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Overconfidence? (Preliminary)

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Abstract

Many studies have shown that people display an apparent overconfidence. In particular, it is common for a majority of people to describe themselves as better-than-average. The literature takes for granted that this better-than-average is problematic. We argue, however, that, even accepting these studies on their own terms, there is nothing at all wrong with a strict majority of people rating themselves above the median.

When it comes to overconfidence, there is a consensus on a consensus: writers agree that researchers have found overconfidence to be common. Typical comments include “Dozens of studies show that people...are generally overconfident about their skills” (Camerer, 1997), “Perhaps the most robust finding in the psychology of judgment is that people are overconfident” (DeBondt and Thaler, 1995), and “The tendency to evaluate oneself more favorably than others is a staple finding in social psychology” (Alicke et al. 1995). While the study of overconfidence originated in the psychology literature, the phenomenon has migrated into the economics and finance literature, taking its place in the growing list of “irrational” aspects of human attitudes and behaviour that have moved from the fringes to the forefront of mainstream thinking.¹

If people are indeed overconfident there are important implications for our understanding of the economy, and for public policy. For instance, a basic principle of competition is that firms will enter an industry only up to the point that they earn zero expected profits. But if, to take one industry, restaurateurs overestimate their abilities, we can expect too many restaurants to open only to close shortly thereafter, and the restaurant business to lose

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¹Papers on overconfidence in economics include Camerer and Lovallo (1999), Garcia, Sangiorgi and Urošević (2007), Hoelzl and Rustichini (2005), Koszegi (2006), Menkhoff et al. (2006), Noth and Weber (2003), Van den Steen (2004), Zabojsnik (2004). In finance, recent (published) papers include Barber and Odean (2001), Biais et al. (2005), Bernardo and Welch (2001), Chuang and Lee (2006), Daniel, Hirshleifer and Subrahmanyam (2001), Kyle and Wang (1997), Malmendier and Tate (2005), Peng and Xiong (2006), Wang (2001).

money on average. At the same time, if people overestimate their driving ability, then merely informing them of general risks will not induce them to take sufficient care.

Overconfidence has been reported in peoples' beliefs in the precision of their estimates, in their beliefs about the likelihood their answers to questions are correct, and in their appraisal of their relative skills and virtues. In this paper, we are concerned with the last form of overconfidence.² As Myers (1999, p.57) writes, "on nearly any dimension that is both *subjective* and *socially desirable*, most will see themselves as better than average." As evidence, he cites research showing that most people perceive themselves as more intelligent than their average peer, most business managers rate their performance as better than their average peers, and most high school students rate themselves as more original than the average high-schooler. In an oft-quoted study, Svenson found that 77% of Swedish subjects felt they were safer drivers than the median, and 69% felt they were more skillful. These findings, and others like them, are typically cited as evidence of overconfidence, at least in peoples' estimation of their relative skills, without any explanation as to why such data is indicative of mistaken self-appraisals. For instance, Alicke et al. (1995) simply assert that "the better-than-average effect provides compelling evidence that people maintain *unrealistically* positive images of themselves relative to others" [italics added]. Presumably, the reason for this lack of explanation is that, since "it is logically impossible for most people to be better than average" (Taylor and Brown (1988)), it seems obvious that some people *must* be making errors in their self-evaluations. But the simple truism that most people cannot be better than average – more precisely, the median – does not imply that most people cannot rationally rate themselves above average. Indeed, we will show that *none* of the evidence cited above is evidence of unrealistically positive images at all. This is true even if we accept the evidence described on its own terms (and do not, for example, argue that subjects misunderstood the questions, or disagreed in their interpretations). Failure to recognize this fact comes from a failure to frame the issue of overconfidence precisely.

To illustrate the main point of this paper, consider a large population with three types of drivers, low skilled, medium skilled, and high skilled, and suppose that the probabilities of any one of them causing an accident in any single period are $p_L = \frac{4}{5}$, $p_M = \frac{2}{5}$, and $p_H = 0$, respectively. In period 0, nature chooses a skill level for each person with equal probability. Initially no driver knows his or her own skill level, and so each person (rationally) evaluates himself as no better or worse than average. In period 1, everyone drives and learns something about his skill, based upon whether or not he has caused an accident. Each person is then asked how his driving skill compares to the rest of the population. How should a driver who

²Some authors, such as Burson et al. (2005) reserve the term "overconfidence" for people who overestimate their absolute abilities, but we see no reason for this restriction. In any case, the literature uses the term in all the ways we have listed, and more.

has not caused an accident reply?

Using Bayes' rule, he evaluates his own skill level as follows:

$$\begin{aligned}
 p(\text{High skill} \mid \text{No accident}) &= \frac{\frac{1}{3}}{\frac{1}{3} + \frac{1}{3}\frac{3}{5} + \frac{1}{3}\frac{1}{5}} = \frac{5}{9} \\
 p(\text{Medium skill} \mid \text{No accident}) &= \frac{\frac{1}{3}\frac{3}{5}}{\frac{1}{3} + \frac{1}{3}\frac{3}{5} + \frac{1}{3}\frac{1}{5}} = \frac{1}{3} \\
 p(\text{Low skill} \mid \text{No accident}) &= \frac{\frac{1}{3}\frac{1}{5}}{\frac{1}{3} + \frac{1}{3}\frac{3}{5} + \frac{1}{3}\frac{1}{5}} = \frac{1}{9}
 \end{aligned}$$

Such a driver thinks there is over a $\frac{1}{2}$ chance (in fact, $\frac{5}{9}$) that his skill level is in the top third of all drivers. His mean probability of an accident is $\frac{5}{9}0 + \frac{1}{3}\frac{2}{5} + \frac{1}{9}\frac{4}{5} = \frac{2}{9}$, which is better than for $\frac{2}{3}$ of the drivers, and better than the population mean. Furthermore, his beliefs about himself strictly first order stochastically dominate the population distribution. Any way he looks at it, a driver who has not had an accident should evaluate himself as better than average. Since $\frac{3}{5}$ of drivers will not have an accident, $\frac{3}{5}$ will rank themselves better than average. Thus, the population of drivers will seem overconfident on the whole. However, rather than being *overconfident*, which implies some error in their judgements, they will simply be using all the information available to them in the best possible manner.

We emphasize that we are not providing an explanation for overconfidence. Quite the contrary, we are showing that, as in the above example, much of the supposed evidence does not indicate overconfidence at all; the apparent overconfidence is illusory. Missing from the discussion in the literature has been the recognition that when a person ranks himself, this is just a summary statistic which provides only limited information about the entire distribution of his beliefs. In the above driving example, although the statement “ $\frac{3}{5}$ of the people rank themselves above average” appears to be problematic, an examination of the complete beliefs of the population shows that there is no anomaly. Indeed, since the $\frac{2}{5}$ of the population that do cause an accident have beliefs “I am low skill with probability $\frac{2}{3}$, medium with probability $\frac{1}{3}$, and high with probability 0,” the beliefs of the population average out to the actual population distribution, as they should.

Moreover, we will show that not only can a majority of people rationally rank themselves above the median, but, depending upon the definitions one adopts, even 99% of the population can rank itself in the top 1% without any cognitive error being implied. Moreover, the failure to properly frame the issue has led authors to make plausible sounding statements that are simply wrong, such as Camerer's (1997, p. 173) claim that two firms cannot both think they are each more likely to have the most skill (assuming a common prior). We will return to Camerer's claim in Section 1.3.

In some experiments, subjects are asked to take actions, rather than answer questions. Overconfidence is then inferred from their actions. But actions, too, provide only a summary

statistic of beliefs, and the same errors that have been made in interpreting answers to questionnaires have been made in interpreting the actions that subjects take.

The remainder of this paper is organized as follows. In Section 1, we provide a careful framework for analyzing overconfidence. We distinguish between *apparent* overconfidence, which gives a possibly misleading impression of overconfidence (as in the above driving example), and (true) overconfidence. We show that much of the evidence in the literature purporting to show overconfidence does nothing of the sort. In this section, we analyze experiments in which subjects are asked to evaluate themselves. In Section 2, we look at two papers in which subjects are asked to take actions, rather than make statements. Using the framework developed in Section 1, we show that, despite the authors' claims, the experiments in these papers do not provide a proper test of overconfidence. In Section 3 we suggest two experiments that do provide a proper test of overconfidence.

Recent work has challenged the universality of the finding that most people rate themselves as above average. In particular, there is evidence that this effect is attenuated when the attribute under consideration is objectively measurable, and even reversed when the skill under consideration is a difficult one to master. In Section 4, we provide an explanation for these findings. In Section 5, we discuss why it is important to distinguish between apparent overconfidence and overconfidence. In Section 6, we review some of the literature.

1 Questionnaires

Consider a person who asserts "I am very intelligent." How are we to tell whether or not this confidence is merited? It may well be impossible, given the vagueness of the term "very". Suppose that instead the person asserts "I am more intelligent than most people." The concept "more than most" is clearer than "very," but the statement remains difficult to assess, since it is unclear how to measure intelligence, IQ tests notwithstanding.

Researchers have attempted to surmount these difficulties by considering entire populations at once. The idea is that, while it may be difficult to judge whether or not a specific individual is overconfident, it may be possible to determine that a population is overconfident on the whole. For instance, if everyone in a room asserts "I am definitely the most intelligent person in this room", it could be concluded that all but one of them is overconfident, at least in their evaluations of their relative abilities³ (and assuming that they agree on what constitutes intelligence).

³Each individual may or may not also have an overflated opinion of his absolute level of intelligence. In fact, individuals may not even have a clear notion of what this absolute level is. Note that for many economic problems, the relative ranking is the relevant one. For instance, the wisdom of attempting a career as a professional football player, depends on a person's relative, not absolute, ability.

This research can be divided into two types: work that proceeds by means of questionnaires and work that asks subjects to take actions. We consider the questionnaire work first, and subdivide this work into two categories, one ordinal and one cardinal:

1. Ranking questionnaires: People are asked to rank themselves relative to others on some attribute (“I am more intelligent than 80% of the people in this room”).
2. Scale questionnaires: People are asked to compare themselves to the population on a scale (“On a scale of -5 (much less intelligent than average) to 5 (much more intelligent than average), I am a 3 .”)

We consider the ranking literature first.

1.1 Ranking Questions

Svenson’s (1981) work is a prototypical example of a ranking questionnaire. Svenson gathered subjects into a room and presented them with the following instructions (among others):

We would like to know about what you think about how safely you drive an automobile. All drivers are not equally safe drivers. We want you to compare your own skill to the skills of the other people in this experiment. By definition, there is a least safe and a most safe driver in this room. We want you to indicate your own estimated position in this experimental group. Of course, this is a difficult question because you do not know all the people gathered here today, much less how safely they drive. But please make the most accurate estimate you can.

Each subject was then asked to place himself or herself into a safety decile. In one respect, Svenson was very careful. Realizing that the subjects had little information about the other drivers in the room, he explicitly stated: *Of course, this is a difficult question because you do not know all the people gathered here today, much less how safely they drive.* But there is another aspect he left unaddressed: Does a driver know how safely he himself drives? Of course, a driver has more information about himself than about a stranger (for instance, he knows the number of accidents he has had), but there is no reason to presume that he knows precisely how safe his driving is (even assuming that he knows exactly what it means to drive “safely”)⁴. This raises the question of what exactly a respondent means when he ranks himself as being, say, in the 7th decile of drivers when it comes to safety.

⁴One well-recognized problem with interpreting Svenson’s data is that people may have different notions of what it means to drive safely (see Dunning (1993)). Here, we give the best case for the data and assume that all subjects agree on the meaning.

To isolate the nature of the problem, let us consider a more carefully delineated problem. Suppose a subject is asked to rank her “reaction time”. She is told that reaction time is measured to the nearest tenth of a second, and that it varies in the general population uniformly from 1 second to 0.1 seconds, so that, for instance, a time of .3 seconds places a person in the 8th decile (smaller reaction times are better). She is asked to estimate her position in the population. Suppose that her beliefs about her own reaction time are given by Chart I below (she estimates that with probability 0.16, her reaction time is .5 seconds, with probability 0.2 her reaction time is .4 seconds, etc...). The chart also lists population deciles.

Reaction Time	1	.9	.8	.7	.6	.5	.4	.3	.2	.1
Prob. own time	0	0	0	0.16	0.16	0.16	0.20	0.30	0.02	0
Decile	1	2	3	4	5	6	7	8	9	10

Chart I

In what decile will she place herself? Three reasonable answers immediately come to mind, corresponding to three common notions of “average”.

- (α) She can reasonably place herself in the 7th decile. After all, there is over a 50% chance that her reaction time will be .4 or better, and this is the fastest time for which she can make such a claim. Another way of saying this is that .4 is the median of her distribution, and this places her in the 7th decile .
- (β) She can reasonably place herself in the 6th decile. After, all .462 is her mean reaction time, which rounds up to .5 which is in the 6th decile.
- (μ) She can reasonably place herself in the 8th decile. After all, her modal time .3 places her in the 8th decile.

Certainly, this list is not exhaustive. Thus, when a person places herself in a certain decile, we, as researchers, have no real way of knowing the significance of her answer. Is there a “correct” or “rational” answer? No; she is being asked to summarize her beliefs with a single parameter, but no single reply supplies the best information for all circumstances. For instance, if she is risk-neutral, and we are interested in knowing whether she would place an even money bet that her reaction time is better than that of $x\%$ of the population, then her median belief provides the requisite information. On the other hand, if we would like to know whether she would place a bet where she receives a payment based on how much faster or slower she is than other people, her mean answer may be more informative. If she is not risk-neutral, then no single parameter may be of much use.

Returning to Svenson’s driving question, a person may consider herself to be quite a safe and skillful driver since she has never had an accident and always manoeuvres well in

traffic, but at the same time realize that her limited experience restricts her ability to make a precise self-appraisal. In ranking herself, she must estimate her own ability as well as that of the others in the room. As a result, it is unclear what to make of her answer to Svenson’s question and, hence, of Svenson’s data. Rather than ascribe a particular meaning, we will consider several possibilities.

1.1.1 Population Median Data

Consider a population where each person is asked to rank his or her skill level relative to the other people in the population. (We use the word “skill” loosely here to denote the attribute under consideration.) The literature is not always very careful in defining when this population displays overconfidence (or, equivalently for this paper, when the population displays the so-called better-than-average effect), but the general idea is that there is overconfidence if, as Myers (1999, p.57) writes, most people “see themselves as better than average.”

An immediate difficulty with this formulation is the ambiguity in the notion of “average” – does this refer to the mean or the median? It is easy to see that the mean cannot possibly provide the right definition, at least when the underlying trait distribution may be skewed. For example, in a population of ten people, one who has scored 0 on a test, and nine who have scored 50, the nine have, in fact, performed better than the mean, so there is certainly nothing wrong in them believing that they have. Thus, Definition 1 below, which uses the median, is what the literature has in mind, whether explicitly or implicitly.⁵

Given a set of individuals who are asked to rank themselves, let *population median data* x be the fraction of people who rank themselves strictly above the median.

Definition 1 *Population median data* x is **apparently overconfident** if $x > \frac{1}{2}$.

