IJCRT.ORG ISSN : 2320-2882

INTERNATIONAL JOURNAL OF CREATIVE RESEARCH THOUGHTS (IJCRT)

An International Open Access, Peer-reviewed, Refereed Journal

Application Of Fuzzy Game Theory In Behavioral Economics

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Abstract: The integration of behavioral economics and fuzzy game theory offers a novel framework for analyzing strategic interactions under uncertainty and cognitive limitations. Traditional game theory, rooted in rational choice and crisp utility functions, fails to fully capture the ambiguity, subjectivity, and bounded rationality observed in human decision-making. Behavioral economics highlights how real-world choices are influenced by psychological factors such as loss aversion, fairness concerns, and heuristics. In response, fuzzy game theory incorporates fuzzy set theory to model imprecise preferences and ambiguous outcomes. This paper explores the theoretical foundation and practical relevance of fuzzy game theory within behavioral contexts. Key concepts such as fuzzy Nash equilibrium and fuzzy core are defined and examined through illustrative examples and simplified proofs. The study demonstrates that fuzzy game theory provides more realistic and flexible tools for understanding economic behavior where exact payoffs and strategies cannot be clearly defined. This has profound implications for negotiation, market analysis, and policy design under behavioral uncertainty.

Keywords: Fuzzy Game Theory; Behavioral Economics; Fuzzy Nash Equilibrium; Bounded Rationality; Fuzzy Core; Decision-Making under Uncertainty; Strategic Behavior; Prospect Theory; Fuzzy Sets.

1. Introduction

In recent decades, **behavioral economics** has emerged as a powerful interdisciplinary field, combining insights from psychology and economics to better understand human decision-making under uncertainty, bounded rationality, and social influence. Traditional economic models often assume rational agents with well-defined preferences; however, empirical findings suggest that real-world behavior frequently deviates from these assumptions due to cognitive biases, heuristics, and emotions (Kahneman, 2011).

Game theory, a central analytical tool in economics, models strategic interactions among rational agents. Yet, classical game theory is also grounded in the assumption of perfect information, crisp utility values, and deterministic outcomes. In contrast, behavioral settings often involve **imprecise preferences**, **vague beliefs**, and **ambiguous payoffs**, which are not easily captured by traditional game-theoretic frameworks.

To address these challenges, researchers have increasingly turned to **fuzzy set theory**, introduced by Zadeh (1965), which allows modeling of imprecise, subjective, and uncertain information. **Fuzzy game theory** extends classical game theory by incorporating fuzzy sets and fuzzy payoffs into strategic models, thus providing a more realistic representation of human behavior in uncertain environments (Jain, 1976). This is particularly relevant in behavioral economics, where agents' preferences and strategies are often based on linguistic assessments or incomplete knowledge.

The integration of fuzzy logic into game-theoretic models enables the study of **fuzzy Nash equilibria**, **fuzzy bargaining solutions**, and **fuzzy cores**, which are better suited to analyze situations

with ambiguity and imprecision. Applications of fuzzy game theory in behavioral economics include modeling cooperative behavior under social norms, market decision-making with fuzzy expectations, and negotiation processes with imprecise information.

This paper aims to explore the foundational concepts, theorems, and practical applications of fuzzy game theory in the context of behavioral economics. By providing formal definitions, illustrative examples, and proofs of key results - such as the **existence of fuzzy Nash equilibria** and the **fuzzy core** - the study contributes to a more nuanced understanding of strategic decision-making under fuzzy conditions.

2. Definitions and Preliminaries

2.1 Fuzzy Set Theory

A **fuzzy set** A in a universal set X is defined as:

$$A = \{(x, \mu_A(x)) * x \in X, \mu_A(x) \in [0,1]\}$$

where $\mu_A(x)$ denotes the degree of membership of element x in the set A.

Example: Let X = {Low, Medium, High}, and define $\mu_{\text{RiskTolerance}}$ as:

$$\mu_{\text{RiskTolerance}}(\text{Low}) = 0.9,\ \mu_{\text{RiskTolerance}}(\text{Medium}) = 0.5,\ \mu_{\text{RiskTolerance}}(\text{High}) = 0.2$$

This represents a player with low risk tolerance.

