem from a change in beliefs. Temptation might be resisted but at a cost.

As in GP, by assuming that preference is defined over (contingent) menus, we are able to model the agent's dynamic behavior via maximization of a stable (complete and transitive) preference relation. This is possible because our agent is sophisticated - she is forward-looking and anticipates her exuberance or, more generally, her psyche as it affects her reactions to signals ex post. Are individuals typically self-aware to this degree? We are not familiar with definitive evidence on this question and in its absence, we are inclined to feel that full self-awareness is a plausible working hypothesis.[4] Even where the opposite extreme of complete

[3] An appendix outlines the parallel analysis for changes in risk attitude. We focus on changes in beliefs because we find this route to be both intuitive and useful - it leads to a new model of and way of thinking about non-Bayesian updating.

[4] Comparable sophistication is assumed by GP and also in the literature on non-geometric discounting where the agent is often modeled as gaming against herself (see Laibson(1997), for

naivete seems descriptively more accurate, our model may help to clarify which economic consequences are due to non-Bayesian updating per se and which are due to naivete. Finally, it is the agent's sophistication that permits updating behavior to be inferred from her (in principle observable) ranking of contingent menus. This permits us to model "time-varying beliefs" while staying within the choice-theoretic tradition of Savage. We think it worthwhile to explore such modest departures from standard models before discarding the entire framework.

Several systematic deviations from Bayesian updating have been discussed in the psychology literature and some of these have been incorporated into modeling exercises in behavioral finance.[5] Our model cannot address these findings directly because the experimental literature deals with settings where prior probabilities are given objectively, while our model deals with the case where probabilities are subjective (which case we would argue is more relevant for economic modeling). Nevertheless, we show in Section 2.3 that our model can accommodate updating biases analogous to several discussed by psychologists and in the behavioral economics literature. This serves to demonstrate the richness of the model. Because it is also axiomatic, we suggest that it may provide a useful encompassing framework for addressing updating and related behavior.

The difference between objective and subjective probabilities is important for how one thinks about non-Bayesian updating. When probabilities are objective, deviations from Bayes' Rule are typically viewed as mistakes, the results of bounded rationality in light of the complexity and nonintuitive nature of Bayes' Rule (see Tversky and Kahneman (1974), for example). We agree with this view when probabilities are objective. However, updating behavior can be understood differently when probabilities are subjective. As described above, the agent in our model is sophisticated and she uses Bayes' Rule, but she applies it to a retroactively changing prior. Changing priors retroactively is not a 'mistake' or a sign of irrationality. After all, there are no objectively correct beliefs here, only an initial prior formulated ex ante and the agent is presumably entitled to change her view of the world given the new perspective afforded by the passage of time or the realization of a particular signal. This way of thinking of non-Bayesian updating in terms of changing priors recalls the literature, stemming from Strotz (1956), concerning non-geometric discounting and changing tastes.

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example).

[5] See the surveys by Camerer (1995) and Rabin (1998) for references to the psychology literature. Two recent applications in finance that contain extensive bibliographies to the behavioral literature are Brandt et al (2004) and Brav and Heaton (2002).

1.2. Updating, Temptation and Self-Control

This section elaborates on the GP model and on the way in which we adapt it.

Let $\Delta(X)$ denote the set of lotteries with payoffs in X and let $\succeq$ be a preference relation on menus of lotteries (suitably closed subsets of $\Delta(X)$). The interpretation is that at an unmodeled ex post stage, a lottery is selected from the menu chosen ex ante according to $\succeq$. GP axiomatize a representation for $\succeq$ of the form

$$\mathcal{U}(A) = \max_{x \in A} \left\{ U(x) + V(x) - \max_{y \in A} V(y) \right\}, \tag{1.1}$$

for any menu A, where U and V are vNM utility functions over lotteries. For singleton menus, $\mathcal{U}(\{x\}) = U(x)$ and thus U describes preference under commitment, which we interpret as describing the agent's view of what is in her best interest. The function V describes the agent's urges at the second stage. In the absence of commitment, there is a temptation to maximize V and hence to deviate from the ex post choices that would be prescribed by U. Temptation can be resisted, but at the cost of self-control given by $\max_{y \in A} V(y) - V(x)$. A balance between commitment preference and the cost of self-control is achieved by choosing a lottery ex post that maximizes the compromise utility function $U + V$.

Temptation and self-control costs are illustrated behaviorally by the ranking

$$\{x\} \succ \{x, y\} \succ \{y\}. \tag{1.2}$$

The strict preference for $\{x\}$ over $\{x, y\}$ indicates that even though x is strictly preferred to y under commitment, the presence of y in the menu is tempting. The ranking $\{x, y\} \succ \{y\}$ reveals that self-control is exercised to resist the temptation and to choose x out of $\{x, y\}$. The above intuition is captured more generally in GP's central axiom of Set-Betweenness:[6] For all menus A and B,

$$A \succeq B \implies A \succeq A \cup B \succeq B.$$

In the special case where $A \succeq B \implies A \sim A \cup B$, a menu can be valued according to the best lottery in the menu as in the standard approach. See Kreps (1988, Ch. 13) who coins the label *strategic rationality*.

[6] The axiom restricts the nature of temptation so that a set of alternatives is as tempting as its most tempting member. See GP (2001, pp. 1408-9) for reasons why Set-Betweenness might be violated. For further critical discussion and for a more general model of temptation see Dekel et al (2004).

The model to follow combines key elements of the GP model with the Anscombe-Aumann model of subjective probability. At a formal level, we introduce state spaces and consider preferences over (suitably contingent) menus of Anscombe-Aumann acts rather than over menus of lotteries. There are 3 periods - an ex ante stage 0, an interim period 1 when a signal $s_1 \in S_1$ is realized, and period 2 when remaining uncertainty is resolved through realization of some $s_2 \in S_2$. At time 0, the agent chooses some F, an s_1-contingent menu of acts over S_2. She does this cognizant of the fact that at time 1, after a particular s_1 is realized, she will update beliefs and then choose an act from the menu $F(s_1)$. Thus the way in which she updates will affect the ultimate choice of an act and therefore also the desirability at time 0 of any contingent menu. In this way, the nature of updating is revealed through preference over contingent menus. In particular, because non-Bayesian updating would lead to the "wrong" choice of an act from the menu after s_1 is realized, the agent is led to value commitment at time 0.

Under suitable axioms, we derive a representation for time 0 preference that admits the following interpretation: there are two measures p and q, rather than a single measure as in Anscombe-Aumann and rather than two utility functions as in (1.1). The significance of p is that expected utility relative to p describes preferences under commitment. Therefore, p can be thought of as the counterpart of the Savage or Anscombe-Aumann prior. Updating does not play a role in the ranking of contingent menus that provide commitment because these do not permit any meaningful choice after realization of the signal. Suppose, however, that the agent faces a nonsingleton menu after seeing the signal s_1 and consider the factors influencing her choice of an act from the menu. In analogy with interpretation of the GP functional form (1.1) given above, the second measure q represents the agent's urges in the form of a *retroactively new view* of the world at the interim stage. Her commitment view calls for choosing an act so as to maximize conditional expected utility computed by applying Bayes' Rule to p, but she is tempted to act in accord with her new prior and to maximize expected utility using the Bayesian update of q. In balancing these forces, she behaves *as though* applying Bayes' Rule to a compromise measure p^* that lies between p and q in a suitable sense: each s_1-conditional of p^* is a mixture of the conditionals of p and q, where the mixture weights may vary with the signal s_1. Consequently, interim choice out of the menu given s_1 is based on the compromise posterior $p^*(\cdot \mid s_1)$. If q and p differ, then so also do p^* and p, and updating deviates from application of Bayes' Rule to the commitment prior p.

Note that temptation does *not* refer to whether or not to apply Bayes' Rule.

Rather, precisely as in GP, it refers to the temptation to follow one's urges in making choices. The only difference from GP is that here the conflict is due to changes in beliefs rather than in abstract utilities.

For an illustration of some of the preceding, consider the following example which adapts GP's motivating example (1.2). The example serves also to illustrate how GP's axiom of Set-Betweenness is adapted below to the present setting. Let $S_1 = \{s^g, s^b\}$. At time 0 the agent selects a contingent menu of portfolios, that is, a menu for each possible signal. At time 1, after realization of a signal, a portfolio is selected from the menu chosen previously for that state. Finally, there are three possible portfolios - *equity* (consisting exclusively of stocks), a riskless *bond* and *diversified* (*div*), which is a combination of stocks and the bond; each portfolio is an act over S_2 with *bond* being a constant act. Think of s^g (s^b) as constituting good (bad) news about the return to stocks.

Consider the following time 0 ranking of contingent menus:

$$F \equiv \begin{bmatrix} \{equity\} & \text{if } s^g \\ \{div\} & \text{if } s^b \end{bmatrix} \succ \begin{bmatrix} \{equity\} & \text{if } s^g \\ \{bond,\, div\} & \text{if } s^b \end{bmatrix} \succ \begin{bmatrix} \{equity\} & \text{if } s^g \\ \{bond\} & \text{if } s^b \end{bmatrix} \equiv G. \tag{1.3}$$

All contingent menus commit the agent to equity in the event of s^g, while F and G provide perfect commitment also in the bad state. The ranking $F \succ G$ indicates that s^b is only moderately bad news in the sense that it does not justify abandoning stocks entirely. Note that updating is irrelevant to this ranking because there is no interim choice, but it is critical for evaluation of the third contingent menu; denote the latter by $F \cup G$. In particular, interpret the ranking $F \succ F \cup G$ as follows: because the two contingent menus agree given the good signal, the preference between them depends only on what they deliver in s^b. The agent knows her own psyche and anticipates that once the bad signal is realized, she will update in a way that exaggerates the importance of the bad news (through Bayesian updating of the new prior q). Subsequently, she will be tempted to panic and to leave stocks entirely. This temptation to choose a different portfolio than she would ex ante under commitment, the source of which is her updating behavior, is captured by the strict preference $F \succ F \cup G$. She may anticipate successfully resisting this temptation and choosing *div* from $\{bond, div\}$ given s^b, which case is captured by $F \cup G \succ G$.[7] But this choice is contrary to her updated beliefs and feelings of panic and thus requires costly self-control.

