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Book review

The Psychology of economic decisions. Volume I: Rationality and well-being, by Brocas, I., Carrillo, J.D. (Eds.), Oxford University Press, Oxford, NY, 2003. pp. 354, ISBN: 0-19-925108-8 (30 figures, 3 tables), $30 (Paperback)

Based on contributions to the CEPR/ECARES conference on economics and psychology in Brussels 2001, Isabelle Brocas and Juan Carrillo have edited this volume of papers in an attempt to compile research from two groups of scientists who work on related topics and yet take different paths. Generally, economists are concerned with creating normative models of human behavior focusing especially on decision outcomes. For the sake of generality, they accept a number of simplifying assumptions. Psychologists, on the other hand, form descriptive models with particular attention to the decision-making process. The general significance of theories is forgone in favor of specificity. As a consequence of this complementarity, the two different avenues of research should enter into a dialogue for their mutual benefit. The book succeeds well in contributing to the agenda of building links between the two disciplines. Especially, progress in incorporating psychological issues of knowledge and memory in economic theory is remarkable. However, the ambiguity of some empirical findings and theoretical predictions documented here still leaves much space for future interdisciplinary cooperation.

The book is divided into five parts. Part one contains papers on irrational conduct of which I would like to highlight two in more detail, albeit for different reasons. In the first chapter, Baumeister explores the causes of self-defeating behavior. He concludes that especially when the ego is threatened, people make foolish choices because they are less able to think carefully. The study is innovative in that it induces moods and explores its subsequent impact on behavior. However, this is achieved at the expense of careful experimental conduct: the way in which subjects are deceived about their own performance (e.g., by telling them that a psychological test qualifies them as injury-prone or as likely to end up alone in life) might not only create negative externalities for experimenters and psychological professionals but also raises an ethical issue. A detailed review of this exact problem is discussed later in the book, as will be seen below. Chapter 2 by Berridge offers the rare view of a neuroscientist on irrational behavior: based on the dopamine activity in specific brain areas, he distinguishes 'wanting' from 'liking' and argues that irrationality is reflected in wanting something disproportionally to the expectation of liking it. Psychologists are naturally interested in neurochemical processes, but economists

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too have recently adopted brain activity as a research topic (the neuroeconomics approach) and are thus increasingly attentive to the physiological correlates of behavior. The author does, however, restrict himself to the presentation of very basic concepts which may leave some audiences unsatisfied. The reader with a deeper interest is thus well advised to consult some of the further readings. In Chapter 3, Schooler and co-authors demonstrate experimentally that the active pursuit of happiness can be self-defeating (and is therefore 'irrational'), since excessive self-reflection impairs the ability to decipher the hedonic value of experiences.

The discussion of rationality is a recurring topic in the interdisciplinary field of economics and psychology, and a central theme of this book. The definitions offered here are, however, not very clear-cut, as every author provides his or her own perspective. It is thus left to the reader whether to regard this variety of opinions as a strength or as a limitation of the literature.

The papers collected in parts 2 and 3 of the book present new directions in economic theory that try to capture the cognitive limitations of the decision maker: imperfect self-knowledge, imperfect memory and imperfect information processing capacity.

Specifically, part 2 introduces models to explain why a lack of information is not necessarily suboptimal. Caplin and Leahy (Chapter 4) suggest that – depending on the psychological disposition – the provision of additional information (e.g., about medical treatment) can be detrimental to the individual. In Brocas and Carrillo's model (Chapter 5), the avoidance of information is optimal when the individual has a self-control problem. Consequently, impulsive behavior does not inevitably rest on emotions but can be explained by a rational decision to commit against future inefficient actions. In the model of Bodner and Prelec (Chapter 6), individuals signal dispositions to their selfs by taking specific actions (e.g., passing on dessert when dieting signals willpower).