The reader will have noticed that we have used the word “apparently” in the above definition. To understand the reason, we must ask why a population that ranks itself highly on average should be called *overconfident*, rather than simply *confident*. Clearly, the idea is that in an *overconfident* population, there is something incorrect, or at the very least inconsistent, in people’s self-evaluations. To determine if a population that is apparently *overconfident* is truly *overconfident*, we need a notion of what it means for peoples’ self-evaluations to be correct and consistent. Fortunately, we have such a notion readily available, given by the Harsanyi common prior approach in which nature picks a skill level, or type, for each person, and over time each person receives information about her type and updates her beliefs about herself using Bayes’ rule. We formalize this below.

⁵For instance, Hoelzl and Rustichini say that a population exhibits overconfidence if “a majority of people estimates their skills or abilities to be better than the median”.

Definition 2 A *signalling structure* is a triplet $\sigma = (S, \Theta, f)$, where S is a set of signals, $\Theta \subset \mathbf{R}$ is a type space, and $f = \{f_\theta\}_{\theta \in \Theta}$ is a collection of probability distributions over S .

If, for example, S is finite, $f_\theta(s)$ is the probability that a person of type θ receives the signal s .

- Throughout this paper we interpret higher types as more skillful.

Definition 3 A *signalling model* consists of a population of individuals, a signalling structure $\sigma = (S, \Theta, f)$, and a type $\theta \in \Theta$ for each individual such that:

- i) The distribution of types in the population has a unique median.
- ii) Each person knows the distribution of types in the population; initially, each person's belief about her own type is given by this distribution.
- iii) An individual of type θ , receives the signal $s \in S$ according to the probability distribution f_θ .
- iii) Each person updates her initial beliefs using Bayes' rule.

This definition of a signalling model reflects a standard approach to a situation of incomplete information, but since variations are possible within this standard, a few comments are in order. The unique median merely avoids uninteresting complications. Although it is not necessary to do, we posit that each individual knows the distribution of types in the population. On the one hand, this is certainly a plausible condition. For instance, an individual might know the distribution of the number of accidents a person can expect to have in a lifetime, or the distribution of IQs in the population, without knowing either figure for herself.⁶ More importantly, this condition makes our task more difficult: we will show that apparently overconfident data can rationally arise, even if everyone has a perfect understanding of the level of skills in the population.⁷ Note that, although it is not explicit in the definition of a signalling model, a dynamic time structure is allowed. In particular, the signal that an individual receives may consist of various pieces of information obtained over time (for instance, from her driving experience).

This is quite a rational model; indeed for many it is the definition of full rationality. As such, it provides a proper foundation for judging the rationality of a population. Note that since agents in a signalling model use Bayes' rule, for a large population their beliefs average out to the (true) population distribution.

⁶In experiments, the comparison population is sometimes the group of subjects in the room. Even if a subject knows the skill distribution in the general population (or relevant subpopulation, for instance, students), he may not know the distribution of skills in the room. However, the best case for the validity of an experiment is when the subject group is large enough to be representative of the larger population.

⁷By the same token, the assumption of a unique median also makes our task more difficult.

The following proposition indicates that apparent overconfidence is incompatible with rationality *when people know their skill levels exactly*.

Proposition 1 *Consider a signaling model. If everybody’s updated beliefs after receiving their signals are degenerate, the population median data cannot be apparently overconfident.*

Proof. All proofs not in the text are in the appendix ■

If people are certain of their types, then a strict majority of them cannot rationally believe they are better than the median.⁸ However, this is a rather implausible condition – in most, if not all, situations each person will have only an imperfect indication of his own skill.⁹ How imperfect can a rational persons’ self-knowledge be? A priori, it seems difficult to require more of a rational population than that its members derive their beliefs in a rational and consistent manner; that is, that they derive them from a signalling model.

In ranking questionnaires, people do not report their full beliefs, but only a ranking. Rational and consistent individuals report rankings that come from beliefs that are derived from a signalling model; however, as discussed in the previous section, there are many legitimate ways to report a ranking derived from a particular belief. Therefore, in interpreting ranking data we need to consider several possibilities.

Suppose that people use their median beliefs about themselves in their self-evaluations (as in α of Section 1.1). The next definition says that a fraction x can rationally and consistently report themselves as being better than the population median, if, starting from a common prior, and using Bayes’ rule, a fraction x can come to believe their median type is better than the population median.

Definition 4 *Population median data x can be α -rationalized if there exists a signalling model in which x is the expected fraction of people who will believe that their median type is strictly greater than the population median, after receiving their signals and updating.*

(More formally, x can be α -rationalized if there exists a signalling model as follows: Let m be the median of the prior p . Let $S_{med} \subset S$ be the set of signals such that an individual who receives a signal $s \in S_{med}$ has a median belief about himself that is strictly greater than the population median. Thus, $s \in S_{med}$ if and only if $P(\theta \leq m \mid s) < \frac{1}{2}$. Let F denote the

⁸Proposition 1 remains true if we modify the definition of a signalling model to allow people to be uncertain of the population distribution. For instance, nature could pick one of several population distributions with probabilities that are common knowledge.

⁹Many authors explicitly acknowledge that people are not likely to be certain of their skill levels. Thus, Alicke et al. (1995) ask subjects to make “point estimates” of their skill, while Hoelzl and Rusticini (2005) note that a subject in their experiment has only “some idea of his skills in it”. However, these and other authors do not fully explore the implications of this uncertainty.

probability distribution of the signals in S , often called the “marginal”. That is, for each (measurable) $T \subset S$ let

$$F(T) = \int_{\Theta} \int_T df_{\theta}(s) dp(\theta)$$

Then, x can be **α -rationalized** if $x = F(S_{med})$.

In a stochastic environment, it is possible to “explain” a wide range of experimental data as the outcome of a random, although possibly unlikely, process. Definition 4 avoids this “cheat” by insisting that the data x be the *expected* fraction of people who believe themselves to be above average. This can also be interpreted as restricting ourselves to data that comes from large populations.¹⁰ Thus, Definition 4 is a demanding notion of rationalizing. When people self-evaluate using their median types and the data can be α -rationalized, there is no reason *prima facie* case for calling it “overconfident”.

The following definition is for a population in which people use their mean beliefs about themselves (as in β of Section 1.1) for their self-evaluations.

Definition 5 *Population median data x can be β -rationalized if there exists a signalling model in which x is the expected fraction of people who will believe that their mean type is strictly greater than the population median, after receiving their signals and updating.*

Although reporting a modal belief strikes us a plausible way to answer a questionnaire, it also strikes us as less compelling than reporting either a median or a mean belief. Therefore, in the interest of space, from now on we no longer consider mode reports. (Considering mode reports would not modify our results in any essential way.) Instead, we turn to a slightly different approach than the one we have adopted so far.

It is reasonable for a person with no information about herself, other than that she is a random member of the population, to rate herself as average.¹¹ Suppose the person now receives a signal that causes her beliefs about her own type to strictly first order stochastically dominate the population distribution. It is natural for this person to now rank herself above the median person.¹² This leads to the following definition.

Definition 6 *Population median data x can be γ -rationalized if there exists a signalling model in which x is the expected fraction of people who, after receiving their signals and*

¹⁰In Section 1.3 we briefly discuss small populations, where more extreme data can be rationalized.

¹¹A person who has no private information about herself and who self-evaluates using the median of her type, ranks herself as equal to the population median; if she uses her mean type, she ranks herself as equal to the population median if the prior is symmetric, but not necessarily otherwise (which may be an argument against the reasonableness of the mean).

¹²Note, however, that if the population distribution is not symmetric, the fact that a person’s beliefs about herself strictly first order stochastically dominate the population distribution does not imply that either her median or mean type is strictly better than the population median type.

updating, will have beliefs about their own type that strictly first order stochastically dominate the population distribution.

The existing literature assumes that apparent overconfidence implies cognitive errors, or inconsistencies, on the part of (some) respondents without considering the meaning of their replies. In our terms, the literature assumes that apparent overconfidence implies that the data cannot be rationalized without specifying which sense of rationalizing. In some cases, there may be a reason to focus on a particular sense (as in Section 2.2). Absent such a reason, a stringent definition of overconfidence requires that population median data be called overconfident only when it cannot be rationalized using any of the above concepts, for only then can we be sure that there is a “problem” with the data¹³; a lax definition requires only that data be called overconfident when it cannot be rationalized using at least one of the concepts.

Definition 7 *Population median data x is **strongly overconfident** if it is apparently overconfident and it cannot be α -rationalized, and cannot be β -rationalized, and cannot be γ -rationalized.*

Definition 8 *Population median data x is **weakly overconfident** if it is apparently overconfident and it cannot be α -rationalized, or it cannot be β -rationalized, or it cannot be γ -rationalized.*

In a *symmetric* signalling model, the population distribution is symmetric.¹⁴ In what follows, we will note when the data can (also) be rationalized by a symmetric signalling model (and hence the rationalizing does not depend upon a discrepancy between the mean and median).

Theorem 1 *Ostensible overconfidence of population median data x implies weak overconfidence only if $x = 1$. Put differently, it is possible to α -rationalize, and β -rationalize, and γ -rationalize any fraction $x \in (\frac{1}{2}, 1)$ rating themselves above the median. Moreover, these rationalizations can be done with symmetric signalling models.*

If people know the general distribution of skills in the population, and learn about their own skills over time, there is nothing wrong with a strict majority of them ranking themselves above the median. Thus, apparent overconfidence should not be used as an indication of overconfidence. For instance, Svenson’s (1981) finding that “a majority of subjects regarded

¹³In fact, even then we could not be sure as there could be still other reasonable ways for people to evaluate themselves.

¹⁴If P is the distribution, and h is the midpoint of the support, $P(\theta \leq h - y) = P(\theta \geq h + y)$ for all y .

themselves as more skillful and less risky than the average driver” is unproblematic. Note that Theorem 1 restricts x to be greater than $\frac{1}{2}$ only because we are concentrating on overconfidence. The theorem remains true for all $x \in (0, 1)$, so that apparent *underconfidence* is also not problematic. Although the three notions of rationalizing used in Theorem 1 are independent of each other, the drivers example in the introduction illustrates the theorem for all three.

The above theorem concerns a population of individuals who place themselves relative to the median person. The next theorem is even more dramatic: almost everyone can rationally believe that their mean skill level is strictly higher than the skill level of any fraction of the population (even if the population distribution is symmetric).

Theorem 2 *Data in which any fraction $x \in (0, 1)$ of the population ranks itself strictly higher than any fraction $q \in (0, 1)$ of the population can be β -rationalized by a signalling model. In particular, 99% of the people can rationally believe that their mean skill level is strictly higher than the skill level of 99% of the people. Moreover, this rationalizing can be done with a symmetric signalling model.*

1.1.2 Population Ranking Data

Although the results of ranking experiments are typically summarized by the number of people who rank themselves above the median, most of these experiments collect more detailed data, such as the deciles into which subjects place themselves. While the previous section shows that population median data is essentially useless for determining whether or not people are overconfident, this more complete data is potentially helpful.

Suppose that each person is asked to place himself into a “k-cile”, where to be in the j^{th} k-cile means that the person ranks himself above the fraction $\frac{j-1}{k}$ of the population, and below the fraction $\frac{j}{k}$. *Population ranking data* is a vector $x \in \mathbf{R}^k$, $\sum_1^k x_i = 1$, where x_i , $i = 1, \dots, k$ is the fraction of people who rank themselves in the i^{th} k-cile. By definition, the actual fraction of people that lies in each k-cile is $\frac{1}{k}$. We have the following:

Definition 9 *The population ranking data x is **apparently overconfident** if x strictly first order stochastically dominates $(\frac{1}{k}, \dots, \frac{1}{k})$.*

If neither one of x and $(\frac{1}{k}, \dots, \frac{1}{k})$ first order stochastically dominates the other, then the data has neither an unambiguously overconfident nor underconfident appearance. For instance, the data $(\frac{1}{5}, \frac{1}{5}, \frac{3}{10}, 0, \frac{3}{10})$ contains a disproportionately large number of people who consider themselves to be in the top fifth, but a disproportionately small number who place themselves in the top two fifths.

Definition 10 *The population ranking data x can be α -rationalized if there exists a signalling model in which the expected number of people who believe their median type is in the j^{th} k -cile is x_j , $j = 1, \dots, k$.*

The following theorem says that, when people report the median of their beliefs, a rational population can be “twice as confident” as reality would suggest, but no more. For instance, suppose that people place themselves into deciles ($k = 10$). Then apparently overconfident data in which $\frac{2}{10}$ of the people rank themselves in the top decile, $\frac{4}{10}$ rank themselves in the top two deciles, and $\frac{2i}{10}$ rank themselves in the top i decile for $i = 3, 4, 5$ can be rationalized. However, data in which $\frac{3}{10}$ of the population place themselves in the top decile can not be explained as rational. (Although we have been emphasizing overconfident looking data, there is a similar constraint put on underconfident looking data, and that is captured by the second inequality in the theorem.) Let $\lceil n \rceil$ denote the least integer weakly greater than $n \in \mathbf{R}$.

Theorem 3 *The population ranking data x can be α -rationalized if and only if*

$$\sum_i^k x_j \leq \frac{2}{k} (1 + k - i), i = \left\lceil \frac{k+1}{2} \right\rceil, \dots, k \quad \text{and}$$

$$\sum_1^i x_j \leq \frac{2}{k} i, i = 1, \dots, \left\lceil \frac{k-1}{2} \right\rceil$$

Moreover, the rationalizing can be done with a symmetric signalling model.

Corollary 1 *Population ranking data in which the median declared placement is as high as the 75th percentile, but no higher, can be α -rationalized.*

While almost everyone can rationally think they are better than the median, only half can rationally think they are better than the 75th percentile.

Theorem 3 provides some hope for detecting overconfidence by the use of ranking questionnaires. It is worth looking at Svenson’s data in greater detail than that provided by his population median data. Svenson questioned students in Sweden and the United States, asking them both about their driving safety and driving skill. Swedish drivers placed themselves into deciles in the following proportions when asked about their safety:

Decile	1	2	3	4	5	6	7	8	9	10
Reports (%)	0.0	5.7	0.0	14.3	2.9	11.4	14.3	28.6	17.1	5.7

We first note that although the population ranking data has an overconfident feel to it, the data is not, strictly speaking, apparently overconfident, since fewer than 10% of the

population ranks itself in the top 10%. More importantly, Theorem 3 implies that the data can be α -rationalized, so that it is not indicative of cognitive biases.¹⁵ Note, for instance, that while 65.7% of the people rank themselves among the top 40%, Theorem 3 would allow up to 80% to rationally do so. Furthermore, the median ranking is between the seventh and eighth decile, which Corollary 1 permits of a rational population. In fact, out of Svenson’s four questions, only half yield answers that cannot be α -rationalized – namely, the American answers. The median safety placement for American students is between 81% and 90%, which violates Corollary 1. While the median skill placement is in the acceptable 61 – 70% range, 46% of the population places itself in the top 20% of skill level, which is too many to α -rationalize. Thus, Svenson does find some evidence of overconfidence (*if* his subjects based their answers on their median types), but it is not as strong as commonly believed. Note that when 46% of the population place themselves in the top 20% this is only 6% too many, not 26%.