[7] Alternatively, she may anticipate succumbing, in which case $F \cup G \sim G$.

An agent with the ranking (1.3) would be willing to pay a positive price to commit to F, say by having her portfolio managed by a suitable investment manager. One might attempt to interpret the value of commitment in terms of risk aversion that changes in a state-dependent way. For example, the agent may anticipate becoming more risk averse in response to a bad signal, which might lead to the temptation to choose *bond* from $\{bond, div\}$ and hence to the time 0 ranking (1.3). We exclude this interpretation by adopting a suitable axiom of state independence. To illustrate (a special case of) the axiom, let ℓ be a fourth 'security,' thought of as a roulette-wheel whose payoff is independent of the realized state in $S_1 \times S_2$. Suppose that the outcome x is the s^b-conditional certainty equivalent of ℓ in the sense that

$$\begin{bmatrix} \{equity\} & \text{if } s^g \\ \{\ell\} & \text{if } s^b \end{bmatrix} \sim \begin{bmatrix} \{equity\} & \text{if } s^g \\ \{x\} & \text{if } s^b \end{bmatrix}.$$

Then state independence requires that x also be the certainty equivalent conditional on s^g, that is,

$$\begin{bmatrix} \{\ell\} & \text{if } s^g \\ \{equity\} & \text{if } s^b \end{bmatrix} \sim \begin{bmatrix} \{x\} & \text{if } s^g \\ \{equity\} & \text{if } s^b \end{bmatrix}.$$

Where this invariance is accepted, state-dependent risk aversion is excluded, leaving non-Bayesian updating as the only apparent explanation for (1.3).

2. MODEL

2.1. Primitives

The model's primitives include:

- time $t = 0, 1, 2$
- outcome set X (compact metric)

  $\Delta(X)$ denotes the set of lotteries (Borel probability measures) over X

  it is compact metric under the weak convergence topology
- (finite) period state spaces S_1 and S_2 corresponding to the uncertainty resolved at times 1 and 2

- $(\Delta(X))^{S_2}$ is the set of (Anscombe-Aumann) acts over S_2

  the generic act is $f : S_2 \longrightarrow \Delta(X)$

- a closed subset M of $(\Delta(X))^{S_2}$ is called a *menu* (of acts over S_2)

  $\mathcal{M}(S_2)$ is the set of menus

  it is compact metric under the Hausdorff metric[8]

- $F : S_1 \longrightarrow \mathcal{M}(S_2)$ is a *contingent menu*

  $F(s_1)$ is the menu of acts over S_2 from which the agent can choose if s_1 is realized

- $\mathcal{C} = (\mathcal{M}(S_2))^{S_1}$ is the set of all contingent menus

- time 0 preference $\succeq$ is defined on $\mathcal{C}$

The interpretation is that a contingent menu F is chosen ex ante (at time 0) according to $\succeq$. Then at the interim stage $t = 1$, the agent observes the realization of s_1, updates her beliefs about S_2, and finally chooses an act from the menu $F(s_1)$. The state s_2 and hence also the outcome of the chosen act are realized at time 2. Updating and choice behavior at time 1 are anticipated ex ante and underlie the ranking $\succeq$ of contingent menus.

Contingent menus are natural objects of choice.[9] The consequence of a physical action taken at time 0 is that it determines a set of opportunities for further action at time 1, which set depends also on the interim state s_1; that is, the physical action can be identified with a contingent menu. For example, savings at time 0 and the realized state s_1 determine wealth and asset prices, and hence a feasible set of portfolios from which a choice can be made at time 1.

Degenerate contingent menus F, where each $F(s_1)$ is a singleton, play a special role. Each such F can be identified with a map $F : S_1 \times S_2 \longrightarrow \Delta(X)$ and thus is an act over $S_1 \times S_2$. The set of such acts is $\mathcal{A} \subset \mathcal{C}$.

[8]See Aliprantis and Border (1994, Theorem 3.58), for example.

[9]Kreps (1992) proposes contingent menus of alternatives (as opposed to acts) as the natural objects of choice in a model of unforeseen contingencies; see also Nehring (1999). Contingent menus of lotteries appear in Ozdenoren (2002).

2.2. Utility

Define the utility function $\mathcal{U}$ on $\mathcal{C}$ in two stages. First, evaluate F via the (state-dependent) expected utility form

$$\mathcal{U}(F) = \int_{S_1} \mathcal{U}(F(s_1); s_1)\, dp_1, \quad F \in \mathcal{C}, \tag{2.1}$$

where p_1 is a probability measure on S_1 and each $\mathcal{U}(\cdot; s_1)$ is a utility function on the collection of menus of acts over S_2. Its specification is the heart of the model.

The GP utility functional form (1.1) suggests the form

$$\mathcal{U}(F(s_1); s_1) = \max_{f \in F(s_1)} \{U(f; s_1) + V(f; s_1)\} - \max_{f' \in F(s_1)} V(f'; s_1), \tag{2.2}$$

for suitable functions $U(\cdot; s_1)$ and $V(\cdot; s_1)$. The particular specification that we adopt is

$$\mathcal{U}(F(s_1); s_1) = \max_{f \in F(s_1)} \left\{ \int_{S_2} u(f)\, dp(\cdot \mid s_1) + \alpha(s_1) \int_{S_2} u(f)\, dq(\cdot \mid s_1) \right\} \tag{2.3}$$

$$- \max_{f' \in F(s_1)} \alpha(s_1) \int_{S_2} u(f')\, dq(\cdot \mid s_1),$$

where components of the functional form satisfy the *regularity conditions*:

Reg1 $u : \Delta(X) \longrightarrow \mathbb{R}^1$ is mixture linear, continuous and nonconstant.

Reg2 Each $p(\cdot \mid s_1)$ and $q(\cdot \mid s_1)$ is a probability measure on S_2, $q(\cdot \mid s_1)$ is absolutely continuous with respect to $p(\cdot \mid s_1)$.

Reg3 $\alpha : S_1 \longrightarrow [0, \infty)$.

Reg4 p_1 has full support on S_1.

Utility is defined by (2.1), (2.3) and the regularity conditions.

Let p be the measure on $S_1 \times S_2$ generated by p_1 and the conditionals $\{p(\cdot \mid s_1) : s_1 \in S_1\}$. It is convenient also to define the measure q generated by p_1 and the conditionals $\{q(\cdot \mid s_1) : s_1 \in S_1\}$. Then p_1 is the S_1-marginal of p, $p(\cdot \mid s_1)$ is the Bayesian conditional of p, and similarly for q. Further, q and p have identical S_1-marginals and q is absolutely continuous with respect to p (denoted $q << p$). Note that the full support assumption is without loss of generality in that states

s_1 for which $p_1(s_1) = 0$ could be deleted - our model has nothing to say about updating in response to "null" events.

The representation admits the interpretation outlined in the introduction. For prospects that offer commitment, that is, if $F \in \mathcal{A}$, utility simplifies to

$$\mathcal{U}(F) = \int_{S_1 \times S_2} u(F)\ dp, \ \text{ for } F \in \mathcal{A}. \tag{2.4}$$

Thus p is the *commitment prior*, and is the counterpart of the usual prior. Since p is formed with the detachment afforded by the ex ante stage, the agent views the beliefs described by p as 'correct.'

For a general contingent menu F, $\mathcal{U}(F(s_1); s_1) =$

$$\max_{f \in F(s_1)} \left\{ \int_{S_2} u(f)\, dp(\cdot \mid s_1) + \alpha(s_1) \left[\int_{S_2} u(f)\, dq(\cdot \mid s_1) - \max_{f' \in F(s_1)} \int_{S_2} u(f')\, dq(\cdot \mid s_1) \right] \right\}.$$

Though the Bayesian update $p(\cdot \mid s_1)$ is the 'correct' conditional to use at time 1. However, choice of an act from the menu $F(s_1)$ is influenced also by the fact that the agent retroactively adopts the revised prior q, which leads to a temptation to maximize $\int_{S_2} u(f')\, dq(\cdot \mid s_1)$. To the extent that she resists this temptation and chooses another act f, she incurs the (utility) self-control cost

$$\alpha(s_1) \left[\max_{f' \in F(s_1)} \int_{S_2} u(f')\, dq(\cdot \mid s_1) - \int_{S_2} u(f)\, dq(\cdot \mid s_1) \right];$$

$\alpha(s_1)$ parametrizes the cost of self-control in state s_1 (see further discussion in Section 3.2). Compromise between the commitment perspective and the cost of self-control leads to choice from the menu according to

$$max_{f \in F(s_1)} \left\{ \int_{S_2} u(f)\ dp(\cdot \mid s_1) + \alpha(s_1) \int_{S_2} u(f)\ dq(\cdot \mid s_1) \right\}. \tag{2.5}$$

Finally, define p^* on $S_1 \times S_2$ by

$$p^*(s_1, s_2) = \tfrac{p(s_2|s_1) + \alpha(s_1) q(s_2|s_1)}{1+\alpha(s_1)} p_1(s_1). \tag{2.6}$$

Then choice from the menu is made as though maximizing expected utility using the Bayesian update of p^*, where p^* can be thought of as a *compromise prior* and

$$p^*(\cdot \mid s_1) = \tfrac{p(\cdot|s_1) + \alpha(s_1) q(\cdot|s_1)}{1+\alpha(s_1)}. \tag{2.7}$$

The latter differs from the Bayesian update of p to the extent that the conditionals $q(\cdot \mid s_1)$ and $p(\cdot \mid s_1)$ differ.

For perspective, consider an alternative functional form for utility which satisfies (2.1)-(2.2) with

$$U(f; s_1) = \int_{S_2} u(f)\, dp(\cdot \mid s_1),$$

but where the specification of temptation utility $V(\cdot; s_1)$ is modified so that $\mathcal{U}(F(s_1); s_1) =$

$$\left\{ \max_{f \in F(s_1)} \int_{S_2} [u(f) + v(f)]\; dp(\cdot \mid s_1) \right\} - \max_{f' \in F(s_1)} \int_{S_2} v(f')\; dp(\cdot \mid s_1).$$

Here there is a single probability measure p but two utility indices u and v. The functional form suggests an interpretation whereby temptation arises from changes in taste rather than from changes in beliefs. Appendix B describes axiomatic foundations for this model (augmented by suitable regularity conditions) that support the noted interpretation and that, more generally, provide further perspective for our model.

