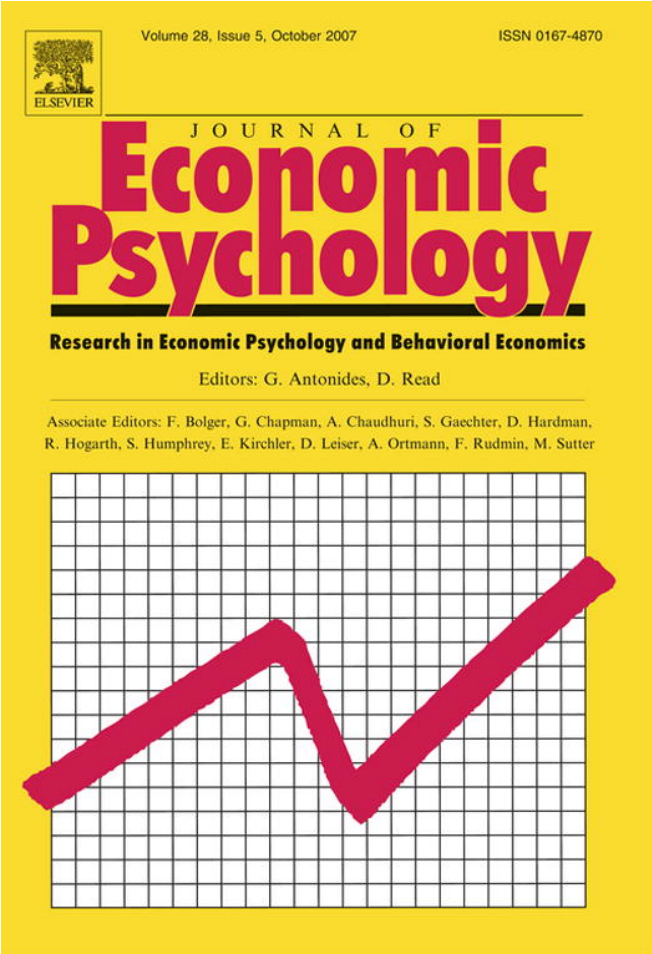
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Book Review ☆

Behavioral Economics and Its Applications, Peter Diamond, Hannu Vartiainen (Eds.), Princeton University Press, USA, (2007), (p. xvi+312), $45.00, ISBN-13: 978-0-691-12284-7

Most of economics uses sophisticated analytical methods, but relies on relatively simplistic assumptions about human nature. Research in neighboring social sciences, by contrast, generally uses less mathematics while entertaining a richer description of man. Behavioral economics (BE) combines the strengths of each approach, incorporating psychological insights into economic analysis with continued use of tools that make economists feel at home (including game theory and experiments with monetary payoffs and no deception).

BE has recently become the fastest growing field in economics and by many accounts the most exciting. The background is a wealth of evidence identifying empirical phenomena that are not adequately explained by traditional economic analysis. Researchers have developed new models that incorporate emotions, fairness, reciprocity, social norms, bounded rationality, myopia, etc.

As interest in BE grows, subfields emerge. This pioneering book describes six – public economics; development; law and economics; health; wage determination; organization economics – in which, as the editors argue in their lucid introduction, "behavioral argumentation has proven to be useful but has not yet been integrated as a part of the established framework." The well-established field of behavioral finance is left out; it is "beyond the phase where contributions such as the ones in this volume can shift a field" (p. 2).

The production of the volume started with a conference proposed and supported by the Yrjö Jahnsson Foundation, held in Finland in June 2004. The authors of the six core chapters – Douglas Bernheim and Antonio Rangel; Sendhil Mullainathan; Christine Jolls; Truman Bewley; Richard Frank; Colin Camerer and Ulrike Malmendier – are leaders in their fields. They have produced thoughtful texts that survey and offer penetrating analysis and much food for thought. Several other eminent scholars offer excellent commentary and "wrap-up panel" discussion. Readers of the book get a great introduction to a wide spectrum of hot emerging BE areas.