Theorem 3 is our first positive result: if people self-evaluate using their median rankings, then questionnaires have the potential to detect overconfidence. Unfortunately, our next result indicates that if people use their mean rankings, then even the more complete population ranking data is useless.¹⁶

Definition 11 *The population ranking data x can be β -rationalized if there exists a signalling model in which the expected number of people who believe their mean type is in the j^{th} k -cile is x_j , $j = 1, \dots, k$.*

Theorem 4 *Any population ranking data can be β -rationalized.*

1.1.3 Reasonableness

The previous discussion has been in the rather abstract language of signalling models. Some readers may wonder if the results somehow depend upon “bizarre” signalling structures. In this section, we address this concern.

One obvious reason for a person to consider herself a safe driver is that she has not had any accidents. Thinking of driving as a “test”, and not having an accident as passing the test, motivates the next definition.

Definition 12 *A **testing model** consists of a test, a population of individuals, a type space $[0, 1]$, and a (prior) probability distribution p over $[0, 1]$ with unique median such that:*

¹⁵Theorem 4 below shows that the data can be β -rationalized as well.

¹⁶Theorem 4 is the first result that relies on a signalling model that is not symmetric. This could be considered to be a flaw, if there is a reason to believe that the trait under consideration is symmetrically distributed in the population. As far as we know, no one in the literature has argued that their data is significant because the trait distribution is symmetric.

- i) Nature chooses a type $\theta \in [0, 1]$ for each individual independently according to the prior p ; initially, each person's beliefs about his own type are described by p .*
- ii) Each person takes the test. A person of type θ , passes the test with probability θ and fails with probability $1 - \theta$.*
- iii) Each person updates his beliefs about himself using Bayes' rule.*

A testing model is a natural and simple signalling model. In a *symmetric* testing model, the prior distribution is symmetric.

Theorem 5 *Population median data x , for any $x \in (0, 1)$, can be α -rationalized, β -rationalized, and γ -rationalized by a symmetric testing model. Furthermore, data in which any fraction $x \in (0, 1)$ of the population rank themselves strictly above any fraction $q \in (0, 1)$ of the population can be β -rationalized by a symmetric testing model.*

Theorem 5 implies Theorems 1 and 2 of Section 1.1.1. As it depends only upon a symmetric testing model, which is quite simple and straightforward, it shows that those results do not depend upon a strained signalling model.

While the simplicity of a testing model is a virtue, it has a cost: since it involves only two signals, pass and fail, it can only generate data in which the population's updated beliefs divide into at most two sets. Thus, while population median data can be rationalized by a testing model, population ranking data in which the population places itself into more than two k -ciles ($k > 2$) cannot be. At the same time, a driver, for example, self-evaluates using not only the number of accidents she has had, but also the number of near-accidents, her beliefs about her reflexes and eyesight, and myriad other factors, which may be better captured by the abstractness of a signalling model than by a more concretely specified model.

What makes for a reasonable signalling model? A plausible restriction is that better types should be more likely to receive better signals (for instance, a relatively safe driver should expect to have relatively few accidents and near-accidents). More precisely, we say that a signalling model, with signalling structure (S, Θ, f) , is **f-reasonable** if $\theta_1, \theta_2 \in \Theta, \theta_1 < \theta_2$ implies that f_{θ_2} f.o.s.d. f_{θ_1} . The following proposition shows that this restriction has implications for population ranking data.

Proposition 2 *For small enough ε , the population ranking data $(\varepsilon, \varepsilon, \frac{1}{2} - \varepsilon, \frac{1}{2} - \varepsilon)$ cannot be α -rationalized by a signalling model that is f -reasonable.*

Proposition 2 stands in contrast to Theorem 3 and Theorem 4 of Section 1.1.2. This proposition leaves open the possibility that population ranking data might be more useful than is implied by those theorems. For instance, one might hope to argue that Svenson's Swedish data is, in fact, indicative of some overconfidence, as it could not be rationalized

by a “reasonable” signalling model. While this possibility is intriguing, the following result shows that it is not immediate what form such an argument would take.¹⁷

Example 1 *The data $x = (\frac{1}{8}, \frac{1}{8}, \frac{3}{8}, \frac{3}{8})$ can be α -rationalized by a signalling model that is f -reasonable. For instance, let the type space be $\Theta = [0, 4]$, let the set of signals be $S = \{1, 2, 3, 4\}$, and let the probability with which type θ receives signal s be given by, for any $\varepsilon \leq \frac{1}{6}$, f_i :*

$$\begin{aligned} \theta \in [0, 1) &= \begin{cases} \frac{1}{4} + \varepsilon & s = 1 \\ \frac{1}{4} - \varepsilon & s = 2 \\ \frac{1}{4} & s = 3, 4 \end{cases}, & \theta \in [1, 2) &= \begin{cases} \frac{1}{4} - \varepsilon & s = 1 \\ \frac{1}{4} + \varepsilon & s = 2 \\ \frac{1}{4} & s = 3, 4 \end{cases} \\ \theta \in [2, 3) &= \begin{cases} \frac{3}{4} & s = 3 \\ \frac{1}{4} & s = 4 \end{cases}, & \theta \in [3, 4] &= \begin{cases} \frac{1}{4} & s = 3 \\ \frac{3}{4} & s = 4 \end{cases} \end{aligned}$$

Finally, let the population be uniformly distributed on Θ . Then, $\frac{1}{8}$ of the population receives the signal 1, $\frac{1}{8}$ the signal 2, $\frac{3}{8}$ the signal 3 and $\frac{3}{8}$ the signal 4. An individual who receives the signal i has a median type that places him in the i^{th} quartile. The population (rationally) reports the data $(\frac{1}{8}, \frac{1}{8}, \frac{3}{8}, \frac{3}{8})$.

The next theorem shows that when it comes to β -rationalizing, f -reasonableness imposes no additional restrictions.

Theorem 6 *Any data x with $x_i \in (0, 1)$ for all i can be β -rationalized with an \mathbf{f} -reasonable signalling model.*

1.2 Scale Questions

In scale questionnaires, participants are asked to make evaluations using a scale. There are variations, but in the version we consider people are asked to compare themselves to the average person on a designated scale.¹⁸ For instance, Alicke et al. (1995) present subjects

¹⁷The technically minded reader will notice that the information structure of Example 1 does not satisfy the maximum likelihood ratio property (mlrp): for some $\theta' > \theta$, $\frac{f_{\theta'}(s)}{f_{\theta}(s)}$ is not increasing. In particular, $3 = \frac{f_2(3)}{f_0(3)} > \frac{f_2(4)}{f_0(4)} = 1$. The failure to satisfy the mlrp is not a problem, however, since the mlrp is just a means to an end, namely, that “high signals are good news”, and higher signals are good news in the example, since the posteriors from higher signals f.o.s.d the posteriors from lower signals. For example, $p(\theta \in [0, 1)|3) = p(\theta \in [1, 2)|3) = \frac{1}{6}$, $p(\theta \in [2, 3)|3) = \frac{1}{2}$, $p(\theta \in [3, 4]|3) = \frac{1}{6}$, while $p(\theta \in [0, 1)|4) = p(\theta \in [1, 2)|4) = p(\theta \in [2, 3)|4) = \frac{1}{6}$, $p(\theta \in [3, 4]|4) = \frac{1}{2}$.

¹⁸In a common variant each person places him or herself on a scale from 1 to T and indicates the fraction of the population that falls into each scale position. This is formally equivalent for defining ostensible overconfidence. However, the notions of rationalizing becomes relatively involved, as the different population distributions must also be explained.

with a personality trait, such as intelligence or dependability, and ask them “to rate the extent to which the trait describe(s) themselves relative to the average college student of the same sex, on a single 9-point scale (0 =much less than the average college student; 4 =about the same as the average college student; 8 =much more than the average college student).”

More generally, in a scale survey (of this type), a comparison scale T and “average” m are specified, and each person i is asked to compare himself to this average by choosing an $x_i \in T$. **Population scale data** is a quadruple (T, m, n, \bar{x}) , where $T \subset \mathbf{R}$ is the scale used in the questionnaire, $m \in T$ is the specified scale average, n is the number of individuals, and $\bar{x} = \frac{1}{n} \sum_{i=1}^n x_i$, where each $x_i \in T$. The literature uses the notion that the population scale data is **apparently overconfident** if $\bar{x} > m$.

Before proceeding, we must note that the fundamental methodology in many scale questionnaires seems a bit dubious. The basic idea, apparently, is that in a rational population, the answers given should average out. But given the subjective nature of many of these scales, it is unclear why this should be so, even when there is no uncertainty at all and everyone is in perfect agreement. Imagine the following question posed to two drummers, A and B , in a room:

On an integer scale from -5 (much worse), 0 (the same) to 5 (much better), please rate yourself as a drummer compared to the other drummer.

Suppose that, as it happens, both A and B are of the opinion that the only skill that matters in a drummer is accurate time keeping. Furthermore, they both agree that A 's time keeping is 80% accurate, while B 's is 30% accurate. There seems to be little scope for “true” overconfidence (or underconfidence). There also seems to be nothing wrong with A rating himself with a 4, and B rating herself with a -2 . After all, the scale markings are subjective. Nonetheless, the standard measure indicates overconfidence since the average rating is 1, not 0.¹⁹

Despite our reservations, we will proceed as if the scales are interpreted in a consistent manner by all concerned. Alternatively, we will only be considering scale questionnaires in which there is an objective scale. As an example, Weinstein (1980) asks students how their chances of obtaining a good job offer before graduation compare to those of other students at their college, with choices ranging from 100% less than average to 5 times the average. Here, there is no ambiguity in the meaning of the scale, but another ambiguity remains; namely, what is meant by an average student?²⁰

¹⁹There are still other potential problems with scale questions. For instance, Schwarz et al. (1991) ask subjects how successful they have been in life, and find that answers differ significantly depending upon whether subjects are presented with a scale from -5 to 5 , or 0 to 10 .

²⁰Weinstein asks subjects to compare themselves to “other Cook students” using terms such as “50% less than average”. Alicke et al. ask their subjects to compare themselves to the average student.

As we saw, in ranking questionnaires the median is the only notion of an average that it is reasonable for us to consider.²¹ It turns out that in scale questionnaires only the mean provides a useful notion, although it is reasonable for respondents to use either notion. To illustrate the issue, suppose, for the sake of discussion, that all of Weinstein’s subjects agree that there are two types of students at their college, low and high, with job offer probabilities $p_L = 0.3$ and $p_H = 1$, and that 80% of the population are low type. A reasonable interpretation of an average student is one with an 0.3 chance of obtaining an offer. Consider a respondent who thinks that there is a 50% chance that she is a low type. Her probability of obtaining a good job offer is $(.5 \times 0.3) + (.5 \times 1) = 0.65$. A perfectly reasonable response to Weinstein’s question is that her chances are 35% above average. Note that we are claiming that a reasonable, perhaps the most reasonable, way to answer uses the median (or mode) in determining the population average, but the mean (of her own beliefs) for self-evaluating. It is not necessary that the the reader accept this as the *most* reasonable way of answering, merely that he or she accepts that this as a plausible way. Of course, this is not to deny that it is also reasonable for a respondent to use the population mean in defining the average student and her own mean for self-evaluating. Moreover, for other questions, in particular those not involving probabilities, it may be reasonable for subjects to use their median type, rather than mean type, when self-evaluating. Thus, just considering medians and means, there are four ways to interpret answers to scale questions.

We will spare the reader the formalization of all four treatments. It is fairly obvious that in the two cases where people self-evaluate using the median of their beliefs, apparent overconfidence does not imply overconfidence, since there is no particular reason why weighted sum of medians should equal the population mean or median. Example 2 shows that the same holds true when people self-evaluate using their mean belief, and the population “average” is taken to be the median.

the population average represents the median. Theorem 7 below covers the fourth case.

Example 2 *Consider an experiment in which 150 subjects are asked to compare themselves to others on a scale $T = \{0, 1, \dots, 9, 10\}$, where 5 is “average”, 0 indicates “much below average”, and 10 indicates “much above average.” Suppose that the number of people who place themselves at 5 is 50, and that for each of 6, 7, 8, 9, and 10 the number is 20. Clearly, the data is apparently overconfident, since nobody places himself below the average, and 2/3 of the people place themselves strictly above. We now show how to rationally explain this data when the average 5 represents the median type, and respondents self-evaluate using their mean type.*

²¹More precisely, if the trait described is not symmetrically distributed, there is no reason for 50% of the people to be ranked above the mean. If the trait is symmetrically distributed, then the mean equals the median anyway.

Suppose that, in fact, of the 150 subjects, 90 are 5's and 60 are 10's. Note that the median type is 5. This general information is common knowledge. Beyond this, each person receives a signal giving him further information about his own type. The set of signals is $S = \{0, 1, \dots, 9, 10\}$ and, for the two types in the population, the probability of receiving a signal are given by:

$$f_5(s) = \begin{cases} 0 & s < 5 \\ \frac{5}{9} & s = 5 \\ \frac{20-2i}{45} & s > 5 \end{cases} \quad \text{and} \quad f_{10}(s) = \begin{cases} 0 & s \leq 5 \\ \frac{i-5}{15} & s > 5 \end{cases}$$

Some simple calculations show that the expected number of people who will receive the signal 5 is 50, and that any one receiving this signal knows that his type is 5. For each $i = 6, \dots, 10$, the expected number who will receive the signal is 20, and, using Bayes' rule, a person receiving the signal i has a mean type of i . Therefore, we expect 50 people to rationally rate themselves as 5s, and 20 people to rationally rate themselves each of 6, 7, 8, 9, and 10, as reported in the experiment.

The next theorem contrasts markedly with this result. It shows that if “average” is interpreted as the mean of the population, and people self-evaluate using the mean of their beliefs, then apparent overconfidence implies overconfidence. More precisely, consider a population whose mean type is m , and whose members know the overall distribution of types and learn about themselves over time. If individuals report their mean type, then at any point in time, the expected average report must be m . Therefore, if the population is large enough it will not display apparent overconfidence.

Theorem 7 Consider a population where individual $i = 1, \dots, n$ is of type $t_i \in T \subset R$, and m is the mean type. Suppose that each person knows the distribution of types in the population and receives a signal about his own type. Then $E\left(\frac{1}{n} \sum_{i=1}^n \bar{t}_i\right) = m$, where \bar{t}_i is the mean of person i 's updated beliefs.

Theorem 7 provides the first case where the standard interpretation of the data found in the literature has merit. Weinstein finds that his subjects display apparent overconfidence. If we assume that his subjects consider the average subject to be represented by the mean of the population, and that they self-evaluate using their mean type, then his subjects also display overconfidence.²² Since Weinstein asks his subjects for probability information, it does seem most reasonable to interpret their responses as reflecting their mean self-evaluations. However, as we argued earlier, it may be more reasonable to assume that subjects consider the average type to be the population median, rather than mean.

²²On the other hand, as a psychological matter, asking subjects for probability information in and of itself may lead to dubious replies.

1.3 Small Samples

As we discussed in Section 1.1.1, our definitions of rationalizing, which rely on “expected data”, can be understood as implicitly insisting that the data be generatable by infinitely large populations. Naturally, an experimenter prefers to have as large a subject pool as possible, so that her results cannot be dismissed as a statistical aberration (or experimental error). Thus, our implicit assumption that the data comes from an infinitely large population provides the best case for the data. Nonetheless, actual experimental populations are, of course, finite, and many experiments involve quite small numbers. It is worth noting that finite samples permit data that is even more (seemingly) anomalous.