We discuss our central model further in Section 3.2 after describing its axiomatic foundations. First, however, we describe some examples.

2.3. Examples of Updating Biases

This section demonstrates the richness of the model by showing how it can produce, through suitable specifications for p, q and α, a variety of updating biases, including some that are analogous to biases discussed by psychologists in the context of objective probabilities. Our claim here is not that we can accommodate all or many of these with a single specification, though future research will explore that possibility. For now we content ourselves with suggesting the potential of our model to provide a unifying and choice-theoretic framework.

Underreaction and Overreaction: Let

$$q(\cdot \mid s_1) = (1 - \lambda(s_1))\, p(\cdot \mid s_1) + \lambda(s_1)\, p_2(\cdot), \tag{2.8}$$

where p_2 denotes the S_2-marginal of p and $\lambda(s_1) \leq 1$. If $0 \leq \lambda(s_1) \leq 1$, then $q(\cdot \mid s_1)$ is a mixture of $p(\cdot \mid s_1)$ and prior beliefs p_2. Because $p(\cdot \mid s_1)$ embodies "the correct" combination of prior beliefs and responsiveness to data, and because p_2 gives no weight to data, the updating implied by (2.8) gives "too much" weight to prior beliefs and "too little" to observation. Prior beliefs exert undue influence, relative to Bayesian updating, also if $\lambda(s_1) < 0$. To interpret this case, fix a state s_2 and rewrite (2.8) in the form

$$q(s_2 \mid s_1) = p(s_2 \mid s_1) - \lambda(s_1)(p(s_2 \mid s_1) - p_2(s_2)).$$

If $p(s_2 \mid s_1) - p_2(s_2) > 0$, then s_1 is a strong positive signal for s_2. In this case the agent overreacts to such positive signals to a degree described by $-\lambda(s_1)$. Prior beliefs have an undue (negative) influence in that they are already taken into account to a proper degree in $p(s_2 \mid s_1)$.

Choice after realization of s_1 is based on the Bayesian update of the compromise prior, and hence, by (2.7), on the conditional measure

$$p^*(\cdot \mid s_1) = \left(1 - \tfrac{\alpha\lambda}{1+\alpha}\right) p(\cdot \mid s_1) + \tfrac{\alpha\lambda}{1+\alpha} p_2(\cdot). \tag{2.9}$$

Assume that $\lambda(\cdot)$ and $\alpha(\cdot)$ are constant. Evidently, $p^*(\cdot \mid s_1)$ is less sensitive to the signal s_1 than is $p(\cdot \mid s_1)$ if $\lambda > 0$ and more sensitive if $\lambda < 0$. In particular, $\lambda < 0$ can capture the temptation to panic in the face of the bad signal s^b as discussed in the introductory portfolio choice example. The larger is α, the greater is the deviation from Bayesian updating, the larger is the temptation to panic and the more likely is it that the agent will yield to the urge to leave stocks entirely.

The functional form specialization (2.8) is studied more closely and axiomatized in Section 3.3 under the heading Prior-Bias.

Confirmatory Bias: Let q be given by (2.8) where $\lambda \geq 0$. Then if $\gamma = \frac{\alpha\lambda}{1+\alpha}$ varies suitably with the signal s_1, the weight given by the compromise prior in (2.9) to a particular piece of evidence is larger when the evidence supports prior beliefs. Such a bias towards supportive evidence is reminiscent of the well-documented *confirmatory bias*; see Rabin and Schrag (1999) for references to the relevant psychology literature and for an alternative model of the bias.

To illustrate, suppose that

$$S_1 = \{a, b\},\ S_2 = \{A, B\}, \text{ and } p(a \mid A) = p(b \mid B) > \tfrac{1}{2}. \tag{2.10}$$

Then B is more likely under prior beliefs ($p_2(B) > \frac{1}{2}$) if and only if $p_1(b) > \frac{1}{2}$. Thus the desired bias is captured by the specification

$$\gamma(s_1) = \gamma^* \left(\frac{p_1(s_1)}{max_{s_1' \in S_1} p_1(s_1')} \right), \quad s_1 = a, b,$$

with $\gamma^* : [0,1] \longrightarrow [0,1]$ decreasing. If the agent believes initially that B is more likely than A, then the conflicting signal a will be underweighted.

Representativeness: Once again, adopt (2.10). The likelihood information given there indicates that a is representative of A and b is representative of B. According to the representativeness heuristic (Tversky and Kahneman (1974), for example), people often weight such representativeness too heavily when judging conditional probabilities of A given a and B given b. To capture the resulting updating bias, take

$$q(A \mid a) = q(B \mid b) = 1.$$

Then the conditional of the compromise prior given by (2.7) satisfies

$$p^*(A \mid a) > p(A \mid a) \text{ and } p^*(B \mid b) > p(B \mid b).$$

Sample-Bias: Think of repeated trials of an experiment and take $S_1 = S_2 = S$. Denote by $\delta_s(\cdot)$ the measure assigning probability 1 to s and let

$$q(\cdot \mid s) = (1-\lambda)\ p(\cdot \mid s) + \lambda\, \delta_s(\cdot),$$

where $\lambda \leq 1$ is a constant. When $\lambda > 0$, the Bayesian update of p is adjusted in the direction of the "empirical frequency" measure $\delta_s(\cdot)$, implying a bias akin to the *hot-hand fallacy* - the tendency to overpredict the continuation of recent observations. If $\lambda < 0$, then[10]

$$q(\cdot \mid s) = p(\cdot \mid s) - \lambda\ (p(\cdot \mid s) - \delta_s(\cdot)),$$

and the adjustment is proportional to $(p(\cdot \mid s) - \delta_s(\cdot))$, as though expecting the next realization to compensate for the discrepancy between $p(\cdot \mid s)$ and the most recent observation. This is a form of negative correlation with past realizations akin to the *gambler's fallacy*.

3. FOUNDATIONS

3.1. Axioms for the General Model

Consider axioms for the preference order $\succeq$ defined on the set $\mathcal{C}$ of contingent menus.

[10] To ensure that $q(\cdot \mid s)$ is a probability measure (hence non-negative), assume that $p(s \mid s) \geq \frac{-\lambda}{1-\lambda}$ for all s.

Axiom 1 (Order). *$\succeq$ is complete and transitive.*

Axiom 2 (Continuity). *The sets $\{F \in \mathcal{C} : F \succeq G\}$ and $\{F \in \mathcal{C} : F \preceq G\}$ are closed.*

The set $(\Delta(X))^{S_2}$ of Anscombe-Aumann acts over S_2 is a mixture space. Any two menus of such acts, M and N, can be mixed according to

$$\lambda M + (1-\lambda) N = \{\lambda f + (1-\lambda) g : f \in M, g \in N\}.$$

Finally, for any two contingent menus F and G, define the mixture statewise by

$$(\lambda F + (1-\lambda) G)(s_1) = \lambda F(s_1) + (1-\lambda) G(s_1), \quad s_1 \in S_1.$$

We can now state the Independence Axiom for our setting.

Axiom 3 (Independence). *For every $0 < \lambda \leq 1$, $F \succeq G$ iff $\lambda F + (1-\lambda) F' \succeq \lambda G + (1-\lambda) F'$.*

A first stab at intuition for Independence is similar to that familiar from the Anscombe-Aumann model and also to that offered in [5, 10] for their versions of the axiom. For completeness, we describe it briefly. The mixture $\lambda F + (1-\lambda) F'$ is the contingent menu that delivers the set of acts $\lambda F(s_1) + (1-\lambda) F'(s_1)$ in state s_1. Consider instead the lottery over $\mathcal{C}$, denoted $\lambda \circ F + (1-\lambda) \circ F'$, that delivers F with probability λ and F' with probability $(1-\lambda)$. Supposing that the agent can rank such lotteries, then the familiar intuition for the usual form of Independence suggests that $F \succeq G$ iff $\lambda \circ F + (1-\lambda) \circ F' \succeq \lambda \circ G + (1-\lambda) \circ F'$. Thus the intuition for our version of Independence is complete if we can justify indifference between $\lambda \circ F + (1-\lambda) \circ F'$ and $\lambda F + (1-\lambda) F'$. The difference between them is that under the former, randomization is completed immediately, at $t = 0$, while for the latter, the timing is such that s_1 is realized, (beliefs are updated), and then the agent chooses an act from the convex combination $\lambda F(s_1) + (1-\lambda) F'(s_1)$ of menus of acts. The latter corresponds also to the randomization with weight λ occurring after the interim choice of an act. Thus the desired indifference amounts to indifference to the timing of resolution of uncertainty. (Dekel, Lipman and Rustichini (2001, pp. 905-6) provide a normative justification for indifference to timing that can be adapted to the present setting.)

However, there is more implicit in Independence. Consider the lottery $\lambda \circ F + (1-\lambda) \circ F'$. After the randomization is completed, the agent updates her beliefs over $S_1 \times S_2$. Though the randomization is objectively independent of events in $S_1 \times S_2$, given that she changes her view of the world after making an observation, the agent might change her beliefs over $S_1 \times S_2$. As a result, she might prefer $\lambda \circ G + (1-\lambda) \circ F'$ to $\lambda \circ F + (1-\lambda) \circ F'$ even while preferring F to G. Thus intuition for Independence assumes that, consistent with our agent not being one who makes mistakes, she recognizes the *objective* fact that randomization is unrelated to the state space. At the same time, she may, according to our model, view the events $E_1 \subset S_1$ and $E_2 \subset S_2$ as *subjectively* independent according to her initial (commitment) prior and yet change her beliefs about E_2 after seeing E_1.

