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# Book review

**Isabelle Brocas, Juan D. Carrillo, The Psychology of Economic Decisions, Vol. 1: Rationality and Well-Being, Oxford University Press, Oxford, 2003, ISBN 0-1992-5106-1 ($ 85.00).**

This intelligently edited volume brings together fifteen papers all of which were first presented at a conference held in Brussels in 2001 organised by the Centre for Economic Policy Research. The cast list of participants is outstanding and includes a number of distinguished psychologists, behavioural economists and economic theorists. Broadly speaking, the contributions reflect this division: psychologists summarise their work; economic theorists outline theories of boundedly rational behaviour and experimental economists report results of particular experiments. Now, many of the chapters can be found in slightly different versions in refereed journals or working papers. In general, in order to reach a wider audience, formal economic modelling has been left to one side in the book, so the main difference between chapters and their journal siblings lies in the degree of rigour. Nevertheless there is still plenty to chew on throughout the volume.

A line that runs through many of the contributions is that of time inconsistency, its causes and consequences. Baumeister summarises experimental results on the failure of regulation, arguing that self-regulation is energy consuming and hence, performance in contexts in which self-restraint must be exercised can be negatively affected by recent acts of self-regulation. In one experiment, for instance, subjects were measured on the length of time before they gave up on an impossible puzzle. Those who had previously to eat radishes while sitting near freshly baked chocolate cookies gave up more quickly than the subjects who did not eat or who were allowed to indulge in the cookies.

Meanwhile, Trope and Liberman put forward their view of the source of time inconsistency: future events are evaluated in terms of abstract and fundamental attributes, whereas in immediate decisions superficial and peripheral features are weighted more heavily. For instance the clarity of the picture on a new television would receive a higher weighting in the long term compared to, for instance, the awkward position of the video connections.

The economists also focus on time inconsistency: Gilboa and Gilboa-Schectman put forward their solution to the absent-minded driver problem. They argue that the principle of over-generalisation which seems important in many instance of mental accounting

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(to stop temptation) can also apply. In a paper which has interesting echoes of the experiments reported by Baumeister, Bénabou and Tirole offer their own take on time inconsistency and self-regulation: confidence is useful to an individual because it enables them to take on tasks that otherwise they would drop for lack of will-power. Brocas and Carrillo's argument starts from O'Donoghue and Rabin's work on procrastination. In this case an individual must choose whether to make a costly investment immediately or postpone it. Hyberbolic discounting implies that for some benefit cost ratios, the individual would make the investment tomorrow, but will not make it today. When the day for the investment arrives, reappraisal means that it is once more delayed until the following morning. Although the individual is aware that this endless delay will occur, he or she has no commitment devices to circumvent it. In Brocas and Carillo ignorance of an individual's true costs and benefits may lead the person to invest when full information would lead to procrastination. Most of these models are characterised by multiple selves – a planner and a doer for instance – engaged in strategic interaction. By contrast, Bodner and Prelec in their stimulating chapter on diagnostic utility, argue that in many instances 'it is hard to discern two agents, the one who *signals* and the one who is *signalled to*' (p. 121). They conclude that all choices will be affected by the desire to signal motives to oneself.

Looking at the volume as a whole, the prominence of three general themes becomes apparent.

First, as the excellent chapter by Hertwig and Ortmann makes clear, experimental economists and psychologists have very different working practices. The difference in attitudes to deception within experiments is well-known, but reading the contributions made by psychologists elsewhere in the book, there is also a sense that economists in their experiments have yet to explore the full range of emotional conditions under which human beings typically make decisions. Some of these situations may be extreme – Baumeister reports on experiments with treatments in which subjects make decisions after being crushed by the news that they were deemed uncreative or that other members of the group were unwilling to work with them. Nevertheless such conditions may well be relevant contexts for economic decisions in real life.

A second and more general theme from the book is of a relationship between economics and psychology that is not entirely healthy. The sense is that economists propose theories, psychologists debunk them and then economists propose new theories, but without any necessarily deeper contact between the disciplines.