Consider the following quote from Camerer (1997):

The now-standard approach to games of imperfect information pioneered by John Harsanyi presumes that players begin with a “common prior” probability distribution over any chance outcomes. As an example, consider two firms A and B, who are debating whether to enter a new industry like Internet software. Suppose it is common knowledge that only one firm will survive—the firm with more skilled managers, say—so firms judge the chance that their managers are the more skilled. The common prior assumption insists both firms cannot think they are each more likely to have the most skill.

This statement is simply wrong. We now show that, using the “standard approach,” each of two firms can, in fact, concurrently believe that it is more likely to be the more skillful. Furthermore, this state of affairs can arise with probability arbitrarily close to one. The following is a simple and straightforward model yielding this result.

1. Nature moves first. With probability $\frac{1}{2}$, Firm 1 has high skill, Firm 2 has low skill; with probability $\frac{1}{2}$ Firm 1 has low skill, Firm 2 has high skill. Both firms know this, but neither is told Nature’s choice.
2. Each firm takes a test. The high skill firm passes with probability p_h , the low skill firm passes with probability p_l , where $p_h > p_l$.
3. Each firm uses Bayes’ rule to determine the probability that it is the more skillful.

Proposition 3 *For any $p \in (0, 1)$, the parameters in the above model can be chosen so that with probability p each firm will believe there is strictly more than a $\frac{1}{2}$ chance that it is the more skillful. In particular, the parameters can be chosen so that with a 50% chance each firm will believe there is a $\frac{2}{3}$ chance that it is the more skillful; in order for the chance to be more than 50%, the belief must be smaller than $\frac{2}{3}$, in order for the belief to be greater than $\frac{2}{3}$, the chance must be less than 50%.*

Proof of Proposition 3. The probability that a firm that passes the test is high skill is:

$$p(\theta = H \mid pass) = \frac{\frac{1}{2}p_h}{\frac{1}{2}p_h + \frac{1}{2}p_l} > \frac{1}{2}$$

The probability that both firms pass the test is $p_h p_l$. Fixing $p \leq p_l < \sqrt{p}$ (to ensure that $1 \geq p_h > p_l$), and setting $p_h = \frac{p}{p_l}$ establishes the first part.

To establish the second part, note that the solution to the problem

$$\max_{p_l, p_h} \frac{\frac{1}{2}p_h}{\frac{1}{2}p_h + \frac{1}{2}p_l}$$

subject to $p_h p_l \geq \frac{1}{2}$ and $p_h > p_l$, is $\frac{2}{3}$ at $p_h = 1, p_l = \frac{1}{2}$. ■

As an illustration, if $p_h = 0.99$ and $p_l = 0.98$, then with probability 0.97 both firms will pass the test and each will believe there is a 0.502 chance that it is the more skillful; if $p_h = 1$ and $p_l = 0.5$, then with probability $\frac{1}{2}$ each of the two firms will simultaneously believe it has a $\frac{2}{3}$ chance of being the more skillful.

We note that the first part of the proposition has nothing to do with there being two firms – an arbitrary finite number of firms can all believe they are the best firm with any probability $p \in (0, 1)$.

2 Actions

We have emphasized the ambiguity inherent in the interpretation of replies to questionnaires. A different approach to the study of overconfidence circumvents this ambiguity by asking subjects to take actions. The subjects' beliefs are then inferred from their actions. In this section we look at two such studies.

2.1 Entry

In an oft-cited paper, Camerer and Lovo (1999) test for overconfidence using an experiment meant to model firms' entry decisions. N subjects ("firms") must decide whether to play In or Out. After the entry decisions are made, the subjects who have played In are ranked. The payoff to playing In is greater than the payoff to playing Out if and only if an entrant is ranked in the top $k < N$ (hence, all subjects who play In do better than all subjects who play Out if fewer than k choose In). There are two treatments.

1. Treatment 1. The subjects who play In are ranked randomly.
2. Treatment 2. The subjects who play In are ranked according to their results on a skill or trivia test. (The test is administered after the entry decisions, but subjects are given sample questions beforehand).

Since the number of subjects that can profitably play In is independent of the treatment, the authors test for overconfidence on the part of subjects by testing if the number of entrants is greater under Treatment 2 than under Treatment 1.²³ They find that, indeed, more subjects enter under the second treatment than the first. But is this an indication of overconfidence, with its implication of irrationality, or apparent overconfidence, with no such implication?²⁴

We now show that if more firms enter under Treatment 2 than Treatment 1, this only shows apparent overconfidence.

We proceed with a slightly simpler setup than the one used by Camerer and Lovallo; the basic methodology and conclusions remain valid for their more intricate setup. Suppose there are two subjects ($N = 2$), and that only one of them can profitably play In ($k = 1$). Specifically, if both subjects enter, the higher ranked one earns 1, the lower ranked one loses 3. A subject who enters alone, again earns 1. A subject who does not enter earns 0. We can write “the subjective expected payoff matrix” for the game as follows, where p_i is a subject i ’s belief that he or she will be the higher ranked:

	In	Out
In	$p_1 - 3(1 - p_1), p_2 - 3(1 - p_2)$	1, 0
Out	0, 1	0, 0

Since there are only two participants, the two treatments in this case are:

1. Under Treatment 1, if both firms enter, the higher ranked subject is randomly chosen with probability $\frac{1}{2}$.
2. Under Treatment 2, if both firms enter, their ranking is determined by a trivia test. The test is administered only after entry decisions have been made, but each subject is shown a sample question before.

To explain Camerer and Lovallo’s finding of more entry under Treatment 2 than Treatment 1 as the result of apparent overconfidence, rather than overconfidence, we must specify a signalling model (preferably, a “reasonable” one); Section 1.3 provides one. Suppose that, before seeing the sample question, each subject believes there is a $\frac{1}{2}$ chance that he will do better on the test, and (correctly) believes that if he is to do better (resp., worse) on the

²³As they write “The *difference* in the number of entrants in the random and skill conditions is the primary measure of interest.”

²⁴In fact, as a test of any kind of overconfidence, the results of the paper are muddled by several complicating issues, including the risk attitudes of the participants and their ability to play to an equilibrium. We consider the best case scenario (for their paper) in which participants are risk-neutral and play to an equilibrium.

test, he will know the answer to the sample question with probability p_h (resp, p_l , $p_l < p_h$). Suppose also that $p_h p_l > \frac{1}{2}$, so that there is a greater than 50% chance that both subjects will correctly answer the test (and each will think he is likely to be the more skillful).

We find symmetric equilibria of the games induced by the two treatments:

1. Under the first treatment, each subject enters with probability $\frac{1}{2}$. The expected number of subjects that enters is 1.
2. Under the second treatment, each subject adopts the following strategy: If I pass the test, I enter with probability $\frac{p_h + p_l}{4p_h p_l} > \frac{1}{2}$, if I fail the test I do not enter. The expected number of firms that enter is $\frac{1}{4p_h p_l} (p_h + p_l)^2$.

Note that $\frac{1}{4p_h p_l} (p_h + p_l)^2 > 1$. Therefore, an experimenter should expect to find that more subjects enter under Treatment 2 than under Treatment 1, but this is only an indication of apparent overconfidence, not overconfidence.²⁵

2.2 A Vocabulary Test

Hoelzl and Rustichini (2005) divide subjects into groups and present them with two options:

1. Option 1. You will be given a monetary prize M with probability $\frac{1}{2}$, as determined by the toss of a die.
2. Option 2. Everyone in your group will be administered a vocabulary test. You will be given M if your score places you in the top half of your group.

Hoelzl and Rustichini write, “Since only half of the subjects will win if the test decides the winner, any excess over a half of the subjects voting for the test indicates an erroneous evaluation of their own relative skills”. This statement, which forms the basis of their analysis, is incorrect.

To see why the statement is incorrect, first note that a subject will prefer the test condition if she thinks that there is more than a 50% chance that her performance will be in the top half. If we assume, as Hoelzl and Rusticini do, that each person believes that test taking ability can be summarized by a single parameter, or type, then a person will prefer the test if the median of her beliefs about herself is better than the group median. If more than 50%

²⁵A different test is on the expected profits that firms make, rather than the number of firms. If firms are (truly) overconfident under Treatment 2, rather than ostensibly overconfident, they will make negative expected profits (see Section 5). However, Camerer and Lovallo do not find that firms make negative profits (in the setting that does not suffer from a self-selection problem, which is a separate issue that the authors identify)

of the people (strictly) prefer the test, then the population displays apparent overconfidence; this apparent overconfidence “indicates an erroneous evaluation” only if the data cannot be α -rationalized (given that people are using their median types). However, as Theorem 1 indicates, any amount of apparent overconfidence can be α -rationalized.²⁶ Thus, there is no error in judgement implied when more than half the subjects vote for the test.

In fact, even without the formalization in this paper, it is rather trivial to see that there is nothing wrong with more than half the subjects voting for the test. Imagine, for the sake of argument, 10 subjects who reach the following conclusion in the waiting room: Nine of them are native English speakers, with a perfectly ordinary command of the language, while one is a Haitian with a more recent knowledge of English. There is certainly nothing wrong with the nine native speakers voting for an English vocabulary test on the grounds that this gives each of them a $\frac{5}{9} > \frac{1}{2}$ chance of winning the prize. Thus, the experimental design of Hoelzl and Rustichini cannot possibly prove what they set out to prove.

The authors actually run two treatments of their experiment, one in which the vocabulary test is easy, one in which it is difficult. In both cases, subjects vote on the options before the test is administered, but are shown sample questions (either easy or difficult) before the vote. Hoelzl and Rustichini find that more subjects vote for the test option when the test is easy, than when it is difficult. They write “Two interpretations of this result are possible. The first interpretation is that subjects confuse ‘being good’ with ‘being better’... A second interpretation is possible in terms of ambiguity aversion”. In fact, a third interpretation is possible within a completely rational framework. In Section 4.2 we show that one should expect apparent overconfidence when the test is easy and apparent *underconfidence* when the test is difficult.²⁷ To understand this result in the present context, imagine that the difficult (on average) test is a Haitian Creole vocabulary test. Now we should expect nine of the subjects to vote against the test, on the grounds that it would give each of them a $\frac{4}{9} < \frac{1}{2}$ chance of winning.

3 Testing for Overconfidence

While the experiment run by Hoelzl and Rustichini does not provide a proper test of overconfidence, we now provide two modifications that do provide a proper test. The validity of both experiments derives from Theorem 8 below, which generalizes the necessary conditions

²⁶More precisely, Theorem 1 says that any degree of ostensible overconfidence short of 100% can be α -rationalized. In fact, given that any experiment must allow a margin for error, one could argue that even 100% ostensible overconfidence is not problematic. Moreover, α -rationalization is (implicitly) for an infinite population; for a finite rational population 100% ostensible overconfidence can be obtained without experimental error.

²⁷In fact, Proposition 3 can also be turned on its head to the same effect.

of Theorem 3.

First Experiment

Suppose subjects are given the following two options:

1. Option 1. You will be given a monetary prize M with probability $\frac{1}{2}$, determined by the toss of a die.
2. Option 2. Everyone in your group will be administered a vocabulary test. You will be given M if your score places you in the top $x\%$ of your group.

A subject prefers the test condition if she thinks that there is more than a 50% chance that she will perform in the top $x\%$ of her group. That is, a person will prefer the test if her median type is in the top $x\%$. From Theorem 8, at most $2x\%$ of the people can rationally hold such a belief (at least if the population is large), so that a choice of x smaller than 50 by the experimenter provides a viable test. For instance if $x = 30$ so that a subject wins if he or she places in the top 30%, then at most 60% can rationally vote for the test.²⁸

Second Experiment

Suppose that 10 subjects are given the option between winning M with probability $\frac{6}{10}$, and winning M if they place among the top 5 in a vocabulary test. As the following theorem indicates, at most 8 of the subjects can rationally prefer the test.

Theorem 8 *A fraction y or greater of a population can rationally believe that there is at least a probability p that their types are strictly better than the worse type in the top $x\%$ of the population if and only if $py \leq x$.*

4 Ostensible Overconfidence?

Recent work has questioned the universality of overconfidence. In particular, there is evidence that when the skill under consideration is objectively measurable, populations do not display much apparent overconfidence, and that they even display apparent underconfidence when the skill is a difficult one to master. In this section, we explain these facts within our rational framework.

4.1 Objectivity

Moore (2007) writes “Attributes that are specific, public, and objectively measurable tend to show the weakest BTA [better-than-average] effects, whereas vague, private and subjective

²⁸We gratuitously (since we have not run an experiment) remark that we doubt that more than 60% would vote for the test.

attributes tend to show the strongest BTA effects”. It is reasonable to presume that people have more information and, hence, tighter estimates of their own abilities for attributes that are more objectively measurable. The following proposition indicates that when people are quite certain of their types, there cannot be much apparent overconfidence.

For simplicity, suppose the type space Θ is finite. For any two probability distributions p and q on Θ , let the distance between them be

$$d(p, q) = \max_j |p_j - q_j|.$$

We say that a distribution q is δ -**close to a degenerate** if there exists a $j \leq |\Theta|$ such that for e^j (the j^{th} canonical vector) $d(q, e^j) \leq \delta$.

Proposition 4 *Consider a signalling model where the proportion of individuals strictly above the median of the population distribution is π . For all ε there are a δ and a t such that, if at least a fraction t of the population have beliefs, after receiving their signals, that are δ -close to a degenerate, then $|x_m - \pi| < \varepsilon$ and $|x_\mu - \pi| < \varepsilon$, where x_m (x_μ) is the population median data when people self-evaluate using their median type (mean type).*

Recall that Proposition 1 showed that when people’s beliefs about themselves are degenerate the population median data cannot be apparently overconfident. Technically, Proposition 4 tells us that that result was “continuous”.

We motivated the above proposition with reference to objectively defined traits. On a different dimension, people updating using Bayes’ rule will have tighter estimates of their skill as they gather more information. This suggests that, if our reasoning is correct, we should expect, say, older drivers, to display less apparent overconfidence than younger drivers.

4.2 Confidence and Difficulty

Kruger (1999) finds a “*below-average effect* in domains in which absolute skills tend to be low”. Moore (2007), summarizing similar work, writes “When the task is difficult or success is rare, people believe that they are below average”. Standard explanations for this discrepancy focus on cognitive errors, such as a tendency for people to “focus egocentrically on their own skills and insufficiently take into account the skills of the comparison group” (Kruger (1999)). In this section, we offer a rational explanation (of course).

Imagine a large pool of subjects who are informed that the level of “g-ability” in the population varies uniformly from 0 to 1. Since none of them has ever heard of g-ability, each one (rationally) considers that his or her g-ability is equally likely to be anywhere from 0 to 1. Now suppose that they are given a test which measures g-ability. They are told that the test is an easy one: a person with ability t will pass with probability $0.7 + 0.2t$.