To rule out trivial cases, adopt:[11]

Axiom 4 (Nondegeneracy). *There exist x, y in X for which $x \succ y$.*

At this point we depart from Anscombe-Aumann. While their model can be viewed as (implicitly) imposing a form of strategic rationality (see the discussion following Theorem 3.1), in order to permit temptation and self-control we adopt a counterpart of Gul and Pesendorfer's Set-Betweenness axiom. To state the axiom, define the union $F \cup G$ statewise, that is,

$$(F \cup G)(s_1) = F(s_1) \cup G(s_1).$$

Axiom 5 (Set-Betweenness). *For all states s_1 and all menus F and G such that $F(s_1') = G(s_1')$ for all $s_1' \neq s_1$,*

$$F \succeq G \implies F \succeq F \cup G \succeq G. \tag{3.1}$$

Because F and G are identical in all states $s_1' \neq s_1$, $F \succeq G$ means that given s_1 at the interim stage, the agent would rather have $F(s_1)$ than $G(s_1)$ from which to choose after updating. Conditional preference over menus at any s_1 is derived from the subsequent choice of acts that is anticipated to follow immediately, as in the GP model. Thus the motivation offered by GP (2001, p. 1408) applies here. In particular, the hypothesis that temptation cannot increase utility and that the utility cost of temptation depends only on the most tempting alternative, leads to the agent's conditional preference at the interim stage for $F(s_1)$ over $F(s_1) \cup G(s_1)$ and preference for the latter over $G(s_1)$. But F, $F \cup G$

[11] $x \in X$ is identified with the contingent menu that, in every state s_1, yields the (singleton menu comprised of the) lottery yielding x with probability 1.

and G coincide in all states $s_1' \neq s_1$ and thus, from the ex ante perspective, the desired ranking of $F \cup G$ follows. The portfolio choice example (1.3) illustrates the preceding.

For perspective, consider the stronger axiom that would impose (3.1) for all contingent menus and not just for those that differ only in one state s_1. It is easily seen that this stronger axiom is not intuitive.[12] For example, suppose that

$$F \equiv \begin{bmatrix} \{f\} & \text{if } s_1 \\ \{f'\} & \text{if } s_1' \end{bmatrix} \succ \begin{bmatrix} \{g\} & \text{if } s_1 \\ \{g'\} & \text{if } s_1' \end{bmatrix} \equiv G,$$

where f and g' are very attractive acts over S_2 while f' and g are less attractive but suitably tempting. Suppose that

$$\{f\} \succ_{s_1} \{f, g\} \sim_{s_1} \{g\} \text{ and}$$

$$\{g'\} \succ_{s_1'} \{f', g'\} \sim_{s_1'} \{f'\},$$

where $\succeq_{s_1}$ and $\succeq_{s_1'}$ denote preference at the interim stage given realization of s_1 and s_1' respectively. In particular, g is so tempting given s_1 that it would be chosen out of $\{f, g\}$, and f' is so tempting given s_1' that it would be chosen out of $\{f', g'\}$. Therefore, $F \cup G$ would lead ultimately to the choice of g given s_1 and f' given s_1', the worst of both worlds, which suggests the ranking $G \succ F \cup G$.

The next axiom is the principal way in which temptation is connected to changing beliefs. At the functional form level, the axiom is important in tracing the difference between the counterparts of the two GP functions U and V in (1.1) to differences in beliefs rather than to differences in risk attitudes or utilities over final outcomes (see Appendix B).

Identify any menu of lotteries $L \subset \Delta(X)$ with the contingent menu that yields L for every s_1. Thus rankings of the form $L' \succeq L$ are well-defined.

Axiom 6 (Strategic Rationality for Lotteries (SRL)). *For all menus of lotteries L' and L, $L' \succeq L \implies L' \sim L' \cup L$.*

To interpret, compare the prospect of receiving the menu of lotteries L' in every state s_1 as opposed to receiving L in every state. After observing the realized s_1, she will choose a lottery from L' or from L. Because the payoff to any lottery does

[12] The problem arises from comparisons of F and G such that the $\succeq_{s_1}$ ranking of $F(s_1)$ and $G(s_1)$ differs depending on s_1. Thus (3.1) *is* intuitive and indeed, is implied by the representation, hence by the set of axioms, if $F(s_1) \succeq_{s_1} G(s_1)$ for all s_1.

not depend on the ultimate state s_2, the expected payoff at the interim stage does not depend on beliefs about S_2. Therefore, if temptations arise only with a change in beliefs, a form of strategic rationality should be valid for such comparisons.

The sequel requires a notion of nullity and some added notation that we now introduce. For any act f over S_2 and state s_2 in S_2, denote by f_{-s_2} the restriction of f to $S_2 \backslash \{s_2\}$. Say that (s_1, s_2) is *null* if $F' \sim F$ for all F' and F satisfying *both*

$$F'(s_1') = F(s_1') \quad \text{for all } s_1' \neq s_1, \text{ and}$$

$$\left\{f'_{-s_2} : f' \in F'(s_1)\right\} = \left\{f_{-s_2} : f \in F(s_1)\right\}.$$

In words, (s_1, s_2) is null if any two contingent menus that "differ only on (s_1, s_2)" are indifferent.

For any act f over S_2, lottery ℓ and state s_2, denote by $\ell s_2 f$ the act over S_2 that assigns ℓ if the realized state is s_2 and $f(s_2')$ if the realized state is $s_2' \neq s_2$. Similarly, for any menu $M \in \mathcal{M}(S_2)$ and menu of lotteries $L \subset \Delta(X)$,

$$Ls_2M \equiv \{\ell s_2 f : \ell \in L, f \in M\}. \tag{3.2}$$

To illustrate this notation, consider the example in the introduction and let $S_2 = \{s_2', s_2\}$. Recall that *div* is an act over S_2; denote by $div(s_2')$ the payoff to the diversified portfolio in state s_2', and so on. The *bond* is a constant act, that is, a lottery. Let ℓ be any other lottery, $L = \{bond, \ell\}$ and $M = \{equity, div\}$. Then Ls_2M consists of the following four acts:[13]

$$\begin{bmatrix} div(s_2') \\ bond \end{bmatrix}, \begin{bmatrix} div(s_2') \\ \ell \end{bmatrix}, \begin{bmatrix} equity(s_2') \\ bond \end{bmatrix}, \begin{bmatrix} equity(s_2') \\ \ell \end{bmatrix}.$$

The significance of the special structure for menus described in (3.2) is as follows. Consider the agent after s_1 is realized and facing the menu Ls_2M of acts over S_2. In evaluating the menu, she anticipates updating to incorporate the observed signal s_1 and then choosing an act from the menu Ls_2M. Her payoff is then determined by the chosen act and the realized state in S_2. Though the choice of an act is made before learning whether or not s_2 is true, menus of the above form permit the full range of contingent choices that would be possible if choice could be made 'ex post' after learning if s_2 is true, (as is evident in the portfolio example). Thus we can equally well think of choice as being made ex

[13] Acts are 2-vectors where the components give payoffs in states s_2' and s_2 respectively.

post and of the agent as having the following perspective: if s_2 is realized, then I will choose a lottery from L, and if s_2 is not realized, then I will choose an act from M. Similarly when evaluating $L's_2M$. Thus when comparing $L's_2M$ and Ls_2M, the usual intuition for separability across disjoint events suggests that the comparison reduces to the question "given state s_2, would I rather choose a lottery from L' or from L?"

Finally, denote by (F_{-s_1}, Ls_2M) the contingent menu that delivers $F(s_1')$ if $s_1' \neq s_1$ and Ls_2M otherwise. We can now state:

Axiom 7 (State Independence). *For all non-null states* (s_1, s_2),
$L' \succeq L \iff (F_{-s_1}, L's_2F(s_1)) \succeq (F_{-s_1}, Ls_2F(s_1))$.

As in Anscombe-Aumann, a form of state independence is needed. We now argue that the stated axiom expresses an intuitive form of state independence. Consider the ranking of $G' = (F_{-s_1}, L's_2M)$ and $G = (F_{-s_1}, Ls_2M)$. By the intuition underlying the Sure-Thing-Principle, the agent compares them ex ante by considering how she would rank the menus $G'(s_1')$ and $G(s_1')$ upon realization of any state s_1', that is, on the ranking of $L's_2F(s_1)$ versus $Ls_2F(s_1)$ after seeing s_1. Thus in light of what we have just seen about such comparisons, the ranking of G' and G can be understood in terms of the question "*given the states* s_1 *and* s_2, would I rather choose a lottery from L' or from L?" Suppose that choosing from L' is preferable. Since payoffs to lotteries do not depend on states, if taste, or risk aversion is also independent of the state, then L' should be preferable to L also where they are received unconditionally, that is, $L' \succeq L$. Moreover, the converse should obtain as well. If (s_1, s_2) is null, then G' is necessarily indifferent to G and for reasons that have nothing to do with the specific menus L' and L. Thus the preceding intuition must be qualified in a way that is familiar from the Anscombe-Aumann model.[14]

Finally, we adopt:

Axiom 8 (S_1-Full Support). *For every* s_1, *there exist* F' *and* F *such that* $F' \nsim F$ *and yet* $F'(s_1') = F(s_1')$ *for every* $s_1' \neq s_1$.

If two contingent menus are indifferent whenever they agree on all states other than s_1, then the evaluation of any contingent menu does not depend on what it assigns to s_1, and s_1 could simply be dropped. Thus there is no loss of generality in assuming that no such states exist.

[14] Recall also Savage's axiom $P3$.

3.2. Representation Result

The central result of the paper is the following axiomatization of utility over contingent menus:

Theorem 3.1. $\succeq$ *satisfies Order, Continuity, Independence, Nondegeneracy, Set-Betweenness, Strategic Rationality for Lotteries, State Independence and S_1-Full Support if and only if it admits a representation of the form (2.1)-(2.3), including the regularity conditions Reg1-Reg4.*

The relation of the theorem to the (dynamic) Anscombe-Aumann model merits emphasis. The latter is obtained if one strengthens Set-Betweenness to strategic rationality, that is, if one requires that $F \succeq G \implies F \sim F \cup G$ whenever F and G differ only in one state s_1.

Because it imposes little structure on the relation between p and q (or equivalently between p and the compromise prior p^*), the model can accommodate a range of updating biases (see the illustrations in Section 2.3). On the other hand, some may view the above model as "too general" in that it permits beliefs to change ($q \neq p$) even when S_1 is a singleton and thus when there is no real signal.[15] This reflects the fact, stated in the introduction, that the driving force in our model is that beliefs may change with the passage of time. Nevertheless, when the signal space S_1 is nontrivial, this leads to a theory of updating.