One difficulty created by this relationship is that while economists learn something about psychology, psychologists spend rather less time learning about economics. For instance, in an otherwise informative chapter on self-defeating choices, Baumeister states that, in a choice between two lotteries one of which yields a 70 percent chance of winning $2 (otherwise nothing) while the other involves a 2 percent chance of $25, 'the two-dollar lottery was the correct, rational choice' (p. 7). The $25 option is described as 'foolish', 'stupid' and 'irrational'. Baumeister is making an interesting argument that deserves more attention from economists – people who are upset tend to make riskier choices. However, many economists (and non-economists for that matter) would wince at such pejorative descriptions.

A second difficulty of the relationship is illustrated by the fact that much of the theorising by economists about time inconsistency is only loosely related to the experimental results

presented by the psychologists. As a result, this book presents the central dilemma faced by the emerging sub-discipline of behavioural economics: is it a primarily a deductive, theoretical endeavour in which one set of intuitions about human nature replace an earlier set, now viewed as less credible or does it represent a change in the methods by which economists seek knowledge? In the former view, theorists can rely on psychologists to supply the raw material for new theories. In the latter view, economists have to become immersed in ideas from psychology and to avoid potentially harmful divisions of labour in which theorists do not do experiments and experimenters eschew the development of new theory.

Fehr and Tyran's paper provides a neat epilogue to the volume and one that exemplifies the advantages of an integrated approach to economic psychology in which the researchers have a good understanding of both disciplines. In their article they test theories of money illusion by asking their subjects to play a price-setting game in which the optimal choice is increasing in the price set by opponents but which, theoretically, exhibits money neutrality. The experiment is designed to distinguish between two explanations of non-neutrality: whether it is due to framing effects on the part of market participants or whether it is due to the beliefs of market participants that other players are subject to framing effects. Using controls in which the 'opponents' are computers and are revealed as such to the participants, Fehr and Tyran come down firmly on the side of the second explanation.

The final theme in the book, though less to the fore, is the policy implication of behavioural models of the individual. Much of behavioural economics denies the possibility of a fully rational consumer with complete and consistent preferences. However, normative theories of individual welfare do typically assume that individual welfare rankings are complete and transitive. As a result, behavioural economics has broken the link between positive and normative branches of economics – presenting an enormous conundrum for the would-be welfare economist. Caplin and Leahy have an interesting chapter in which they discuss some of the possible policy applications of their recent work on anticipation. Though insightful, the investigation is clearly preliminary and leaves unanswered two fundamental questions: how do we model the effects of policy when individual behaviour deviates from the textbook model of the consumer in multiple directions and not just one; secondly, what welfare metric should be employed to evaluate policies? Daniel Kahneman has a partial answer to the second question, advancing his notion of 'objective happiness' the basis for which is an integral over time of each moment of happiness experienced by an individual. This integration is subject to some normative restrictions, notably an assumption of separability between time periods. Such restrictions make it hard to see how moments of objective happiness can be calculated from behavioural data since it is normally the case (as Kahneman readily acknowledges) that feelings of happiness in one moment are often closely tied to feelings in preceding moments. Perhaps a better, though less ambitious approach is to view behavioural data as potentially flawed *evidence* on individual welfare, without pre-supposing that any one piece of choice data is sufficient to make a watertight conclusion about welfare.

Overall this is a fascinating and timely book. Although researchers may need to refer to the journal versions of the papers, anyone working in economic psychology or behavioural economics will find it valuable to have this volume on their bookshelf. For economists,

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the most interesting parts of the book may well be the summaries of recent psychological research on decision-making. They have certainly given me some ideas for experiments.

Alistair Munro*
*School of Economics, University of East Anglia*
*Norwich NR4 7TJ, UK*
*Tel.: +44 1603 593404
*E-mail address:* a.a.munro@uea.ac.uk

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