What will a person who passes the test conclude about his ability? He certainly will not be surprised that he passed, since he expected to pass the test regardless of his ability. Nonetheless, his confidence in his g-ability will increase, if only slightly. More precisely, using Bayes' rule, he will ascribe probability $\frac{0.7+0.2t}{.8} = 0.25t + 0.875$ to being of type t . His median type will be .53 and his mean type will be .52,²⁹ both better than the median (or mean) of the population. Thus, whether he ranks himself by his median type or mean type, he will consider himself to be better than average. Furthermore, his beliefs about himself will strictly first order stochastically dominate the prior. But, (about) 80% of population will pass the test, and so the population will exhibit apparent overconfidence. While the population is apparently overconfident, it is not overconfident.

Now let us change just one thing: The test is a difficult one, and everyone is so informed.³⁰ Specifically, the probability of passing the test is now $0.1 + 0.2t$, so that 80% of the people are expected to fail. Using Bayes' rule, those who fail will have a median type of 0.47, and mean type of 0.48, and the population distribution will strictly first order stochastically dominate their beliefs. Thus a population facing a difficult test will exhibit *apparent underconfidence*.

Theorem 9 below formalizes the above argument using a testing model (defined in Section 1.1.3). Let p be the prior that nature uses in the testing model and P be the associated cumulative distribution function. Then $E(\theta) = \int \theta dP$ is the average number of people who pass the test, and this number is naturally interpreted as the difficulty of the test. We say that a test is **easy** if $E(\theta) < \frac{1}{2}$ and **difficult** if $E(\theta) > \frac{1}{2}$. Let m be the median type.

Theorem 9 *Suppose that beliefs are generated by a non-degenerate symmetric testing model. Following the test, on average a fraction $E(\theta)$ will consider that their mean type is strictly better than the population median and will have beliefs about themselves that strictly f.o.s.d the population distribution; a fraction $1 - E(\theta)$ will consider that their mean type is strictly worse than the population median and will have beliefs about themselves that are strictly f.o.s.d by the population distribution. Furthermore, the fraction $E(\theta)$ will consider that their median type is weakly better than the population median. If p is a density, or $p(m)$ is small enough, the fraction $E(\theta)$ ($1 - E(\theta)$) will consider that their median type is strictly better (worse) than the population median. Thus, if the test is easy the population will exhibit apparent overconfidence, while if it is difficult, the population will exhibit apparent underconfidence.*

Thus, when a “task is difficult or success is rare” we can expect apparent underconfidence, and when a task is easy, we can expect apparent overconfidence.

²⁹The median is the solution to $\int_0^t (0.25t + 0.875) dt = \frac{1}{2}$, while the mean is given by $\int_0^1 (0.25t + 0.875) t dt$.

³⁰The crucial difference between our discussion here and the reasoning of Healy and Moore (2007), is that here everybody knows precisely the difficulty of the test they are taking. See Section 6 for a discussion of Healy and Moore (2007).

5 Does it Matter?

In Section 2.1, we saw that apparently overconfident entrepreneurs might enter an industry at a greater rate than entrepreneurs with neutral beliefs about their abilities. The same, of course, is true about (actually) overconfident entrepreneurs. This invites the question: does it really matter if a population is apparently overconfident but not overconfident, or is the distinction merely semantic minutia? In this section, we argue that the distinction is important.

Recall that in the two player game analyzed in Section 2.1, under the random ranking treatment the equilibrium expected number of firms is 1 while under the test treatment – which leads to apparent overconfidence – the equilibrium expected number of firms is greater than 1. Crucially, however, the expected profits of each firm is zero *under both treatments* (as is easily verified). In contrast, let us posit that the firms are truly overconfident. For instance, suppose each firm irrationally believes there is a $\frac{3}{4}$ chance that it is the more skillful. Then in equilibrium, each firm enters with probability one and earns -1 . Thus, while the presence of overconfidence requires us to rethink the basic economic tenet that firms will not enter an industry if there are negative profits to be made, the presence of apparent overconfidence does not.

Some authors use overconfidence as a springboard for assuming that agents have an irrational bias. For instance, in an influential finance paper, Malmendier and Tate (2005) write “Our overconfidence story builds upon a prominent stylized fact from the social psychology literature, the “better-than-average” effect. When individuals assess their relative skill, they tend to overstate their acumen relative to the average”. Armed with this supposed evidence of irrationality, Malmendier and Tate go on to assume that the CEOs in their model overestimate the returns to their projects. However, if, as we have argued, the evidence is only that people are apparently overconfident, then the evidence is consistent with agents using all the information available to them in the best possible way, in which case it supplies no justification for assuming that agents make biased estimates. In particular, apparently overconfident CEOs who are not overconfident will, on average, have a correct estimate of the returns to their projects.

Should authorities regulate the behaviour of drivers by imposing speed limits, mandating seat belt use, etc..., rather than simply informing them of the risks? One argument in favour of such regulation would be that drivers have too much confidence in their abilities. As Svenson writes, “Why should we pay much attention to information directed towards drivers in general if [we believe] we are safer and more skillful than they are?” But if drivers are only *apparently* overconfident, they may well pay attention. Note that in the driving example from the introduction, the $\frac{3}{5}$ of the population who rate themselves above average still believe that with a probability of $\frac{4}{9}$ they are no more skilled than average, so there is

certainly no reason for them to ignore advice pitched at the general population.

6 Literature

There is a vast literature on overconfidence, both testing for it and providing explanations. We have already mentioned some of the evidentiary literature. On the explanatory side, most of the literature accepts that there is something wrong when a majority of people believe they are above average, and either explains the phenomenon as resulting from a psychological “error”, or finds a rational way around the data.

The first category of explanations include *egocentrism* (Kruger (1999)), *incompetence* (Kruger and Dunning (1999)) and *self-serving biases* (Greenwald (1980)).

In the second category of explanations, Dunning (1993) finds that people may have varying notions of what, say, constitutes a good driver. If people are interpreting the question differently, there is not even an apparent contradiction when most people report themselves to be better than average. Van den Steen (2004) and Santos-Pinto and Sobel (2005) push this further and propose that as a result of these variances, people invest in skills in different ways. Santos-Pinto and Sobel write “Without the ability to add to skills... precisely p percent of the population would claim to be better than $1 - p$ percent of the others.” However, we have shown that there is no need for there to be this perfect calibration, even if everyone agrees on the evaluative criteria of skill, provided only that people do not know their own skills exactly.

In Healy and Moore (2007), people take a test that may be either difficult or easy. Each person is uncertain about his own ability, and about the difficulty of the test he is taking. A person who takes the easy test and does well, is uncertain if this is because he is of high ability or because the test is easy; hence he rationally assigns weight to both possibilities and considers himself to be above average. Since most people who take the easy test do well, those who take the easy test appear to be overconfident. By the same token, those who take the difficult test appear to be underconfident. More precisely, following the logic of Healy and Moore, averaging over the entire population of test takers (both easy and difficult), one should find no apparent overconfidence or underconfidence, but the analyst makes a mistake by focussing on the groups separately. Again following their logic, if subjects understand the difficulty of their tasks, then their respective populations, even viewed in isolation, should not rate themselves above or below average. However, we have shown that there may be apparent overconfidence and underconfidence even in subjects who understand their environments perfectly. As noted in Section 2.2, Hoelzl and Rustichini find apparent overconfidence when their subjects are given an easy test and underconfidence when they are given a difficult test. In their experiment subjects are told which test they are taking

(and it is obvious), so that Healy and Moore’s analysis does not apply. Similarly, Kruger (1999) subjects’ consider easy tasks (e.g., riding a bicycle) and difficult tasks (e.g., juggling) that are clearly delineated. Nonetheless, there are doubtless areas where it is hard to judge difficulty and, even though that additional assumption is not necessary to generate apparent overconfidence, it may yield greater overconfidence. Furthermore, Healy and Moore provide experimental evidence in favour of their thesis.

While the above literature tries to explain how anomalous data can arise, we show that the data is, in fact, not anomalous at all. In this regard, Zájbojnik (2004) is more in the spirit of our paper, although his approach is very different. In his model, agents can choose to forego consumption in order to learn about their abilities, which may be either high or low. Given certain technical assumptions – in particular $U(a_t)$, an individual’s utility as a function of his ability, is strictly convex, and $EU(a_t)/U(a_t)$ is decreasing – the optimal learning rule of agents leads them to halt their learning in a biased fashion. As a result, a disproportionate number end up ranking themselves as high in ability, despite the fact that they are all rational Bayesians. Hence, like us, Zájbojnik finds that the mere fact that a disproportionate number of people rank themselves in the top $x\%$ does not indicate a problem. However, as Zájbojnik readily admits, he is not really concerned with explaining much of the experimental evidence, where his experimentation story is not very compelling. Furthermore, he requires technical assumptions which play no role in our work. For instance, we show that apparent overconfidence can rationally arise whether or not an agent’s utility is convex.

7 Conclusion

Consider two populations. In population A, about 50% of the people declare themselves to be better than the median. In population B, about 80% of the people make the same declaration. On the face of it, population A has good self knowledge, while population B is somewhat delusional. Nonetheless, we have shown that, unless agents have a very good idea of their own skills, the declaration of population B is no more aberrational than the declaration of population A. Put differently, there is no more reason to try and “justify” B’s data than A’s; both sets of data can naturally arise as the result of agents learning about their own skills.³¹

³¹Preston and Harris (1965) find that drivers who have recently had accidents still rate themselves “much closer to the expert driver than to the poor driver”, in a comparable fashion to a control group that has not had any accidents (the actual data is not reported). This finding tends to go against our reasoning. However, the accident drivers were interviewed while still in the hospital, and many faced severe legal and financial consequences as a result of the accidents, so there is considerable reason to view their answers with skepticism. We note that only 15 admitted responsibility, while police reports blamed 34. Given the

Is there a tendency for people to be overconfident? We do not know, and have no stake in the answer one way or the other. Psychologists do have theories independent of the “better-than-average” evidence we have cited for believing in overconfidence. However, it is imperative to have a clear statement of the problem (which we hope to have provided), and to conduct proper empirical tests (such as the ones suggested in Section 3). As it stands, much of the supposed evidence for overconfidence shows nothing of the sort, even if the evidence is completely accepted on its own terms.

Recent evidence has shown that the supposed universality of overconfidence has been overstated. In particular, populations appear to be underconfident with respect to difficult skills, and there is little apparent overconfidence or underconfidence when the skill is objectively defined. Our theory predicts these differences.

8 Appendix

Proof of Proposition 1. We present the proof for the case in which the type space and the signal space are finite; the proof when either is infinite is technically more involved, but the essential reasoning is the same.

Let p describe the distribution of types in the population. Suppose that person i is of type $\hat{\theta}^i$ and has received the signal s_i . Since the posterior of i is degenerate, there is a $\tilde{\theta}^i$ such that

$$\Pr(\tilde{\theta}^i | s_i) = 1 \Leftrightarrow \frac{\Pr(s_i | \tilde{\theta}^i) \Pr(\tilde{\theta}^i)}{\sum_{i=1}^n \Pr(s_i | \theta^i) \Pr(\theta^i)} = 1 \Leftrightarrow \forall \theta \neq \tilde{\theta}^i \text{ s.t. } p(\theta) > 0, \Pr(s_i | \theta^i) = 0.$$

Since only type $\tilde{\theta}^i$ receives the signal s_i , we have $\hat{\theta}^i = \tilde{\theta}^i$. Thus, if beliefs are generated by a signalling model and these beliefs are degenerate, they are correct, and it cannot be that more than half the population believes it is better than the median. ■

Proof of Theorem 1. Fix the population median data that is to be rationalized, $1 > x > 1/2$ and fix $y < \frac{1}{2} - \frac{x}{1+x}$. We now define the elements of a symmetric signalling model that will α , β , and γ rationalize the population data x . The signalling structure consists of the signal space $S = \{0, 1\}$, the type space $\Theta = \{\frac{3x-1}{2}, x, \frac{1+x}{2}\}$, and the probability distributions $f_\theta(1) = \theta$. The types are distributed in the population according to the prior p , which assigns probability $2y$ to x , and $\frac{1}{2} - y$ to each of $\frac{3x-1}{2}$ and $\frac{1+x}{2}$. The expected fraction of people who observe 1 is x . A person that observes 1 has a posterior belief given by

$$p(\theta | 1) = \begin{cases} \frac{1+x}{2x} \left(\frac{1}{2} - y\right) & \theta = \frac{1+x}{2} \\ 2y & \theta = x \\ \frac{3x-1}{2x} \left(\frac{1}{2} - y\right) & \theta = \frac{3x-1}{2} \end{cases}.$$

circumstances, these 19 denials can hardly be deemed irrational.

We now check that this posterior distribution (strictly) first order stochastically dominates the prior:

$$\begin{aligned} p\left(\frac{1+x}{2} \mid 1\right) &= \frac{1+x}{2x} \left(\frac{1}{2} - y\right) > \frac{1}{2} - y = p\left(\frac{1+x}{2}\right) \\ p(x \mid 1) &= 2y = p(x) \\ p\left(\frac{3x-1}{2} \mid 1\right) &= \frac{3x-1}{2x} \left(\frac{1}{2} - y\right) < \frac{1}{2} - y = p\left(\frac{3x-1}{2}\right) \end{aligned}$$

Thus, the population ranking data x can be γ rationalized.

To see that the population ranking data x can be β rationalized, notice that the posterior mean of a person who observes 1 is strictly larger than the prior mean, x , which is also the prior median.

To see that the population ranking data x can be α rationalized, notice that the posterior median of a person that observes 1 is $\frac{(1+x)}{2}$, since

$$p\left(\frac{1+x}{2} \mid 1\right) > \frac{1}{2} \Leftrightarrow \frac{1+x}{2x} \left(\frac{1}{2} - y\right) > \frac{1}{2} \Leftrightarrow \frac{1}{2} - \frac{x}{1+x} > y$$

by construction. Furthermore, $\frac{(1+x)}{2} > x$. ■

Proof of Theorem 2. Pick any $1 > x, q > 1/2$. Let the signalling structure be given by $S = \{0, 1\}$, $\Theta = \left\{\frac{3x-1}{2}, x, \frac{1+x}{2}\right\}$, and $f_\theta(1) = \theta$. On Θ , define a probability distribution p that assigns probability $2q - 1$ to x , and $1 - q$ to each of $\frac{3x-1}{2}$ and $\frac{1+x}{2}$. Notice that the fraction of the population whose type is at most x is q .

An observation of 1 occurs with probability x . A person that observes 1 has a posterior belief given by

$$p(\theta \mid 1) = \begin{cases} \frac{1+x}{2x} (1 - q) & \theta = \frac{1+x}{2} \\ 2q - 1 & \theta = x \\ \frac{3x-1}{2x} (1 - q) & \theta = \frac{3x-1}{2} \end{cases}$$

and an expected type that is strictly larger than x . Therefore, the expected fraction of people who will have a mean type strictly greater than the fraction q of the population is x .

The case $0 < x, q < \frac{1}{2}$ is symmetrical, while the remaining cases are easy. ■

We prove necessity in Theorem 3 with a lemma that will be used elsewhere.