The remainder of this section describes uniqueness properties of the above representation and provides further interpretation.

Say that (u, p, q, α) *represents* $\succeq$ if it satisfies the conditions of the theorem. Next we describe the uniqueness properties of such representing tuples under an additional assumption. To simplify statement of the latter, define the conditional order $\succeq_{s_1}$ on $\mathcal{M}(S_2)$ by

$$M' \succeq_{s_1} M \quad \text{if } \exists F \text{ such that } \left(F_{-s_1}, M'\right) \succeq \left(F_{-s_1}, M\right).$$

Given the other axioms, "$\exists F$" is equivalent to "$\forall F$" and $\succeq_{s_1}$ is represented by $\mathcal{U}(\cdot; s_1)$ defined in (2.3). Though $\succeq_{s_1}$ is defined as an ex ante ranking, we interpret it also as the preference that would prevail at the interim stage after realization of s_1.

The following (elementary) lemma describes several equivalent statements of the needed additional assumption.

[15] This case is ruled out if $S_1 = S_2 = S$, which is a common specification (repeated experiments).

Lemma 3.2. *Let $\succeq$ satisfy the axioms in the theorem and fix s_1 in S_1. Then the following statements are equivalent:*

(a) There exist menus M' and M such that $M' \succeq_{s_1} M$ and $M' \nsim_{s_1} M' \cup M$.

(b) There exist f and g, Anscombe-Aumann acts over S_2, such that

$$\{f\} \succ_{s_1} \{f, g\} \succ_{s_1} \{g\} \ . \tag{3.3}$$

(c) There exists an Anscombe-Aumann act f over S_2 and a lottery ℓ, such that

$$\{f\} \succ_{s_1} \{f, \ell\} \succ_{s_1} \{\ell\} \ . \tag{3.4}$$

(d) There exists a representing tuple (u, p, q, α) such that

$$\alpha(s_1) \neq 0 \quad \text{and } q(\cdot \mid s_1) \neq p(\cdot \mid s_1) \, . \tag{3.5}$$

Part (a) states that $\succeq_{s_1}$ violates strategic rationality. Thus it excludes the case where conditional utility $\mathcal{U}(\cdot; s_1)$ as defined in (2.3) takes the form

$$\mathcal{U}(M; s_1) = \max_{f \in M} \int_{S_2} u(f) \, dp(\cdot \mid s_1),$$

for any menu M of acts over S_2, precisely as in the standard model with Bayesian updating. In that sense, each of the conditions in the Lemma amounts to the assumption of non-Bayesian updating given s_1. In the terminology of GP (2001, p. 1413), (b) states that the agent *has self-control at* $\{f, g\}$ conditionally on s_1. Part (c) asserts the existence of such self-control where g is a lottery (constant act). Finally, (d) provides the corresponding restrictions on the representing functional form.

Corollary 3.3. *Let (u, p, q, α) represent $\succeq$. Then (u', p', q', α') also represents $\succeq$ if and only if: (i) there exists $(a, b) \in \mathbb{R}^1_{++} \times \mathbb{R}^1$ such that*

$$u' = au + b \text{ and } \quad p' = p;$$

and *(ii) for every s_1, either*

$$\alpha'(s_1)\left(q'(\cdot \mid s_1) - p'(\cdot \mid s_1)\right) = 0 = \alpha(s_1)\left(q(\cdot \mid s_1) - p(\cdot \mid s_1)\right), \tag{3.6}$$

$$\text{or } \ \alpha'(s_1) = \alpha(s_1) \quad \text{and } q'(\cdot \mid s_1) = q(\cdot \mid s_1) \, . \tag{3.7}$$

The uniqueness properties of (u,p) are straightforward and expected. For (q,α), the relevant uniqueness property depends on s_1. One possibility is (3.6) which states that both representations violate condition (3.5). In that case, interim choice behavior is based on the Bayesian update of p. Otherwise, the strong uniqueness statement (3.7) is valid for s_1.

If conditions of the Lemma are satisfied for every s_1, then (u',p',q',α') and (u,p,q,α) both represent $\succeq$ if and only if

$$u' = au+b \text{ and } (p',q',\alpha') = (p,q,\alpha),$$

for some $a>0$ and $b \in \mathbb{R}^1$. Then q and $\alpha(\cdot)$, in addition to p, are unique and hence meaningful components of the functional form. It makes sense then to consider their behavioral meaning. For p, we have already observed that it is the prior that guides choice under commitment. The meaning of α can be described explicitly under conditions of the Lemma as we now show.[16]

Let x^{**} and x^{*} be best and worst alternatives under commitment, that is, such that

$$\{x^{**}\} \succeq \{x\} \succeq \{x^{*}\} \quad \text{for all } x \text{ in } X.$$

(They exist by Continuity and compactness of X.) Then also

$$\{x^{**}\} \succeq_{s_1} M \succeq_{s_1} \{x^{*}\}$$

for all states s_1 and menus M. Normalizing u so that

$$u(x^{**}) = 1 \text{ and } u(x^{*}) = 0,$$

then, as in vNM theory, utilities are directly observable as 'mixture weights'. That is, because each $\mathcal{U}(\cdot;s_1)$ is mixture linear, $\mathcal{U}(M;s_1)$ is the unique weight m such that

$$m\{x^{**}\} + (1-m)\{x^{*}\} \sim_{s_1} M. \tag{3.8}$$

Similarly for the special case $\mathcal{U}(\{\ell\};s_1) = u(\ell)$.

This permits isolation of the behavioral meaning of $\alpha(\cdot)$, as described in the following corollary.

Corollary 3.4. *Suppose that $\succeq_{s_1}$ satisfies conditions of the Lemma and that*

$$\{f\} \succ_{s_1} \{f,\ell\} \succ_{s_1} \{\ell\} \text{ and } \{f\} \succ_{s_1} \{f,\ell\} \succ_{s_1} \{\ell\},$$

[16] The explication of q is straightforward but omitted for brevity.

for some act f and lotteries ℓ and ℓ', with $\{\ell'\} \nsim_{s_1} \{\ell\}$. Then

$$\alpha(s_1) = \frac{\mathcal{U}(\{f,\ell\};s_1) - \mathcal{U}(\{f,\ell'\};s_1)}{u(\ell') - u(\ell)}. \tag{3.9}$$

For lotteries ℓ and ℓ' as in the statement, compute that

$$\mathcal{U}(\{f\};s_1) - \mathcal{U}(\{f,\ell\};s_1) = \alpha(s_1)\left[u(\ell) - \int_{S_2} u(f)\, dq(\cdot \mid s_1)\right],$$

and similarly for ℓ'. Expression (3.9) follows. It is important to note that each utility level appearing on the right side of (3.9) is observable from behavior using (3.8). Thus we have a *closed-form and behaviorally meaningful* expression for $\alpha(s_1)$. Because each mixture weight appearing in (3.8) is unit-free, so is the expression given for $\alpha(s_1)$.

For further interpretation of $\alpha(s_1)$, Theorem 9 of GP(2001), translated to our setting, yields that $\succeq_{s_1}$ (satisfying conditions in the Lemma) exhibits less self-control the larger is $\alpha(s_1)$.[17] Following GP, $\succeq_{s_1}$ exhibits less self-control than $\succeq'_{s_1}$ if, for all menus M and N of acts over S_2, $M \succ_{s_1} M \cup N \succ_{s_1} N$ implies the same ranking in terms of $\succ'_{s_1}$. In addition to this interpretation in terms of comparative self-control, the expression (3.9) permits interpretation of $\alpha(s_1)$ as an absolute measure of self-control. If there is self-control at $\{f,\ell\}$ as in (3.4), then $\mathcal{U}(\{f\};s_1) - \mathcal{U}(\{f,\ell\};s_1)$ is the utility cost of having ℓ available and exerting self-control in order to choose f, where utility is measured in probabilities as in (3.8). Thus $\alpha(s_1)$ gives the rate at which this self-control cost increases as ℓ improves in the sense measured by $u(\ell)$. In that sense, $\alpha(s_1)$ is the *marginal cost of self-control* in state s_1.

3.3. Prior-Bias

Here we specialize the model by focussing on the weight given to prior beliefs versus observations when updating. To state the new axioms, we require some added notation and terminology. For any act f over S_2, denote by $\overline{\{f\}}$ the contingent menu that commits the agent to f in every state s_1. Evidently, the evaluation of any such prospect reflects marginal beliefs about S_2 held at time 0, that is, the agent's prior on S_2. Say that s_1 is a *neutral signal* if, for all acts over S_2,[18]

$$\{f\} \succeq_{s_1} \{g\} \Longleftrightarrow \overline{\{f\}} \succeq \overline{\{g\}}.$$

[17] Theorem 9 seems misstated - the correct statement should fix the parameter γ to equal 1. In their (2004) paper, the authors refer to this corrected version of Theorem 9.

[18] The conditional order $\succeq_{s_1}$ is defined as in the last section.

Given our representation, s_1 is a neutral signal if and only if $p(\cdot \mid s_1) = p_2(\cdot)$.

Axiom 9 (Prior-Bias). *Let $s_1 \in S_1$ and let f and g be any acts over S_2 satisfying*

$$\{f\} \succ_{s_1} \{g\}.$$

Then $\{f\} \sim_{s_1} \{f,\ g\}$ if either s_1 is a neutral signal or if $\overline{\{f\}} \sim \overline{\{g\}}$.

To interpret, suppose that holding fixed what the contingent menu gives in states other than s_1, committing to f in state s_1 is strictly preferred to committing to g in state s_1. By Set-Betweenness, $\{f\} \succeq_{s_1} \{f, g\}$, where strict preference indicates the expectation that g would be tempting in state s_1, and hence that updating would lead to a change in beliefs from those currently held. Prior-Bias rules this out if s_1 is a neutral signal. For any non-neutral s_1, g can be tempting given s_1 only if $\overline{\{f\}} \nsim \overline{\{g\}}$, that is, only if prior beliefs differ on the two acts. That the presence of temptation conditionally on s_1 depends not only on how f and g are ranked conditionally but also on how attractive they were prior to realization of s_1, indicates excessive influence of prior beliefs at the updating stage.