To illustrate some part of the book in more detail, let me single out Section 2.3, titled "Saving", from Bernheim and Rangel's public economics chapter. The authors first give an excellent summary of the "standard" approach ("the neo-classical perspective"). They

☆ I wrote this review while visiting Göteborg University. I appreciate very much the discussions about the content I had with Fredrik Carlsson, Håkan Eggert, Olof Johansson-Stenman, and Mark Walker.

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then list a number of empirical regularities that are hard to reconcile, including drops in consumption near retirement, self-reported savings mistakes, limited planning skills, absence of planning, and framing effects such as when "default options" in 401(k) plans influence saving. Bernheim and Rangel suggest that this reflects psychological insights regarding lack of self-control. They then describe several behavioral theories that incorporate this, with reference to notions including quasi-hyperbolic discounting, cue-triggered mistakes, and temptation. Finally, they ask what kind of policy may improve welfare: mandatory savings programs, subsidies and taxes, credit restrictions, and regulation of advertising are considered. Which instrument works best depends crucially on which behavioral theory is assumed to be relevant. Bernheim and Rangel also note that policy may have an effect through a number of "behavioral channels" which conventional analyses tend to neglect. For example, the availability of 401(k) plans may affect how individuals perceive retirement and savings decisions as well as how others they interact with (peers, financial advisors, employers) approach and influence them.

The first waves of BE work were descriptive. Researchers asked questions such as what are the implications for bargaining if parties feel guilty when they renege on promises, or how will consumption patterns change if decision makers procrastinate. I sense a tendency for the next surge of research to be normative, delivering advice to people, firms, or governments. As regards the last (policy) angle, many researchers seem to favor interventionist perspectives: how can government 'help' boundedly rational people who cannot help themselves? Some of the contributions in this book take such an outlook. Bernheim/Rangel's chapter is especially explicit, but the perspective is there also in (parts of) the chapters on development, law, and health.

I take the opportunity to note that there is no logical reason why BE research has to come down that road. To see where I am headed, consider first the following claim which certainly none of the books' contributors makes: "Millions of people play poker on the internet. Billions of dollars change hands. Some people are more skillful than others, some lose money. No sensible person would go on and propose that government intervenes and puts restrictions on internet poker sites. Poker is good for you! It is fun, exciting, and sharpens the mind. A loser should go and buy himself a good textbook on poker strategy."

This claim reflects how BE insights might support less government action. More generally, I see at least four reasons: (i) Bounded rationality of politicians may be a source of poor policy. (ii) Bad judgment of BE researchers may caution against too confident policy advice. (iii) BE insights may actually support economic efficiency, like when the human tendency to avoid feelings of guilt fosters trustworthy behavior so that contract-theorists can worry less about 'market failure' due to 'moral hazard' or 'hold-up'. (iv) Happiness and personal development may depend directly on the processes by which markets and politics run, and aspects of liberty and absence of coercive intervention may be crucial in this connection.

People choose to emphasize different angles, and the contributors to this volume for the most part do not stress the perspectives I listed in the previous paragraph. There are some notable exceptions though, mainly related to (i)–(ii) in my list. Mullainathan has an interesting discussion of "the damaging role of self-serving bias in evaluation;" he stresses how a "greater reliance on randomized trials ... will better insulate us from the psychological fallibilities of researchers and policy makers" (Section 3.6). Ian Ayres, who comments on the law and economics chapter, notes that the "same bounded rationality and bounded willpower that distorts private decision-making should also distort the decisions of individual public decision makers'' (p. 147). Ann Case closes her comments on the development chapter with some words of caution: ''When revealed preference no longer provides a measure of policy success, we find ourselves without a compass. ... The role that society should play in protecting people from themselves is far from clear'' (p. 114).

All in all, I learned a substantial amount from reading this thought-provoking book. I congratulate the editors, and the Yrjö Jahnsson Foundation, on having collected so many intriguing contributions from so many prominent scholars.

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