Lemma 1 *A fraction y or greater of a population can rationally believe that there is at least a probability p that their types are: strictly better than the worse type in the top $x\%$ of the population only if $py \leq x$; weakly better than a type θ^* such that $P(\theta \geq \theta^*) = x$ only if $py \leq x$; weakly worse than a type θ_* such that $P(\theta \leq \theta_*) = x$ only if $py \leq x$*

Proof. For the first claim, we say that given P , the distribution of types in the population, a type z is in the top $x\%$ of the population if $P(\theta \leq z) \geq 1 - x$, so the worse type in the

top $x\%$ is $\theta^* = \min \{z : P(\theta \leq z) \geq 1 - x\}$, which implies $P(\theta > \theta^*) \leq x$. Let $S_w \subset S$ be the set of signals s such that $P(\theta > \theta^* | s) \geq p$, and let F denote the marginal distribution over signals so that $y = F(S_w)$. Then,

$$x \geq P(\theta > \theta^*) = \int P(\theta > \theta^* | s) dF(s) \geq \int_{S_w} P(\theta > \theta^* | s) dF(s) \geq \int_{S_w} p dF(s) = py.$$

For the second claim, Let $S_w^* \subset S$ be the set of signals s such that $P(\theta \geq \theta^* | s) \geq p$, and let F denote the marginal distribution over signals so that $y = F(S_w^*)$. Then,

$$x = P(\theta \geq \theta^*) = \int P(\theta \geq \theta^* | s) dF(s) \geq \int_{S_w^*} P(\theta \geq \theta^* | s) dF(s) \geq \int_{S_w^*} p dF(s) = py.$$

The third claim is analogous to the second, and omitted. ■

Proof of Theorem 3. Necessity. To prove necessity, simply apply claims 2 and 3 of Lemma 1 with $p = 1/2$ and $x = i/k$ for $i = 1, 2, \dots, k$.

Sufficiency. Let $\Theta = [0, k]$ and the prior is uniform. We then get that $\theta_i^k = i$, and the k -cile i is $D_i = [i - 1, i] = [\theta_{i-1}^k, \theta_i^k]$.

Case 1: $x_i < 2/k$ for all i . We will construct the posterior beliefs given signal s^j for all j , assuming first that for all i , $x_i \leq 2/k$. Let the posterior distribution over types after a signal s_j be

$$\begin{array}{cccccc} D_1 & \dots & D_j & \dots & D_k \\ \frac{1}{k} - \frac{x_1}{2} & \dots & \frac{1}{k} - \frac{x_j}{2} + \frac{1}{2} & \dots & \frac{1}{k} - \frac{x_{10}}{2} \end{array}$$

which adds up to 1 :

$$\sum \left(\frac{1}{k} - \frac{x_i}{2} \right) + \frac{1}{2} = 1 - \frac{\sum x_i}{2} + \frac{1}{2} = 1 - \frac{1}{2} + \frac{1}{2} = 1.$$

Given these posterior distributions, we build a joint probability distribution for signals and types that gives as a result the observed data (in a ‘‘law-of-large numbers’’) large population. Let $Q^j = (q_1^j, q_2^j, \dots, q_k^j)$ denote the posterior probability distribution over types, after having observed s^j , where q_i^j is the probability that Q^j assigns to the types in k -cile i . Then, the initial joint probability distribution for types and signals is given by

$\begin{array}{c} k\text{-cile} \rightarrow \\ \text{signal} \downarrow \end{array}$	1	2	...	k	Marginal
s^1	$q_1^1 x_1$	$q_2^1 x_1$	...	$q_k^1 x_1$	x_1
s^2	$q_1^2 x_2$	$q_2^2 x_2$	...	$q_k^2 x_2$	x_2
\vdots	\vdots	\vdots	$\vdots \vdots \vdots$	\vdots	\vdots
s^k	$q_1^k x_k$	$q_2^k x_k$	...	$q_k^k x_k$	x_k
Marginal	$\frac{1}{k}$	$\frac{1}{k}$	...	$\frac{1}{k}$	1

That the probability of s^1 with this joint distribution is x_1 follows immediately from the fact that Q^j is a probability distribution, and that therefore $\sum_i q_i^j = 1$. We now show that indeed the probability of the i th k -cile is indeed $\frac{1}{k}$. We have

$$\begin{aligned} \sum_j q_i^j x_j &= \sum_{j \neq i} q_i^j x_j + q_i^i x_i = \sum_{j \neq i} q_i^j x_j + \left(\frac{1}{k} - \frac{x_i}{2} + \frac{1}{2} \right) x_i \\ &= \sum_{j \neq i} \left(\frac{1}{k} - \frac{x_i}{2} \right) x_j + \left(\frac{1}{k} - \frac{x_i}{2} + \frac{1}{2} \right) x_i = \sum_j \left(\frac{1}{k} - \frac{x_i}{2} \right) x_j + \frac{x_i}{2} \\ &= \frac{1}{k} - \frac{x_i}{2} + \frac{x_i}{2} = \frac{1}{k}. \end{aligned}$$

Sufficiency. Case 2: $x_i > 2/k$ for some i .

Step 1. For all $x_i \leq 2/k$, the posterior after s^i initially allocates 50% to the i th k -cile. For $x_j > 2/k$, the posterior after s^j initially allocates a probability $1/kx_j$ to the j th k -cile, D_j .

Step 2. Take the largest j such that $x_j > 2/k$ (notice that by the necessity part of the Theorem, $j < k$) and allocate the probability mass

$$\frac{1}{2} - \frac{1}{kx_j} \tag{1}$$

on D_{j+1}, \dots, D_k . Before clarifying how, notice that if $j \geq 1 + k/2$ the following argument shows that there is enough “space” on the k -ciles larger than j to allocate the left over mass from j :

$$\begin{aligned} x_j + x_{j+1} + \dots + x_k &\leq \frac{2k - 2(j-1)}{k} \Leftrightarrow x_{j+1} + \dots + x_k \leq \frac{2k - 2(j-1)}{k} - x_j \Leftrightarrow \\ -\frac{x_{j+1}}{2} - \dots - \frac{x_k}{2} &\geq \frac{x_j}{2} - \frac{k - (j-1)}{k} \Leftrightarrow \\ \frac{1}{k} - \frac{x_{j+1}}{2} - \dots + \frac{1}{k} - \frac{x_k}{2} &\geq \frac{k-j}{k} + \frac{x_j}{2} - \frac{k - (j-1)}{k} = \frac{1}{2}x_j - \frac{1}{k} \end{aligned} \tag{2}$$

Then, the total mass to be allocated (from those who receive signal s^j , who are a proportion x_j of the population), the quantity in (1), times the probability of signal s^j happening, which is x_j , yields the right hand side of (2), which is less than the “space” available in the k -ciles greater than j . In each k -cile i greater than j , we have only used $\frac{1}{k} - \frac{x_i}{2}$ of the mass available and that is the left hand side of (2). Similarly, if $j \leq 1 + k/2$, the “total space” available in k -ciles $1 + k/2$ and greater is also enough to allocate at least 50% of the mass of $\sum_{i \geq j} x_i$, since the sum is at most 100%, and k -ciles $1 + k/2$ through k accumulate more than 50% of the total probability.

Allocate as much as possible (of $\frac{1}{2}x_j - \frac{1}{k}$) in D_k ; if D_k is enough go to the next step; if D_k is not enough, allocate as much as possible in D_{k-1} ; continue in this fashion until $\frac{1}{2}x_j - \frac{1}{k}$

has been exhausted (we know from equation (2) that it will be exhausted before getting to j).

Step 3. Repeat Step 2 with the largest $h < j$ such that $x_h > 2/k$, starting to allocate its left over probability in the largest k -cile that has less than $1/k$ probability already allocated to it (generically, that will be the last k -cile “used” by x_j). Continue with the largest $k < h$ such that $x_k > 2/k$, starting to allocate its left over probability in the largest k -cile that has less than $1/k$ probability already allocated to it; continue in this fashion until there are no other x_j s such that $x_j > 2/k$.

Step 4. For each signal s^j we have now allocated 50% of the posterior probability distribution. In the case of $x_j \leq 2/k$, 50% of the posterior is allocated in k -cile D_j ; for $x_j > 2/k$, 50% of the probability has been allocated through Steps 2 and 3. Hence for each signal s^j we need to allocate 50% more. Of course, since the sum of the “masses supplied” by each signal is the same as the masses received by the k -ciles, there is exactly room for the 50% that we need to allocate now. A more formal proof of that argument now follows.

Suppose that k -ciles $i + 1, \dots, k$ are “full” (in the sense that the probability allocated to them from their own x_i ’s and the j ’s such that $x_j > 2/k$ already accounts for $1/k$) while only part of k -cile i has been used. Note that the space available in D_i before Step 3 was $\frac{1}{k} - \frac{x_i}{2}$, and that in Step 3 we allocated

$$\underbrace{\sum_{j:x_j>2/k} \frac{x_j}{2} - \frac{|\{j : x_j > 2/k\}|}{k}}_{\text{excess in the } j\text{'s such that } x_j > 2/k} - \underbrace{\left(\frac{k-i}{k} - \sum_{i+1}^k \frac{x_m}{2} \right)}_{\text{part absorbed by } k\text{-ciles } D_{i+1}, \dots, D_k}$$

to D_i . Therefore, the available space in D_i after Step 3 is

$$R_i \equiv \frac{1}{k} - \frac{x_i}{2} - \sum_{j:x_j>2/k} \frac{x_j}{2} + \frac{|\{j : x_j > 2/k\}|}{k} + \frac{k-i}{k} - \sum_{i+1}^k \frac{x_m}{2}.$$

Note that since

$$|\{f < i : x_f \leq 2/k\}| + |\{j : x_j > 2/k\}| + |\{i, i+1, \dots, k\}| = k$$

the total space available in all k -ciles after Step 3 is

$$\begin{aligned} & \frac{|\{f < i : x_f \leq 2/k\}|}{k} - \sum_{f<i:x_f\leq 2/k} \frac{x_f}{2} + \frac{1}{k} - \frac{x_i}{2} - \sum_{j:x_j>2/k} \frac{x_j}{2} + \frac{|\{j : x_j > 2/k\}|}{k} + \frac{k-i}{k} - \sum_{i+1}^k \frac{x_m}{2} \\ &= \frac{|\{f < i : x_f \leq 2/k\}|}{k} + \frac{|\{j : x_j > 2/k\}|}{k} + \frac{k-i}{k} + \frac{1}{k} - \sum_{f<i:x_f\leq 2/k} \frac{x_f}{2} - \frac{x_i}{2} - \sum_{j:x_j>2/k} \frac{x_j}{2} - \sum_{i+1}^k \frac{x_m}{2} \\ &= 1 - \sum_{f<i:x_f\leq 2/k} \frac{x_f}{2} - \frac{x_i}{2} - \sum_{j:x_j>2/k} \frac{x_j}{2} - \sum_{i+1}^k \frac{x_m}{2} = 1 - \sum_1^k \frac{x_m}{2} = \frac{1}{2}. \end{aligned}$$

We now construct the remainder of the probability distribution conditional on any signal s^j .

$\begin{array}{c} \text{destination} \rightarrow \\ \text{source} \downarrow \end{array}$	$D_m : x_m \leq 2/k$	D_i	$D_h : x_h > 2/k$	D_{i+1}, \dots, D_k	Total
s^j	$\frac{1}{k} - \frac{x_m}{2}$	R_i	0	0	$\frac{1}{2}$
Weighted Total	$\frac{1}{k} - \frac{x_m}{2}$	R_i	0	0	$\frac{1}{2}$

Step 5. Build the joint probability distribution of signals and deciles by multiplying the conditional distributions given s^j by x_j . ■

Proof of Theorem 4. For any x_i we will have a collection $\{y_i^j\}$ such that $\sum_j y_i^j = x_i$ and y_i^j will be the proportion of people announcing x_i that actually belong to percentile j .

For all i , define $\pi_i = 1/k - x_i$. If $x_i > 1/k$, we define $y_i^i = \frac{1}{k}$; if $x_i \leq 1/k$, define $y_i^i = x_i$. The number π_i is the amount of probability needed or in excess in k -cile i .

Step 1. Consider x_1 .

- If $x_1 > 1/k$, take

$$j^* = \min \left\{ j : \pi_j > 0 \text{ and } \sum_{i \leq j: \pi_i > 0} \pi_i \geq x_1 - \frac{1}{k} \right\}.$$

The index j^* is the smallest k -cile that accumulates enough left over probability to cover all the people who claimed x_1 . The min is well defined because some large j belongs to the set, because $\sum_1^k \pi_j = 0$ implies that

$$\sum_{j \geq 2: \pi_j > 0} \pi_j \geq \sum_{j \geq 2} \pi_j = x_1 - \frac{1}{k}.$$

For all $j \in E = \{j : j < j^* \text{ and } \pi_j > 0\}$, let $y_1^j = \pi_j$, and let $y_1^{j^*} = x_1 - \frac{1}{k} - \sum_E y_1^j$. For all $j \notin E \cup \{1, j^*\}$, let $y_1^j = 0$. Go to step 2.

- If $x_1 \leq 1/k$, let $y_1^j = 0$ for all $j > 1$. Go to Step 2.

The Step 2 will be repeated for $i = 2, \dots, k$. Start Step 2 with $i = 2$.

Step 2.

- If $x_i > 1/k$ let n be the last index whose excess probability ($\pi_n \geq 0$) was used to “cover” the needs of the “needy” j ($\pi_j < 0$) with the largest index still lower than i . That is, for $h = \max \{j < i : \pi_j < 0\}$ which is the last needy index before i , either through step 1, or some previous iteration of Step 2, we used probability from other k -ciles in order to get that $\sum_{m=1}^k y_h^m = x_h - \frac{1}{k}$. Let n be the largest index such that $y_h^m > 0$: $n = \max \{m : y_h^m > 0\}$. Just as we identified j^* (as the smallest index that accumulated enough probability to cover the needs of x_1) in Step 1, we now find the smallest index larger than n that accumulates enough probability to cover $x_i - \frac{1}{k}$ (when one subtracts from π_n the probability used for indexes h and below). Formally

$$j^* = \min \left\{ j \geq n : \pi_j > 0 \text{ and } \pi_k - \sum_{g: n \neq g} y_g^n + \sum_{n < g \leq j: \pi_g^1 > 0} \pi_g \geq x_i - \frac{1}{k} \right\}.$$

– If $j^* > n$ (i.e. the left-overs in index n are not enough to cover the needs of x_i), let

$$y_i^n = \pi_n - \sum_{n \neq g < i} y_g^n;$$

for all $j \in E = \{j : n < j < j^* \text{ and } \pi_j > 0\}$, let $y_i^j = \pi_j$, and let $y_i^{j^*} = x_i - \frac{1}{k} - y_i^n - \sum_E y_i^j$. For all $j \notin E \cup \{i, j^*\}$, let $y_i^j = 0$.

– If $j^* = n$, let $y_i^n = x_i - \frac{1}{k}$ and for all $j \notin \{i, j^*\}$, let $y_i^j = 0$.

– Go to Step 2, and repeat it with $i + 1$ in place of i , or stop if $i = k$.

• If $x_i \leq 1/k$, let $y_i^j = 0$ for all $j \neq i$. Go to Step 2, and repeat it with $i + 1$ in place of i , or stop if $i = k$.