2.2 Fuzzy Game Theory

A **fuzzy game** is a game where the payoffs or strategies are expressed as fuzzy numbers or fuzzy sets. A fuzzy game GGG with nnn players is defined as:

$$G = \{N, S_i, \bar{u}_i\}_{i=1}^{n}$$

where:

N is the set of players,

S_i is the strategy set of player i,

$\bar{u}_i : S_1 \times S_2 \times \cdots \times S_n \to \tilde{u}$ is the fuzzy payoff function for player i, and $\tilde{u}$ is the set of fuzzy numbers.

2.3 Behavioral Economics and Decision-Making

Behavioral economics considers non-rational behaviors like:

- **Prospect Theory** (Kahneman & Tversky, 1979): Players evaluate gains and losses relative to a reference point rather than final outcomes.
- **Loss Aversion:** Losses hurt more than equivalent gains.
- **Bounded Rationality** (Simon, 1955): Individuals make satisficing rather than optimal decisions.

3. Theoretical Foundation

Theorem 1: Existence of Fuzzy Nash Equilibrium

Statement: Let $G = \{N, S_i, \bar{u}_i\}$ be a fuzzy non-cooperative game with compact, convex strategy sets Si for each player i, and fuzzy utility functions $\bar{u}_i$ that are upper semi-continuous. Then, a fuzzy Nash equilibrium exists.

Proof: We prove this by **reducing the fuzzy game to a family of crisp games** using **α-cuts**, and applying **Kakutani's Fixed Point Theorem**.

Step 1: Understand Fuzzy Payoffs Using α-cuts

Each fuzzy payoff $\bar{u}_i(s)$ can be represented using ***α*-level sets**, for $\alpha \in [0,1]$.

For each α, define a crisp game G^α where each fuzzy payoff is replaced by its α-level interval.

That is, for every strategy profile s = (s_1, ..., s_n),

$$\bar{u}_i(s) \Rightarrow \left[\underline{u}_i^\alpha(s), \bar{u}_i^\alpha(s)\right]$$

Now, each game G^α is a **classical game** with interval-valued payoffs.

Step 2: Construct a Crisp Payoff for Each α

To simplify analysis, we select a **representative value** (e.g., the mid-point):

$$u_i^\alpha(s) \Rightarrow \frac{\underline{u}_i^\alpha(s), \bar{u}_i^\alpha(s)}{2}$$

This gives us a family of classical games $G^\alpha = (N, S_i, u_i^\alpha)$.

Step 3: Apply Nash Equilibrium Theorem to Each G^α

Each G^α has:

- Compact and convex strategy sets.
- Continuous payoff functions (assumed via α-cuts).

Hence, by **Kakutani's Fixed Point Theorem**, a Nash equilibrium exists for each G^α.

Step 4: Define Fuzzy Nash Equilibrium

The set of all equilibria over $\alpha \in [0,1]$ forms a **fuzzy-valued equilibrium correspondence**.

The fuzzy Nash equilibrium is defined as a **fuzzy set of strategy profiles**, where membership is determined by the supremum of α-level equilibria.

Thus, since a Nash equilibrium exists at every α-level, and α-cuts preserve compactness and convexity, the fuzzy Nash equilibrium exists.

4. Application to Behavioral Economics

4.1 Example: Consumer Choice under Ambiguity

Let two players be sellers choosing prices. A consumer has fuzzy utility preferences influenced by behavioral biases like price anchoring.

Let:

- Seller 1 chooses $p_1 \in [10, 20]$,
- Seller 2 chooses $p_2 \in [10, 20]$,
- Consumer's fuzzy utility $\tilde{U}(p_i) = 1 - \mu(p_i)$, where $\mu(p_i)$ represents price aversion. Assume:

$$\mu(p_i) = \frac{p_i - 10}{10}$$

This implies a consumer experiences loss aversion for prices above 10. A fuzzy equilibrium will reveal whether sellers tend toward lower or anchor-biased prices.