Prior-Bias permits prior beliefs to unduly influence updating but does not specify the direction of such influence. Put another way, what happens if $\overline{\{f\}}$ and $\overline{\{g\}}$ are not indifferent? We consider two alternative strengthenings of the axiom that provide different answers.

Axiom 10 (Positive Prior-Bias). *Let $s_1 \in S_1$ and let f and g be any acts over S_2 satisfying*

$$\{f\} \succ_{s_1} \{g\}.$$

Then $\{f\} \sim_{s_1} \{f,\ g\}$ if either s_1 is a neutral signal or if $\overline{\{f\}} \succeq \overline{\{g\}}$.

According to this axiom, g can be tempting conditionally on a non-neutral s_1 only if it was strictly more attractive according to prior beliefs on S_2. Intuitively, this is because prior beliefs are overweighted.

An alternative strengthening of Prior-Bias is:

Axiom 11 (Negative Prior-Bias). *Let $s_1 \in S_1$ and let f and g be any acts over S_2 satisfying*

$$\{f\} \succ_{s_1} \{g\}.$$

Then $\{f\} \sim_{s_1} \{f,\ g\}$ if either s_1 is a neutral signal or if $\overline{\{f\}} \preceq \overline{\{g\}}$.

Suppose that while g is (weakly) preferred according to prior beliefs on S_2, the (necessarily non-neutral) signal s_1 reverses the ranking in favor of f. The agent modeled by this axiom overweights such a signal (and she knows this about herself ex ante). Thus she is not tempted by g after seeing s_1 (or when anticipating its realization ex ante).

Corollary 3.5. *Suppose that $\succeq$ satisfies the axioms in Theorem 3.1. Then $\succeq$ satisfies also Prior-Bias (Positive Prior-Bias or Negative Prior-Bias, respectively) if and only if it admits a representation (2.1)-(2.3) where in addition: for each s_1, either $\alpha(s_1) = 0$, or $\alpha(s_1) > 0$ and*

$$q(\cdot \mid s_1) = (1 - \lambda(s_1))\, p(\cdot \mid s_1) + \lambda(s_1)\, p_2(\cdot), \tag{3.10}$$

with $\lambda(s_1) \leq 1$ ($0 < \lambda(s_1) \leq 1$, $\lambda(s_1) \leq 0$, respectively).

Prior-Bias leads to a concrete relation between the "temptation prior" q and the commitment prior p: the Bayesian update of q is a linear combination of the Bayesian update of p and prior marginal beliefs $p_2(\cdot)$. As a result the agent deviates from Bayesian updating by attaching a (positive or negative) additional weight to prior beliefs over S_2, where this additional weight is signed in the natural direction by Positive or Negative Prior-Bias. This functional form was interpreted further in Section 2.3. Note finally that under Prior-Bias, $q(\cdot \mid s_1) = p(\cdot \mid s_1)$ and updating is standard if S_1 is a singleton, or more generally, if p is a product measure.

4. CONCLUDING REMARKS

The connection of our model to updating relies on the interpretation of the functional form (2.5) as describing interim choice at time 1. This interpretation is suggested by our formal model, but Theorem 3.1 deals only with the ex ante choice between contingent menus and not with the interim choice of acts from menus. A similar issue arises in the GP model and their solution, using suitably extended preferences, can be adapted here. Note that foundations provided in this way are subject to the difficulty pointed out in GP (2001, p. 1415), namely the lack of a revealed preference basis for extended preferences.

One might expect a given individual to update differently in different situations. If by 'situation' one means 'state space', then the present model is consistent with such variation because it is restricted to a given state space. However, it has nothing to say about how behavior is connected across state spaces. Alternatively, one might expect that even given the state space, an individual may exhibit different updating biases depending on the choice problem. This calls for a generalization that would permit updating behavior to depend on the menu available at the interim stage.

Conclude with one application of the model. Our non-Bayesian agent violates the law of iterated expectations, because she uses the compromise measure p^* from (2.6) to guide choice at $t = 1$ but she uses p for choice at $t = 0$. Thus there exist acts $f : S_2 \longrightarrow X$ such that $\{f\} \succ \{-f\}$ at time 0 and yet such that at each s_1, the agent would strictly prefer to choose $-f$ out of $\{f, -f\}$. This amounts to a violation of the "sure-thing principle for action rules", a property that has been identified as central to no-trade theorems, (see Geanakoplos (1994), for example). It is not surprising, therefore, that two such agents may agree to take opposite sides of a bet at every state s_1 even if they have common commitment priors and all the preceding is common knowledge. What may be not so obvious, however, is that common knowledge agreement to bet can arise even though agents have stable (unchanging) preferences, albeit over contingent menus rather than on the usual domain of acts. Future research will explore more deeply the message of this example - that trade may result not only from heterogeneity in prior beliefs or in information, but also from heterogeneity in the way that agents update in response to information.

A. APPENDIX: Proofs of Main Results

Proof of Theorem 3.1: *Necessity*: Set-Betweenness is satisfied because each $\mathcal{U}(\cdot; s_1)$ defined in (2.3) has the GP form. Verify State Independence; verification of the other axioms is immediate.

Claim 1: $p(s_1, s_2) > 0 \Longrightarrow (s_1, s_2)$ is non-null. Take any F with $F(s_1) = Ls_2M$ and define F' by

$$F'(s_1') = F(s_1') \text{ if } s_1' \neq s_1 \text{ and } F'(s_1) = L's_2M.$$

Compute that $\mathcal{U}(Ls_2M; s_1) =$

$$\max_{f \in Ls_2M} \left\{ \int_{S_2} u(f)\, dp(\cdot \mid s_1) + \alpha(s_1) \int_{S_2} u(f)\, dq(\cdot \mid s_1) \right\}$$
$$- \max_{f' \in Ls_2M} \alpha(s_1) \int_{S_2} u(f')\, dq(\cdot \mid s_1)$$

$$= \max_{f \in M} \left\{ \int_{S_2 \setminus \{s_2\}} u(f)\, dp(\cdot \mid s_1) \,+\, \alpha(s_1) \int_{S_2 \setminus \{s_2\}} u(f)\, dq(\cdot \mid s_1) \right\}$$

$$- \max_{f' \in M} \alpha(s_1) \int_{S_2 \setminus \{s_2\}} u(f')\, dq(\cdot \mid s_1)$$

$$+ \max_{\ell \in L} \{ u(\ell)\, p(s_2 \mid s_1) \,+\, \alpha(s_1)\; u(\ell)\, q(s_2 \mid s_1) \} \,-\max_{\ell' \in L} \alpha(s_1)\, u(\ell')\, q(s_2 \mid s_1).$$

It follows that

$$\mathcal{U}(F') - \mathcal{U}(F) = p_1(s_1) \left[p(s_2 \mid s_1) \max_{\ell \in L'} u(\ell) - p(s_2 \mid s_1) \max_{\ell \in L} u(\ell) \right]$$

$$= p(s_1, s_2) \left[\max_{\ell \in L'} u(\ell) - \max_{\ell \in L} u(\ell) \right].$$

Because $u(\cdot)$ is not constant, we can choose L' and L so that the latter expression is nonzero. This proves that (s_1, s_2) is non-null.

Claim 2: $p(s_1, s_2) \,=\, 0 \Longrightarrow (s_1, s_2)$ is null. Compute that $\mathcal{U}(F(s_1); s_1) \;=$

$$\max_{f \in F(s_1)} \left\{ \int_{S_2} u(f)\, dp(\cdot \mid s_1) \,+\, \alpha(s_1) \int_{S_2} u(f)\, dq(\cdot \mid s_1) \right\}$$

$$- \max_{f' \in F(s_1)} \alpha(s_1) \int_{S_2} u(f')\, dq(\cdot \mid s_1).$$

Because $q << p$, the right hand side does not depend on $\{f(s_2) : f \in F(s_1)\}$. In other words,

$$\left\{ f'_{-s_2} : f' \in F'(s_1) \right\} = \{ f_{-s_2} : f : f \in F(s_1) \} \implies$$

$$\mathcal{U}(F'(s_1); s_1) = \mathcal{U}(F(s_1); s_1).$$

It follows that (s_1, s_2) is null.

Return to State Independence. For any menus of lotteries,

$$L' \succeq L \Longleftrightarrow \max_{\ell \in L'} u(\ell) \geq \max_{\ell \in L} u(\ell).$$

Also, $\mathcal{U}(F_{-s_1}, L's_2F(s_1)) - \mathcal{U}(F_{-s_1}, Ls_2F(s_1)) = p(s_1, s_2) [\max_{\ell \in L'} u(\ell) - \max_{\ell \in L} u(\ell)]$, by the calculations above. Thus State Independence follows from the preceding claims.

Sufficiency: We claim that because $\succeq$ satisfies Order, Continuity and Independence on $\mathcal{C}$, there exists a representation for $\succeq$ of the form

$$\mathcal{U}(F) = \Sigma_{s_1 \in S_1} \mathcal{U}(F(s_1); s_1), \tag{A.1}$$

where each $\mathcal{U}(\cdot; s_1)$ is continuous and mixture linear on $\mathcal{M}(S_2)$. Intuition for this claim is provided by the similarity with the Anscombe-Aumann theorem. The latter deals with acts mapping a state space into $\Delta(X)$, while here each F maps states into $\mathcal{M}(S_2)$, which shares with $\Delta(X)$ the existence of a mixing operation. However, $\mathcal{M}(S_2)$ is not a mixture space and thus the analogy is not perfect.[19] To fill this gap, denote by coF the contingent menu taking s_1 into the closed convex hull of $F(s_1)$. The vNM axioms imply that coF and F are indifferent (see Lemma 1 in Dekel, Lipman and Rustichini (2001)). Moreover, the subdomain of $\mathcal{M}(S_2)$ consisting of closed and convex menus is a mixture space, and thus standard arguments apply to deliver the desired representation there. Finally, extend the representation using the noted indifference between coF and F.