The process allocates all the probability in k -ciles where $x_i < 1/k$ to k -ciles where $x_i \geq 1/k$. For each i we have: $\sum_{j=1}^k y_i^j = x_i$, so that all the individuals who actually belong to k -cile j and declare i , are exactly x_i ; $\sum_{j=1}^{100} y_j^i = \frac{1}{k}$, so that all the individuals in k -cile i declare that they are in some (potentially other) k -cile. The resulting matrix is

$\frac{\text{declared} \rightarrow}{\text{actual} \downarrow}$	1	2	...	k	Sum
1	y_1^1	y_2^1	...	y_k^1	$\frac{1}{k}$
\vdots	\vdots	\vdots		\vdots	\vdots
k	y_1^k	y_2^k	...	y_k^k	$\frac{1}{k}$
Sum	x_1	x_2	...	x_k	1

To build the signalling structure let $S = \{s^1, s^2, \dots, s^k\}$ be the set of signals, let $\Theta = \mathbf{R}_+$ be the set of types and in order to build the prior density, start with $p(\theta) = 1/k$ for all $\theta \in [0, 1]$; also, let $f_\theta(s^i) = 100y_i^1$ for all i and all $\theta \in [0, 1]$. Notice that $\theta_0^k = 0$ and $\theta_1^k = 1$ are the lower and upper bound of the first k -cile. Also, since

$$E(\theta | s^1) = \int \theta p(\theta | s^1) d\theta = \int \theta \frac{f_\theta(s^1) p(\theta)}{P(s^1)} d\theta = \int \theta \frac{f_\theta(s^1) p(\theta)}{x_1} d\theta$$

we have that $E(\theta | s^1)$ depends on the values of the θ s that receive signal s^1 . If $x_1 \leq 1/k$, those θ s are just the interval $[0, 1]$ since $x_1 = y_1^1$. If $x_1 > 1/k$, the value of $E(\theta | s^1)$ depends on the values of the θ s that receive signal s^1 that are outside $[0, 1]$. If we assume that all such θ s are equal to 1, we have

$$\begin{aligned} E(\theta | s^1) &= P(\text{1st } k\text{-cile} | s^1) E(\theta | s^1 \&\text{1st}) + P(\text{not 1st } k\text{-cile} | s^1) E(\theta | s^1 \&\text{not1st}) \\ &= \frac{\frac{1}{k}}{x_1} E(\theta | s^1 \&1) + \frac{x_1 - \frac{1}{k}}{x_1} E(\theta | s^1 \&\text{not1}) = \frac{\frac{1}{k}}{x_1} \frac{1}{2} + \frac{x_1 - \frac{1}{k}}{x_1} E(\theta | s^1 \&\text{not1}) \\ &= \frac{\frac{1}{k}}{x_1} \frac{1}{2} + \frac{x_1 - \frac{1}{k}}{x_1} 1 = \frac{2kx_1 - 1}{2kx_1} \in (0, 1). \end{aligned}$$

Since this conditional expected value is in the interior of $(0, 1)$, we have some leeway in choosing the types that will “feed” $E(\theta | s^1)$, so that we can choose the types close enough

to 1 and their densities in such a manner that the conditional expected value is still in the interior of $(0, 1)$. We need this, so that after observing s^1 , individuals will claim that the mean of their beliefs is in the first k -cile.

The main difficulty now will be allocating the probability in such a manner that: types in the i th k -cile receive signal s^j with probability y_j^i (that is $f_\theta(s^j) = ky_j^i$ for types θ in the i th k -cile); $E(\theta | s^i) \in (\theta_{i-1}^k, \theta_i^k)$.

Suppose we have already allocated probability on some interval $[0, z]$, and that the probability allocated so far is $(i-1)/k$. Assume also as an inductive hypothesis that if all the remaining probability, $\frac{k+1-i}{k}$, were allocated to $\theta = z$, we would have $E(\theta | s^j) \in (\theta_{j-1}^k, \theta_j^k)$ for $j \leq i-1$.

Consider now k -cile i .

- Start with the easiest case, one in which $\sum_1^{i-1} x_{i-1} = (i-1)/k$. This is the easiest case because the total mass of people claiming to be in k -ciles less than $i-1$ is the same as the total mass in the prior, so we can re-start the process of defining the prior (as if i were the lowest k -cile). In this case then, we repeat the first step, defining $p(\theta) = 1/k$ and letting $f_\theta(s^j) = ky_j^i$ for all j and all $\theta \in (z, z+1]$. It is then easy to check that: since $y_m^j = 0$ for all $m \leq i-1$ and all $j > i-1$, the expected value of θ for k -ciles below $i-1$ is unaffected by how we define k -ciles weakly above i , and hence, $E(\theta | s^m) \in (\theta_{m-1}^k, \theta_m^k)$ for $m \leq i-1$; $E(\theta | s^i) \in (\theta_{i-1}^k, \theta_i^k)$ if all the remaining probability, $(k-i)/k$ were allocated to $\theta = z+1$.
- Suppose $\sum_1^{i-1} x_{i-1} > (i-1)/k$, which means that k -ciles $i-1$ and below are “borrowing” probability mass from k -ciles above: for some $j \leq i-1$, and some $m > i-1$, $y_j^m > 0$. Therefore, the expected value of θ conditional on s^j for $j \leq i-1$ will depend on the values of the θ s in k -ciles $m > i-1$, such that $y_j^m > 0$. Since, by the induction hypothesis, $E(\theta | s^j) \in (\theta_{j-1}^k, \theta_j^k)$ for $j \leq i-1$, there exists an $\varepsilon > 0$ such that if we define $p(\theta) = \frac{1}{k\varepsilon}$ and $f_\theta(s^j) = ky_j^i$ for all j and all $\theta \in (z, z+\varepsilon]$, and assume that if all the remaining probability, $(k-i)/k$, were allocated to $\theta = z+\varepsilon$, we still keep $E(\theta | s^j) \in (\theta_{j-1}^k, \theta_j^k)$ for $j \leq i-1$ plus we obtain:

- if $x_i \leq 1/k$, $E(\theta | s^i) = \frac{z+z+\varepsilon}{2} = z + \frac{\varepsilon}{2} \in (z, z+\varepsilon) = (\theta_{i-1}^k, \theta_i^k)$;
- if $x_i > 1/k$,

$$\begin{aligned}
E(\theta | s^i) &= P(\textit{ith } k\text{-cile} | s^i) E(\theta | s^i \& i) + P(\textit{not ith } k\text{-cile} | s^i) E(\theta | s^i \& \textit{not } i) \\
&= \frac{\frac{1}{k}}{x_i} E(\theta | s^i \& i) + \frac{x_i - \frac{1}{k}}{x_i} E(\theta | s^i \& \textit{not } i) = \frac{\frac{1}{k}}{x_i} \frac{2z + \varepsilon}{2} + \frac{x_i - \frac{1}{k}}{x_i} E(\theta | s^i \& \textit{not } i) \\
&= \frac{\frac{1}{k}}{x_i} \frac{2z + \varepsilon}{2} + \frac{x_i - \frac{1}{k}}{x_i} (z + \varepsilon) = z + \varepsilon - \frac{\varepsilon}{2kx_i} \in (z, z + \varepsilon) = (\theta_{i-1}^k, \theta_i^k).
\end{aligned}$$

Therefore, we have shown that we can move the induction hypothesis to k -cile i .

- Suppose $\sum_1^{i-1} x_{i-1} < (i-1)/k$, which means that k -ciles $i-1$ and below are “lending” probability mass to the k -ciles above: for some $j \leq i-1$, and some $m > i-1$, $y_m^j > 0$.

Therefore, the expected value of θ conditional on s^j for $j > i - 1$ will depend on the values of the θ s in k -ciles $m \leq i - 1$, such that $y_j^m > 0$. However, and this is important, the expected value of θ conditional on s^j for $j \leq i - 1$ will *not* depend on the values of the θ s in k -ciles $m > i - 1$. This means that we can choose the types and the density in k -ciles i and above without affecting the induction hypothesis, that $E(\theta | s^j) \in (\theta_{j-1}^k, \theta_j^k)$ for $j \leq i - 1$. In particular, we will have to choose a (potentially large) m to play the role of ε before. For sufficiently large m , define $p(\theta) = \frac{1}{km}$ and $f_\theta(s^j) = ky_j^i$ for all j and all $\theta \in (z, z + m]$. Note that if we assume that if all the remaining probability, $(k - i)/k$, were allocated to $\theta = z + m$, we still keep $E(\theta | s^j) \in (\theta_{j-1}^k, \theta_j^k)$ for $j \leq i - 1$ plus we obtain:

- if $x_i \leq 1/k$, $E(\theta | s^i) = \frac{z+z+m}{2} = z + \frac{m}{2} \in (z, z + m) = (\theta_{i-1}^k, \theta_i^k)$;
- if $x_i > 1/k$, for some $y < z$ we have

$$\begin{aligned} E(\theta | s^i) &= P(j < i | s^i) E(\theta | s^i \& j < i) + P(i | s^i) E(\theta | s^i \& i) + P(j > i | s^i) E(\theta | s^i \& j > i) \\ &= P(j < i | s^i) y + \frac{\frac{1}{k} 2z + m}{x_i 2} + P(j > i | s^i) (z + m) < z + m \end{aligned}$$

and also, for $m > 2kx_i(z - P(j < i | s^i)y) - 2z$, we obtain

$$E(\theta | s^i) = P(j < i | s^i) y + \frac{1}{kx_i} \frac{2z + m}{2} + P(j > i | s^i) (z + m) \geq P(j < i | s^i) y + \frac{1}{kx_i} \frac{2z + m}{2} > z.$$

This means that for large m , the induction hypothesis is kept and we can repeat the previous steps with k -cile $i + 1$.

This concludes the proof. ■

Proof of Theorem 5. The proofs of Theorems 1 and 2 used symmetric testing models, in which a signal of 1 is “pass the test”, so there is nothing left to prove. ■

Proof of Proposition 2. Proposition 2 follows immediately from Lemma 2. ■

Lemma 2 *Suppose data $(x_1, x_2, x_3, 1 - x_2 - x_3)$ can be rationalized by distributions $f_\theta = p^\theta = (p_1^\theta, p_2^\theta, p_3^\theta, p_4^\theta)$ for $\theta = 1, 2, 3, 4$. Then, if higher types observe higher signals, in a sense weaker than fosd, namely $p_4^1 \leq p_4^2 \leq p_4^3$, then we get*

$$p_3^3 + p_3^4 \geq p_3^1 + p_3^2 \geq 2 - 8x_1 - 8x_2 + 3(p_1^3 + p_1^4 + p_2^3 + p_2^4) \geq 2 - 8x_1 - 8x_2.$$

This implies that if x_1 and x_2 are small, the data is very close to $(0, 0, 1, 0)$

Proof. Since the signalling structure rationalizes the data, the expected number of people who observe signal j must be x_j , and hence we must have,

$$\sum_i^4 p_1^i = 4x_1, \quad \sum_i^4 p_2^i = 4x_2 \quad \text{and} \quad \sum_i^4 p_3^i = 4x_3$$

In order for those who observe signal s^3 to declare that their median is in quartile 3 (and similarly for s^4) it must be the case that

$$\begin{aligned} \frac{1 - p_1^4 - p_2^4 - p_3^4}{4 - \sum p_1^i - \sum p_2^i - \sum p_3^i} &\geq \frac{1}{2} \Leftrightarrow \sum p_1^i + \sum p_2^i + \sum p_3^i \geq 2 + 2p_1^4 + 2p_2^4 + 2p_3^4 \\ \frac{p_3^3 + p_3^4}{\sum p_3^i} &\geq \frac{1}{2} \Leftrightarrow 2p_3^3 + 2p_3^4 \geq \sum p_3^i \end{aligned}$$

Putting together the two lines, we get

$$2p_3^3 + 2p_3^4 \geq \sum p_3^i \geq 2 + 2p_1^4 + 2p_2^4 + 2p_3^4 - \sum p_1^i - \sum p_2^i \Rightarrow p_3^3 \geq \frac{2 + p_1^4 + p_2^4 - \sum_{i < 4} p_1^i - \sum_{i < 4} p_2^i}{2}.$$

Then,

$$p_4^3 = 1 - p_1^3 - p_2^3 - p_3^3 \leq 1 - p_1^3 - p_2^3 - \frac{2 + p_1^4 + p_2^4 - \sum_{i < 4} p_1^i - \sum_{i < 4} p_2^i}{2} = \frac{p_1^1 + p_1^2 - p_1^3 - p_1^4 + p_2^1 + p_2^2 - p_2^3 - p_2^4}{2}$$

So if higher types observe higher signals in the sense that $p_4^1 \leq p_4^2 \leq p_4^3$, we get

$$p_4^1 \leq p_4^2 \leq p_4^3 \leq \frac{p_1^1 + p_1^2 - p_1^3 - p_1^4 + p_2^1 + p_2^2 - p_2^3 - p_2^4}{2}. \quad (3)$$

Then by this last equation, and since for $j = 1, 2$ we have $\sum_i p_j^i = 4x_j$, we obtain that

$$\begin{aligned} p_3^1 + p_3^2 &= 2 - (p_1^1 + p_1^2) - (p_2^1 + p_2^2) - (p_4^1 + p_4^2) \geq 2 - (p_1^1 + p_1^2) - (p_2^1 + p_2^2) - (p_1^1 + p_1^2 - p_1^3 - p_1^4 + p_2^1 + p_2^2 - p_2^3 - p_2^4) \\ &= 2 - 2(p_1^1 + p_1^2) - 2(p_2^1 + p_2^2) + p_1^3 + p_1^4 + p_2^3 + p_2^4 = 2 - 2(4x_1 - p_1^3 - p_1^4) - 2(4x_2 - p_2^3 - p_2^4) \\ &= 2 - 8x_1 - 8x_2 + 3(p_1^3 + p_1^4 + p_2^3 + p_2^4). \end{aligned}$$

Given this, and the requirement that enough of the mass that goes to quartile 3 must come from quartiles 3 and 4, which is

$$2p_3^3 + 2p_3^4 \geq \sum p_3^i \Leftrightarrow p_3^3 + p_3^4 \geq p_3^1 + p_3^2,$$

we obtain

$$p_3^3 + p_3^4 \geq p_3^1 + p_3^2 \geq 2 - 8x_1 - 8x_2 + 3(p_1^3 + p_1^4 + p_2^3 + p_2^4) \geq 2 - 8x_1 - 8x_2.$$

■

Proof of Theorem 6. Since the case of $k = 2$ is already covered with the teting models, we will concentrate on the case in which $k > 2$. Moreover, we will use a signalling structure that has the monotone likelihood ratio property: for θ' in k -cile j and θ is in k -cile i , for $j > i$, $f_{\theta'}(s)/f_{\theta}(s)$ is increasing in s (if the signalling structure has this property, it is also f -reasonable). Define $d \equiv k - 2 \sum_1^k ix_i$, fix a small ε , and define

$$g_k^\varepsilon(s) = x_s \left(1 - \varepsilon \frac{k - 2s}{k - 2} \right) + \frac{\varepsilon d}{k(k - 2)} \quad \text{and} \quad g_1^\varepsilon(s) = x_s \left(1 + \varepsilon \frac{k - 2s}{k - 2} \right) - \frac{\varepsilon d}{k(k - 2)}.$$