Part 3 more particularly deals with limitations of memory and cognitive processing. Gilboa and Gilboa-Schechtman (Chapter 7) show that with imperfect recall, overgeneralizing situations (e.g., never allowing oneself a luxurious purchase) can be optimal. Apparently contrary behavior in self-restriction (e.g., loafing and workaholism) is successfully explained in a unified framework by Benabou and Tirole (Chapter 8). Depending on the initial belief about the ability to resist temptations, individuals either exhibit deficient or excessive self-regulation. Gabaix and Laibson (Chapter 9) offer a solution to the frame problem, i.e. the question of how much information is considered to make decisions in a complex environment.

All model presentations avoid complex mathematical formalization, which enables readers with little formal training to easily follow the intuition of the theories. Still, the understanding of the central arguments requires basic game-theoretical knowledge. Those in search of a more rigorous derivation of results are recommended to consult the references. It is noteworthy, however, that all models presented still rely on the neo-classical approach, unlike, for instance, the bounded rationality concept proposed by Herbert Simon. Individuals still remain utility maximizers. New results are derived by loosening some assumptions and enriching others. Although the theoretical concepts are very promising in explaining psychological evidence, their actual significance will have to be evaluated on the basis of their predictive power.

Part 4 of the book deals with issues of time and utility. Kahneman (Chapter 10) discusses the shortcomings of memory-based utility elicitation and instead promotes a moment-based assessment. The effect of time on emotional experience is investigated in Chapter 11. According to Wilson and coauthors, the cause for the rapid attenuation of emotional arousal is the human tendency to reduce ex-post uncertainty about the world by reasoning. In a series of experiments, Trope and Liberman (Chapter 12) confirm their theory of temporal construal, which predicts that distant future choices are influenced by their central aspects, whereas near future choices are influenced by their peripheral aspects.

The papers on time and utility provide noteworthy insights into intertemporal decision making, yet a few interesting aspects remain barely discussed: how does the proposition to rely on moment-based utility assessment relate to the insight that hedonic experience crucially changes under constant monitoring? Or, to what extent are physiological processes responsible for emotional evanescence? What is the link between emotions and rationality, particularly with regard to the finding that specific emotions (e.g., regret) seem to be a precondition for learning to take rational decisions? It seems there is still plenty of space for active discussion and research.

Moreover, part of the empirical evidence presented gives rise to a general concern: can behavior be unambiguously labeled as irrational, or is it rather adaptive to situational conditions (and therefore rational in an evolutionary sense)? Additionally, the correlational nature of evidence renders judgments about causalities delicate. Think, for instance, of the finding that people who pursue mainly their self-interest are less happy. First, this evidence rests on a correlation between self-interest and happiness and has little to say about the causality. Second, the pursuit of self-interest may be an adaptation to life circumstances and may lead to increased happiness in the longer run, therefore questioning the initial 'irrationality'.

The last part of the book reflects on the beneficial potential of experiments in economics and psychology. Hertwig and Ortmann (Chapter 13) review the practices of economists and psychologists in conducting experiments and focus especially on two crucial discrepancies: financial incentives and deception. Additional to discussing their long-run impact, the authors provide possible guidance for future research. In Chapter 14, Hilton reviews the literature on psychology and financial markets and enriches the ongoing debate on the relevance of psychology by explicitly addressing human resource management, i.e. debiasing and teaching strategies for financial professionals. The final chapter by Fehr and Tyran presents a rare macroeconomic experiment on nominal inertia. Results identify strategic uncertainty about others' money illusion as a crucial determinant. The study thus succeeds in disentangling effects that are impossible to separate with empirical data.

To sum, the book is recommended to all scholars in the field of decision-making who are interested in how psychological evidence, especially on cognitive limitations, may enter economic theory, which in turn produces clear predictions for testing. Psychological evidence collected with questionnaires, field observations and experiments is fairly reviewed, yet the strength of the book lies in the theoretical conceptualizations. Scholars in psychology get an impression of how specific empirical findings can be formalized without being burdened by extensive mathematical language. Economists, on the other hand, may gain insight into some puzzling psychological findings that call for new directions in economic modeling.

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