It follows that for each s_1, $\succeq$ induces the conditional order $\succeq_{s_1}$ on $\mathcal{M}(S_2)$ via

$$M' \succeq_{s_1} M \text{ if } (F_{-s_1}, M') \succeq (F_{-s_1}, M) \text{ for some } F,$$

and that $\succeq_{s_1}$ is represented by $\mathcal{U}(\cdot; s_1)$. By Set-Betweenness, $\succeq_{s_1}$ satisfies the GP axioms suitably translated to our setting; that is, GP deal with menus of lotteries, while we have menus of Anscombe-Aumann acts over S_2. With this translation, their proof is valid for our setting and delivers:[20]

$$\mathcal{U}(M; s_1) = \max_{f \in M} \left\{ U(f; s_1) + V(f; s_1) - \max_{f' \in M} V(f'; s_1) \right\}, \tag{A.2}$$

where $U(\cdot; s_1)$ and $V(\cdot; s_1)$ are mixture linear (and continuous). Actually, the preceding equality is valid only up to ordinal equivalence, but both sides are mixture linear and so they must be cardinally equivalent. Thus absolute equality may be assumed wlog.

Both $U(\cdot; s_1)$ and $V(\cdot; s_1)$, utility functions defined on the domain $(\Delta(X))^{S_2}$ of Anscombe-Aumann acts, satisfy the basic mixture space axioms there. Thus, by Kreps (1988, Propn. 7.4) and Continuity, we can write

$$U(f; s_1) = \Sigma_{s_2 \in S_2} u(f(s_2); s_1, s_2), \; V(f; s_1) = \Sigma_{s_2 \in S_2} v(f(s_2); s_1, s_2), \tag{A.3}$$

[19] It violates the property $\lambda(\lambda' M + (1-\lambda') N) + (1-\lambda) N = \lambda\lambda' M + (1-\lambda\lambda') N$.

[20] In fact, Kopylov (2005) has extended the GP theorem to a domain of menus of any compact metric mixture space where the mixture operation is continuous.

for all $f : S_2 \longrightarrow \Delta(X)$. (Below we often abbreviate (s_1, s_2) by s.) Each $u(\cdot; s)$ and $v(\cdot; s)$ is mixture linear and continuous.

Lemma A.1. *Assume Order, State Independence and Nondegeneracy. Then:*

(a) For all (s_1, s_2) and non-null (s_1', s_2'), contingent menus F, menus M of acts over S_2 and menus L' and L of lotteries,

$$L' s_2' M \succeq_{s_1'} L s_2' M \implies L' s_2 M \succeq_{s_1} L s_2 M.$$

(b) For all (s_1, s_2) and contingent menus F, if

$$L' s_2 F(s_1) \sim_{s_1} L s_2 F(s_1)$$

for all *menus of lotteries L' and L, then (s_1, s_2) is null.*

Proof. (a) Since (s_1', s_2') is non-null, State Independence applied twice implies

$$L' s_2' M \succeq_{s_1'} L s_2' M \implies L' \succeq L \implies L' s_2 M \succeq_{s_1} L s_2 M.$$

(b) Under the stated hypothesis, if (s_1, s_2) were non-null, then Order and State Independence would imply $L' \sim L$ for all L' and L, contradicting Nondegeneracy. Therefore, (s_1, s_2) is null. ■

Take $F \in \mathcal{A}$, that is, let $F(s_1)$ be a singleton for every s_1. Recall that $\mathcal{A}$ is isomorphic to $(\Delta(X))^{S_1 \times S_2}$, the set of Anscombe-Aumann acts over $S_1 \times S_2$. The preceding three displayed equations imply that $\succeq$ restricted to $\mathcal{A}$ is represented by $\widehat{U}$, where

$$\widehat{U}\left(\widehat{f}\right) = \Sigma_{s_1, s_2} u\left(\widehat{f}(s_1, s_2); s_1, s_2\right), \text{ for all } \widehat{f} \in (\Delta(X))^{S_1 \times S_2}.$$

By part (a) of the Lemma and Nondegeneracy, the order represented by $\widehat{U}(\cdot)$ satisfies all the Anscombe-Aumann axioms. Thus (by Kreps (1988, Theorem 7.17), for example) $\widehat{U}$ has the SEU form

$$\widehat{U}\left(\widehat{f}\right) = \Sigma_{s \in S_1 \times S_2} \, p(s) \, u\left(\widehat{f}(s)\right),$$

for a suitable nonconstant and mixture linear u and probability measure p on $S_1 \times S_2$. (Equality is modulo ordinal equivalence, but the latter qualification can be dropped because $\widehat{U}(\cdot)$ is mixture linear, forcing the ordinal transformation to be cardinal.) Wlog therefore,

$$u(\cdot; s_1, s_2) = p(s_1, s_2)\, u(\cdot)$$

and we can refine (A.3) and write

$$U(f; s_1) = \Sigma_{s_2 \in S_2}\, p(s_1, s_2)\, u(f(s_2)). \tag{A.4}$$

The next step is to show that on X,

$$v(\cdot; s) = a_s p(s)\, u(\cdot) + b_s, \text{ where } a_s \geq 0. \tag{A.5}$$

To do so, note that for any $s = (s_1, s_2)$ and menus $M \in \mathcal{M}(S_2)$ and $L', L \subset \Delta(X)$,

$$L' s_2 M \succeq_{s_1} L s_2 M \iff \mathcal{U}(L' s_2 M; s_1) \geq \mathcal{U}(L s_2 M; s_1),$$

where

$$\begin{aligned} \mathcal{U}(L s_2 M; s_1) &= \max_{f \in M,\, \ell \in L} \{U(\ell s_2 f; s_1) + V(\ell s_2 f; s_1)\} \\ &\quad - \max_{f' \in M,\, \ell' \in L} V(\ell' s_2 f'; s_1), \text{ and hence} \end{aligned}$$

$$\mathcal{U}(L s_2 M; s_1) = \max_{\ell \in L} \left\{ p(s)\, u(\ell) + v(\ell; s) - \max_{\ell' \in L} v(\ell'; s) \right\} + \Phi(M, s), \tag{A.6}$$

where the final term is independent of L and can be ignored for present purposes.

We claim that the ranking of menus of lotteries represented by $L \longmapsto \mathcal{U}(L s_2 M; s_1)$, or equivalently by

$$L \longmapsto \max_{\ell \in L} \left\{ p(s)\, u(\ell) + v(\ell; s) - \max_{\ell' \in L} v(\ell'; s) \right\},$$

is strategically rational, that is,

$$L' s_2 M \succeq_{s_1} L s_2 M \Longrightarrow L' s_2 M \sim_{s_1} (L' \cup L)\, s_2 M.$$

The indifference on the RHS is trivially true if (s_1, s_2) is null. Otherwise, the implication follows from State Independence and Strategic Rationality for Lotteries. Case 1: Suppose $p(s) > 0$. Then $p(s)\, u(\cdot)$ is nonconstant. Hence (A.5) follows as in GP(2001, p. 1414) from the just noted strategic rationality.

Case 2: Suppose that $p(s) = 0$. Then by part (b) of the Lemma, $s = (s_1, s_2)$ is null, and by the definition of nullity, the utility of any F is independent of what it assigns to the state s. Thus *any* specification for $v(\cdot; s)$ is consistent with a representation for $\succeq$. In particular, we can take $v(\cdot; s) = 0$ wlog and (A.5) is valid with $a_s = 0$.

From (A.3)-(A.5), deduce that

$$\begin{aligned} \mathcal{U}(M; s_1) \;=\; & \max_{f \in M} \left\{ \Sigma_{s_2}\, p(s_1, s_2)\, u(f(s_2)) \;+\; \Sigma_{s_2} a_{s_1,s_2} p(s_1, s_2)\, u(f(s_2)) \right\} \\ & - \max_{f' \in M} \left\{ \Sigma_{s_2} a_{s_1,s_2} p(s_1, s_2)\, u(f'(s_2)) \right\}. \end{aligned}$$

Denote by p_1 the S_1-marginal of p; it is everywhere positive by (A.3), (A.5) and S_1-Full Support. Let

$$\alpha(s_1) \;=\; \frac{\Sigma_{s_2} a_{s_1,s_2} p(s_1, s_2)}{p_1(s_1)},$$

and define the measure q so that its S_1-marginal equals p_1, and

$$q(s_2 \mid s_1) \;=\; \begin{cases} \frac{a_{s_1,s_2} p(s_2 \mid s_1)}{\alpha(s_1)} & \text{if } \alpha(s_1) > 0 \\ p(s_2 \mid s_1) & \text{otherwise.} \end{cases}$$

Then

$$\begin{aligned} \mathcal{U}(M; s_1) \;=\; & p_1(s_1) \max_{f \in M} \left\{ \Sigma_{s_2}\, p(s_2 \mid s_1)\, u(f(s_2)) \;+\; \alpha(s_1)\, \Sigma_{s_2} q(s_2 \mid s_1)\, u(f(s_2)) \right\} \\ & - p_1(s_1) \max_{f' \in M} \left\{ \alpha(s_1)\, \Sigma_{s_2} q(s_2 \mid s_1)\, u(f'(s_2)) \right\}. \end{aligned}$$