The distribution g_k^ε is (for small ε) a probability distribution, since for all s , $g_k^\varepsilon(s) \in (0, 1)$ and

$$\begin{aligned} \sum_{i=1}^k g_k^\varepsilon(i) &= \sum_{i=1}^k \left[x_i \left(1 - \varepsilon \frac{k-2i}{k-2} \right) + \frac{\varepsilon d}{k(k-2)} \right] = \sum_{i=1}^k x_i \left(1 - \varepsilon \frac{k-2i}{k-2} \right) + \frac{\varepsilon d}{k-2} \\ &= 1 - \frac{\varepsilon}{k-2} \sum_{i=1}^k x_i (k-2i) + \frac{\varepsilon d}{k-2} = 1 - \frac{\varepsilon}{k-2} \left(k-2 \sum_{i=1}^k i x_i \right) + \frac{\varepsilon d}{k-2} = 1. \end{aligned}$$

A similar calculation applies to g_1^ε . For types θ in k -cile i , the distribution over S will be (for any small ε such that g_k^ε and g_1^ε are probability distributions)

$$f_\theta(s) = \frac{i-1}{k-1} g_k^\varepsilon(s) + \left(1 - \frac{i-1}{k-1} \right) g_1^\varepsilon(s) = x_s + \left(1 - 2 \frac{i-1}{k-1} \right) \varepsilon \left(x_s \frac{k-2s}{k-2} - \frac{d}{k(k-2)} \right).$$

If θ' is in k -cile j and θ is in k -cile i , for $j > i$,

$$\frac{f_{\theta'}(s)}{f_\theta(s)} = \frac{\frac{j-1}{k-1} g_k^\varepsilon(s) + \left(1 - \frac{j-1}{k-1} \right) g_1^\varepsilon(s)}{\frac{i-1}{k-1} g_k^\varepsilon(s) + \left(1 - \frac{i-1}{k-1} \right) g_1^\varepsilon(s)} = \frac{x_s + \left(1 - 2 \frac{j-1}{k-1} \right) \varepsilon \left(x_s \frac{k-2s}{k-2} - \frac{d}{k(k-2)} \right)}{x_s + \left(1 - 2 \frac{i-1}{k-1} \right) \varepsilon \left(x_s \frac{k-2s}{k-2} - \frac{d}{k(k-2)} \right)}$$

that is increasing in s , so the signaling structure has the monotone likelihood ratio property. In addition, with this signalling structure, and setting $P(k\text{-cile } j) = 1/k$, the probability of signal $s = i$ is

$$\begin{aligned} P(i) &= \sum_{j=1}^k P(i | \theta \in k\text{-cile } j) P(k\text{-cile } j) = \sum_{j=1}^k \frac{\frac{j-1}{k-1} g_k^\varepsilon(i) + \left(1 - \frac{j-1}{k-1} \right) g_1^\varepsilon(i)}{k} \\ &= \sum_{j=1}^k \frac{x_i + \left(1 - 2 \frac{j-1}{k-1} \right) \varepsilon \left(x_s \frac{k-2i}{k-2} - \frac{d}{k(k-2)} \right)}{k} = \frac{k x_i + \varepsilon \left(x_s \frac{k-2i}{k-2} - \frac{d}{k(k-2)} \right) \sum_{j=1}^k \left(1 - 2 \frac{j-1}{k-1} \right)}{k} = x_i. \end{aligned}$$

Letting A be the $k \times k$ matrix where row i is

$$[P(\theta \in k\text{-cile } 1 | s = i), P(\theta \in k\text{-cile } 2 | s = i), \dots, P(\theta \in k\text{-cile } k | s = i)]$$

the Perron-Frobenius theorem tells us that there exists a vector θ such that $A\theta = \theta$ (it tells us that there exists a largest eigenvalue r , which in this case, A being a right stochastic matrix, is 1, so that $A\theta = r\theta$). This means that if we set Θ to be the elements of θ , $\Theta = \{\theta_1, \dots, \theta_k\}$, we have that the expected value of your type, conditional on signal $s = i$ is θ_i . Moreover, since the posterior $P(\theta | s = i)$ is increasing in i (that is, higher signals increase the posterior) we have that $\theta_i < \theta_j$ for $i < j$ (since θ_i is the expected value of θ conditional on signal i , and similarly for j).

In order to make the median of the population distribution unique, we: make the type space $[\theta_1 - 1, \theta_k + 1]$; for each i pick a $\theta_{i+\frac{1}{2}} \in (\theta_i, \theta_{i+1})$, and a density h^i on $(\theta_{i-\frac{1}{2}}, \theta_{i+\frac{1}{2}})$ such that the expected value is θ_i . Then, we make the population distribution $\sum h^i/k$. ■

Proof of Theorem 7. We start by showing that p is the distribution of types in the population, $E(\bar{t}) = E(p)$. Let p_s denote the posterior of p given signal s , which is drawn from the distribution f_t for a type t . The following “beliefs are a martingale” argument

$$\sum_s \Pr(s) p_s(t) = \sum_s \left\{ \sum_\theta p(\theta) f_\theta(s) \right\} \frac{f_t(s) p(t)}{\sum_\tau f_\tau(s) p(\tau)} = \sum_s f_t(s) p(t) = p(t)$$

and $\bar{t}(s) = \sum_t t p_s(t)$ imply that

$$E(\bar{t}) = \sum_s \Pr(s) \bar{t}(s) = \sum_s \Pr(s) \left(\sum_t t p_s(t) \right) \Leftrightarrow E(\bar{t}(s)) = \sum_t t \sum_s \Pr(s) p_s(t) = \sum_t t p(t) = E(p).$$

as was to be shown.

Then, since $E(\bar{t}(s)) = E(p) = m$, we get $E\left(\frac{1}{n} \sum_{i=1}^n \bar{t}_i\right) = E(p) = m$, as was to be shown. ■

The proof of Theorem 9 is a simple corollary of the following Lemma, versions of which are well known (see Wolfstetter (1999) Chapter 4) we will use the strict inequalities in this version of our Lemma, and in addition we do not require that P has a density.

Lemma 3 *The posterior after passing a test fosed the prior, which fosed the posterior after failing the test. Moreover, letting n denote a fail, y a pass, and letting P be the population distribution, for any x such that $1 > P(\theta \leq x) > 0$,*

$$P(\theta \leq x | n) > P(\theta \leq x) \quad \text{and} \quad P(\theta \leq x) > P(\theta \leq x | y)$$

Proof of Lemma 3. We only compare the prior to the posterior after n , since the comparison between the prior and the posterior after y is symmetric. Because of Bayes’ Rule we must show that

$$\begin{aligned} P(\theta \leq x | n) &= \frac{\int_0^x (1-z) dP}{\int_0^1 (1-z) dP} \geq \int_0^x dP = P(\theta \leq x) \Leftrightarrow \int_0^x \left[\frac{1-z}{\int_0^1 (1-z) dP} - 1 \right] dP \geq 0 \\ &\Leftrightarrow \int_0^x \left[\frac{1-z}{1-E(\theta)} - 1 \right] dP \geq 0 \Leftrightarrow \int_0^x \frac{E(\theta) - z}{1-E(\theta)} dP \geq 0 \end{aligned} \quad (4)$$

and that the inequality is strict whenever $P(\theta \leq x) > 0$. The integrand in the last inequality is strictly decreasing in z , and is 0 for $z = E(\theta)$. First notice that for any $x \leq E(\theta)$, the inequality is satisfied (because it is the integral of a positive function). If for some $x > E(\theta)$ we had

$$\int_0^x \frac{E(\theta) - z}{1-E(\theta)} dP < 0, \quad (5)$$

for any $x' > x$ we would also have

$$\int_0^{x'} \frac{E(\theta) - z}{1-E(\theta)} dP \leq \int_0^x \frac{E(\theta) - z}{1-E(\theta)} dP < 0,$$

since $\frac{E(\theta)-z}{1-E(\theta)} < 0$ for $x \leq z \leq x'$ (because $\frac{E(\theta)-z}{1-E(\theta)}$ is decreasing, and $\frac{E(\theta)-x}{1-E(\theta)} < 0$ must hold if equation 5 holds). This contradicts that for $x' = 1$ we must have $\int_0^{x'} \frac{E(\theta)-z}{1-E(\theta)} dP = 0$.

Now lets turn to the strict inequalities. Pick any $x \leq E(\theta)$, with $1 > P(\theta \leq x) > 0$. If $x = E(\theta)$, we know that $P(\theta < x) > 0$ (because P is non degenerate, and it can't assign positive probability only to $\theta \geq E(\theta)$), and since the integrand in the last inequality of equation (4) is strictly positive for all $z < E(\theta)$, we must have that the integral is strictly positive, as was to be shown. If $x < E(\theta)$, the strictly positive integrand and $P(\theta \leq x) > 0$ ensure that the integral is also strictly positive.

Pick any $x > E(\theta)$, and assume that

$$\int_0^x \frac{E(\theta) - z}{1 - E(\theta)} dP \leq 0.$$

Since $1 > P(\theta \leq x)$ holds, we must have $P(\theta > x) > 0$. But then, $\frac{E(\theta)-z}{1-E(\theta)} < 0$ for all $z \geq x > E(\theta)$ and $P(\theta > x) > 0$ imply that

$$\begin{aligned} 0 &= \int_0^1 \frac{E(\theta) - z}{1 - E(\theta)} dP = \int_0^x \frac{E(\theta) - z}{1 - E(\theta)} dP + \inf_{w>x} \int_w^1 \frac{E(\theta) - z}{1 - E(\theta)} dP \\ &\leq 0 + \inf_{w>x} \int_w^1 \frac{E(\theta) - z}{1 - E(\theta)} dP < 0 \end{aligned}$$

which is a contradiction. ■

Proof of Theorem 8. Necessity is proved by the first claim in Lemma 1. For sufficiency take any p, y and x such that $py \leq x$. Assume that $y \geq x$ (the opposite case is treated similarly). Let the type space be $\Theta = [0, 1]$, let the population be distributed uniformly on $[0, 1]$, and let $S = \{0, 1\}$. The signalling structure is such that $f_\theta(1) = \frac{y-x}{1-x}$ for $\theta \leq 1-x$, and $f_\theta(1) = 1$ for $\theta > x$. Then,

$$P(\theta \geq x \mid s = 1) = \frac{P(1 \mid \theta \geq x) P(\theta \geq x)}{P(1 \mid \theta \geq x) P(\theta \geq x) + P(1 \mid \theta < x) P(\theta < x)} = \frac{x}{x + (1-x) \frac{y-x}{1-x}} = \frac{x}{y} \geq p.$$

■

Proof of Proposition 4. Let p be the population distribution, m be the median of p . Let $\bar{\delta} < \frac{1}{2}$ be such that if a distribution q over Θ is δ -close to degenerate for any $\delta \leq \bar{\delta}$, and the mean of q is strictly larger than m , then the type θ_i such that $d(q, e^i) = \max_j |q_j - e_j^i| \leq \delta$ satisfies $\theta_i > m$. Similarly, let $\delta^* < \frac{1}{2}$ be such that if a distribution q over Θ is δ -close to degenerate for any $\delta \leq \delta^*$, and the mean of q is weakly lower than m , then the type θ_i such that $d(q, e^i) = \max_j |q_j - e_j^i| \leq \delta$ satisfies $\theta_i \leq m$. Set t and $\delta < \min\{\bar{\delta}, \delta^*\}$ such that $\pi < (1-\delta)(\pi + \varepsilon + t - 1)$ and $1 - \pi < (1-\delta)(t - \pi + \varepsilon)$

Assume that $x_m \geq \pi + \varepsilon$ for some S and $\{f_\theta\}$ that have the property that $P\{s : \text{posterior after } s \text{ is } \delta - \text{close to } t\}$. For this signalling model, and letting $B(p \mid s)$ denote the posterior of p given s , define

$S^* = \{s : B(p | s) \text{ is } \delta\text{-close to degenerate}\}$, $S^m = \{s \in S^* : B(p | s) \text{ has median } > m\}$ and $S^\mu = \{s \in S^* : B(p | s) \text{ has mean } > m\}$. Then, since $\delta < \bar{\delta} < 1/2$, if the median of $B(p | s)$ is $> m$, the type θ_i on which $B(p | s)$ is close to degenerate (for $s \in S^*$) is larger than m , so that $P(\theta > m | s) \geq 1 - \delta$, and therefore

$$\begin{aligned} \pi &= P\{\theta > m\} = \sum_s P(\theta > m | s) P(s) \geq \sum_{S^m} P(\theta > m | s) P(s) \\ &\geq \sum_{S^m} (1 - \delta) P(s) = (1 - \delta) \sum_{S^m} P(s) \geq (1 - \delta)(x_m - 1 + t) \\ &\geq (1 - \delta)(\pi + \varepsilon - 1 + t), \end{aligned}$$

which is a contradiction. Similarly (with S^μ playing the role of S^m , and using the definition of $\bar{\delta}$ in the second inequality) we obtain that $x_\mu < \pi + \varepsilon$.

Assume now that $x_m \leq \pi - \varepsilon$, and let $S_m = \{s \in S^* : B(p | s) \text{ has median } \leq m\}$ and $S_\mu = \{s \in S^* : B(p | s) \text{ has mean } \leq m\}$. Then,

$$\begin{aligned} 1 - \pi &= P\{\theta \leq m\} = \sum_s P(\theta \leq m | s) P(s) \geq \sum_{S_m} P(\theta \leq m | s) P(s) \\ &\geq \sum_{S_m} (1 - \delta) P(s) = (1 - \delta) \sum_{S_m} P(s) \geq (1 - \delta)(1 - x_m - 1 + t) \\ &\geq (1 - \delta)(t - x_m) \geq (1 - \delta)(t - \pi + \varepsilon), \end{aligned}$$

which is a contradiction. Again, the argument for x_μ is similar and omitted, so the proof is complete. ■

Proof of Theorem 9. We will develop the arguments for the posterior after y , since those for n are analogous. The probability of observing y in the test is $E(\theta)$, and then, by Lemma 3, the posterior $P(\cdot | y)$ strictly fofd the population distribution, which also implies that the posterior mean is strictly larger than the prior mean (which is the median by symmetry). Also by Lemma 3 the fraction $E(\theta)$ (who observed y) will consider that their median type is weakly larger than the population median.

Suppose first that the population distribution has a density. Then,

$$P(\theta \leq m | y) = \frac{\int_0^m \theta dP}{E(\theta)} < \frac{m \int_0^m dP}{E(\theta)} = \frac{mP(\theta \leq m)}{E(\theta)} = P(\theta \leq m) = \frac{1}{2}$$

so that m is no longer the median of the posterior. If the distribution does not have a density, and the median is not unique, still $P(\theta \leq m_*) = 1/2$ for all but the highest median, so the argument above establishes that none of those remains a median after a y .

If the distribution does not have a density and the median is unique, assume that $p(m)$ is small enough that

$$p(m)m + p(\theta < m)E(\theta | \theta < m) < m/2$$

(notice that if $p(m) = 0$ the inequality is satisfied). Then, as before (and using the assumption for the strict inequality),

$$P(\theta \leq m) = \int_0^m dP \geq \frac{1}{2} > \frac{p(m)m + p(\theta < m)E(\theta | \theta < m)}{m} = \frac{\int_0^m \theta dP}{E(\theta)} = P(\theta \leq m | y)$$

which establishes that m is not a median of the posterior after y . ■

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