4.2 Prospect-Theoretic Payoff Modeling

Let player *i* evaluate outcomes using a value function $\upsilon(x)$:

$$\upsilon(x) = \begin{cases} x^\alpha, & x \geq 0 \\ -\lambda(-x)^\beta, & x < 0 \end{cases}$$

Incorporating this into a fuzzy game, the payoff function becomes:

$$\bar{u}_i(s) = \tilde{\upsilon}_i(\text{payoff under strategy } s)$$

This models loss aversion ($\lambda > 1$) and diminishing sensitivity ($0 < \alpha, \beta < 1$).

5. Fuzzy Cooperative Games in Behavioral Contexts

Fuzzy cooperative games allow coalitions with uncertain formation likelihoods. In behavioral settings, social preferences (altruism, trust) affect coalition formation.

Definition: Fuzzy Coalition

A fuzzy coalition is a fuzzy subset A of players where $\mu_A(i)$ denotes player i's commitment level to the group.

Theorem 2: Fuzzy Core Existence in Cooperative Games

Statement: Let $G = (N, \upsilon)$ be a fuzzy cooperative game, where:

- $\upsilon : 2^N \to \tilde{u}$ is a fuzzy characteristic function (i.e., assigns fuzzy values to every coalition),
- υ is monotonic and convex in fuzzy terms.

Then the **fuzzy core** $C_f(G)$ is **non-empty**.

Proof:

Step 1: Definition of Fuzzy Core

The fuzzy core consists of allocations $x = (x_1, ..., x_n)x$ such that:

Efficiency: The total allocation equals the grand coalition's fuzzy value:

$$\sum_{i \in N} x_i \in \tilde{\upsilon}(N)$$

Coalitional Rationality: For all coalitions $S \subseteq N$,

$$\sum_{i \in S} x_i \in \tilde{\upsilon}(S),$$

These are interpreted using **α-cuts**:

$$\sum_{i \in S} x_i \in \underline{\upsilon}^{\alpha}(S), \quad \sum_{i \in N} x_i \in \bar{\upsilon}^{\alpha}(N)$$

for each $\alpha \in [0,1]$.

Step 2: Reduce to Crisp Core at Each α

At each α-level, define a crisp game $G^{\alpha} = (N, \upsilon^{\alpha}),$ where $\upsilon^{\alpha}(S) = \underline{\upsilon}^{\alpha}(S)$ is the lower bound at α-level.

Then, the **core of G^{α}** is the set of allocations x satisfying:

$$\sum_{i \in S} x_i \in \upsilon^{\alpha}(S), \quad \sum_{i \in N} x_i \in \upsilon^{\alpha}(N)$$

By the **Bondareva-Shapley Theorem**, a non-empty core exists if υ^{α} is convex.

Step 3: Use Fuzzy Convexity

Since υ is fuzzy convex, for each α-level, υ^{α} is also convex.

Hence, the core of each G^{α} is **non-empty**.

Step 4: Construct Fuzzy Core

The fuzzy core $C_f(G)$ is the **intersection of crisp cores** at all α-levels.

Since each α-core is non-empty, their intersection (as fuzzy sets) is also non-empty.

Conclusion

Therefore, the fuzzy core $C_f(G)$ is non-empty under fuzzy convexity and monotonicity assumptions.

6. Empirical Illustration

A behavioral experiment involves players selecting risk levels in investment. Payoffs are uncertain and fuzzified using triangular fuzzy numbers. Player preferences are elicited using a survey capturing loss aversion and ambiguity tolerance.

Player	Strategy	Fuzzy Payoff (Triangular)
A	High Risk	(−5, 10, 30)
B	Low Risk	(2, 5, 8)

Using fuzzy dominance and α-level comparison, players can choose strategies that align with their behavioral traits.

7. Conclusion

Fuzzy game theory bridges the gap between classical rationality and human behavioral complexity. Its integration with behavioral economics enables the modeling of uncertainty in preferences, decision biases, and social interactions. Future research can extend this framework to neuroeconomic modeling and policy simulations under ambiguity.

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