Positive Affect and Overconfidence

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Beliefs are an important facet of standard utility theory, and a systematic deviation from standard economic theory about beliefs is overconfidence. Overconfidence has been shown to be prevalent among the general public as well as investors, managers, and other important economic actors often considered too experienced to be subject to behavioral deviations from rational choice. The overconfidence of various economic agents—CEOs, investors, or employees—has been critical in explaining the following phenomena: company underperformance; attractiveness of stock options to employees; overtrading; and gender differences in competitiveness. Given the far-reaching and significant implications of overconfidence, identifying its determinants and whether it is subject to manipulation is important. A noteworthy determinant of economic behavior that has been identified in economic and psychological experiments is positive affect. It has been shown to significantly decrease time preference, increase generosity, decrease spending and willingness to pay, increase work effort and productivity, increase [decrease] risk aversion in high [low] stake situations, and increase loss aversion. We conduct a controlled experiment that measures the effect of positive affect on overconfidence. After completing a set of trivia and math questions, the control (treatment) group watches a neutral (positive) affect inducing film clip. Subjects then estimate their performance, both in absolute terms and relative to other subjects. All questions—trivia, math, and estimated performance—are incentivized monetarily. In theory, the effect of positive affect on overconfidence is ambiguous. It has been posited that positive affect increases cognitive flexibility by broadening focus and attention, promoting openness to information, and enabling improved integration of information. This suggests that positive affect should decrease overconfidence. Simultaneously, positive affect has been linked to increased optimism and decreased self-criticism, suggesting that it may bolster overconfidence. Our controlled experiment can hence speak to these competing theories.