With (A.1), this yields the desired representation (2.1)-(2.2). ■

Proof of Corollary 3.3: If (u, p, q, α) represents $\succeq$ and if (u', p', q', α') is related as stated, then clearly it also represents $\succeq$. For the converse, suppose that both tuples represent $\succeq$. Then the subjective expected utility functions defined by (u, p) and (u', p') both represent preference on the subset $\mathcal{A} \subset \mathcal{C}$ of Anscombe-Aumann acts over $S_1 \times S_2$. By the well-known uniqueness properties of the Anscombe-Aumann theorem,

$$u' \;=\; au + b \;\text{ and }\; p' \;=\; p. \tag{A.7}$$

By Lemma 3.2, (u', p', q', α') violates (3.5) iff (u, p, q, α) does, in which case (3.6) is valid. Suppose that (u, p, q, α) satisfies (3.5). The latter implies that $\mathcal{U}(\cdot; s_1)$ is regular in the sense of GP (2001, p. 1414). (Here and below we refer to the translation of GP to our setup, whereby their menus of lotteries are replaced by menus of Anscombe-Aumann acts over S_2.) Thus their Theorem 4 implies that

$$V'(\cdot; s_1) = A_{s_1} V(\cdot; s_1) + B_{V, s_1} \quad \text{and} \tag{A.8}$$

$$U'(\cdot; s_1) = A_{s_1} U(\cdot; s_1) + B_{U, s_1}, \tag{A.9}$$

where

$$V(f; s_1) = \alpha(s_1) \int_{S_2} u(f) \, dq(\cdot \mid s_1), \qquad f \in (\Delta(X))^{S_2}, \tag{A.10}$$

and V', U', V and U are defined similarly. Deduce from (A.7) and (A.9) that $A_{s_1} = a$. Equation (A.8) implies, again by uniqueness properties of the Anscombe-Aumann model, that $q'(\cdot \mid s_1) = q(\cdot \mid s_1)$. Substitution from (A.10) implies further that

$$\alpha'(s_1) \int_{S_2} (au(f) + b) \, dq(\cdot \mid s_1) = a \, \alpha(s_1) \int_{S_2} u(f) \, dq(\cdot \mid s_1) + B_{V, s_1},$$

for all $f \in (\Delta(X))^{S_2}$, which implies that $\alpha'(s_1) = \alpha(s_1)$. ■

Proof of Corollary 3.5: The necessity assertions are obvious. Prove sufficiency of Prior-Bias; the arguments for Positive and Negative Prior-Bias are similar. Given our representation, if $\alpha(s_1) > 0$, then Prior-Bias implies:

$$\text{if} \int (u(f) - u(g)) \, dp(\cdot \mid s_1) > 0 \text{ and } \int (u(f) - u(g)) \, dp_2(\cdot) = 0,$$

$$\text{then} \int (u(f) - u(g)) \, dq(\cdot \mid s_1) \geq 0.$$

By Motzkin's Theorem of the Alternative (see Mangasarian (1969, p. 34),

$$y_p p(\cdot \mid s_1) - y_q q(\cdot \mid s_1) + y_2 p_2(\cdot) = 0 \tag{A.11}$$

for some scalars $y_p \geq 0$, $y_q \geq 0$ and y_2, with $y_p + y_q > 0$.

Case 1 ($y_q > 0$): Solve (A.11) for $q(\cdot \mid s_1)$ and deduce (3.10).
Case 2 ($y_q = 0$): Then necessarily $p(\cdot \mid s_1) = p_2(\cdot)$. Thus s_1 is a neutral signal and Prior-Bias implies that $\{f\} \sim_{s_1} \{f, g\}$. In fact, the corresponding indifference holds for any pair of acts f' and g' for which $\{f'\} \succ_{s_1} \{g'\}$, that is,

$$\int (u(f') - u(g'))\, dp(\cdot \mid s_1) > 0 \Longrightarrow \int (u(f') - u(g'))\, dq(\cdot \mid s_1) \geq 0.$$

Conclude that $q(\cdot \mid s_1) = p(\cdot \mid s_1)$. ■

B. APPENDIX: Changing Risk Aversion

This appendix elaborates on the model of changing risk preference mentioned in Section 2.2. More precisely, consider the utility function on $\mathcal{C}$ given by

$$\mathcal{U}(F) = \int_{S_1} \mathcal{U}(F(s_1); s_1)\ dp_1, \quad F \in \mathcal{C}, \tag{B.1}$$

and $\mathcal{U}(F(s_1); s_1) =$

$$\left\{ \max_{f \in F(s_1)} \int_{S_2} [u(f) + v(f)]\ dp(\cdot \mid s_1) \right\} - \max_{f' \in F(s_1)} \int_{S_2} v(f')\ dp(\cdot \mid s_1), \tag{B.2}$$

where:

*Reg1** $u, v : \Delta(X) \longrightarrow \mathbb{R}^1$ are mixture linear and continuous.

*Reg2** each $p(\cdot \mid s_1)$ is a probability measure on S_2.

*Reg3** There exist lotteries ℓ' and ℓ such that $v(\ell') < v(\ell)$ and $u(\ell') + v(\ell') > u(\ell) + v(\ell)$.

*Reg4** u cannot be expressed as the linear transformation $u = av + b$, where $a < 0$.

Note that these conditions rule out the standard Bayesian model (say if v is constant or a positive affine transformation of u) and that the above model is disjoint from our central model. Turn to the axioms that underlie them.

Adopt all previous axioms with the exception of Strategic Rationality for Lotteries (SRL). To state its replacement, adapt terminology from GP. Say that $\succeq$ has self-control for lotteries if $L' \succ L' \cup L \succ L$ for some menus of lotteries. Consider next:[21]

Axiom 12 (Regular Self-Control for Lotteries (RSCL)). *$\succeq$ has self-control for lotteries and there exists L such that: (i) $L \succeq L''$ for all subsets L'' of L, and (ii) $L \succ \{\ell\}$ for some ℓ in L.*

To interpret the axiom, compare it with SRL. The latter says that where the choice is between (unconditional) menus of lotteries, then there is no temptation, while the new axiom says the opposite - that temptation sometimes occurs even for such choices. Thus while SRL implies that temptation arises only where beliefs are relevant for choice, RSCL implies that it arises even where only risk attitude is relevant for choice. This explains why substituting RSCL for SRL leads to the following alternative to Theorem 3.1.

Theorem B.1. *$\succeq$ satisfies Order, Continuity, Independence, Nondegeneracy, Set-Betweenness, Regular Self-Control for Lotteries, State Independence and S_1-Full Support if and only if it admits a representation of the form (B.1)-(B.2), including the regularity conditions Reg1*-Reg4*.*

Though Theorems 3.1 and B.1 are disjoint, they do not exhaust the class of preferences satisfying all their common axioms. As an example, take (B.1) and $\mathcal{U}(F(s_1);s_1) =$

$$\left\{\max_{f\in F(s_1)}\int_{S_2}u(f)\ dp(\cdot\mid s_1)-\alpha\int_{S_2}u(f)\ dq(\cdot\mid s_1)\right\}-\max_{f'\in F(s_1)}(-\alpha)\int_{S_2}u(f)\ dq(\cdot\mid s_1)$$

$$=\left\{\max_{f\in F(s_1)}\int_{S_2}u(f)\ dp(\cdot\mid s_1)-\alpha\int_{S_2}u(f)\ dq(\cdot\mid s_1)\right\}+\min_{f'\in F(s_1)}\alpha\int_{S_2}u(f)\ dq(\cdot\mid s_1),$$

where $q(\cdot \mid s_1) << p(\cdot \mid s_1)$ and $1 < \alpha$. Though all other axioms are satisfied, SRL and RSCL are violated and thus the functional form does not fit into either model. The interpretation is that the underlying "change in preference" cannot be attributed to a change in only one of taste or beliefs.[22]

[21] GP (2001, p. 1414) refer to (i)-(ii) as the absence of maximal preference for commitment. They also define regularity. The connection is that, given that $\succeq$ has self-control, then $\succeq$ has regular self-control iff it is regular.

[22] The obvious funtional form based on arbitrary pairs (u,p) and (v,q) would also support such a statement, but it would violate State Independence.

Proof. *Necessity*: RSCL is implied by Reg3*, Reg4* and the observations in GP (p. 1414). The other axioms are readily verified.

Sufficiency: As in the proof of Theorem 3.1, we have (A.1)-(A.4). Our objective is to prove that wlog

$$v(\cdot; s_1, s_2) = p(s_1, s_2)\, \widehat{v}(\cdot) \quad \text{for all } (s_1, s_2). \tag{B.3}$$

Conditions Reg1*-Reg4* would then follow; for example, Reg4* would follow from Regular Self-Control along the lines of the observations in GP (2001, p. 1414).

Define the induced order $\succeq_{(s_1,s_2)}$ on menus of lotteries by

$$L' \succeq_{(s_1,s_2)} L \text{ if } L's_2M \succeq_{s_1} Ls_2M \text{ for some } M.$$

Then given any two non-null states (s_1, s_2) and (s_1', s_2'), State Independence implies that

$$L' \succeq_{(s_1,s_2)} L \text{ iff } L' \succeq L \text{ iff } L' \succeq_{(s_1',s_2')} L.$$

Thus $\succeq_{(s_1,s_2)}$ is represented by both

$$W(L; s_1, s_2) = max_{\ell \in L}\{p(s_1, s_2)\, u(\ell) + v(\ell; s_1, s_2)\} - max_{\ell \in L} v(\ell; s_1, s_2),$$

and by the corresponding function $W(\cdot; s_1', s_2')$. Moreover, $\succeq_{(s_1,s_2)}$ satisfies the conditions in GP(2001, Theorem 4). Thus

$$p(s_1, s_2)\, u(\cdot) = ap(s_1', s_2')\, u(\cdot) + b_u,\ v(\cdot; s_1, s_2) = av(\cdot; s_1', s_2') + b_v, \tag{B.4}$$

for some common $a > 0$ (that depends on the two states). From the first equation,

$$(p(s_1, s_2) - ap(s_1', s_2'))\ u(\cdot) \text{ is constant,}$$

which implies that

$$p(s_1, s_2) - ap(s_1', s_2') = 0 = b_u.$$

Lemma A.1 implies that $p(s_1', s_2') > 0$ because (s_1', s_2') is non-null. Therefore,

$$v(\cdot; s_1, s_2) = \tfrac{p(s_1,s_2)}{p(s_1',s_2')}\, v(\cdot; s_1', s_2'), \tag{B.5}$$

where wlog b_v has been set equal to zero. Thus $\frac{v(\cdot;s_1,s_2)}{p(s_1,s_2)}$ is invariant across non-null states. Denote the common function by $\widehat{v}(\cdot)$, which yields (B.3) for all non-null states (s_1, s_2).

Finally, if (s_1, s_2) is null, then: (i) $p(s_1, s_2) = 0$, and (ii) the utility of any F is independent of what it assigns to (s_1, s_2). The latter implies that *any* specification for $v(\cdot; s_1, s_2)$ is consistent with a representation for $\succeq$. In particular, we can take $v(\cdot; s_1, s_2) = 0$ consistent with (B.3). ■

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