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Book Reviews

000 General Economics; Theory; History; Systems

010 General Economics

Psychological economics: Development, tensions, prospects. Edited by Peter E. Earl. Recent Economic Thought Series. Norwell, MA, Lancaster and Dordrecht: Kluwer Academic, 1988. Pp. xi, 274. $52.50. ISBN 0–89838–234–3. *JEL 88–0614*

Among the many criticisms of the neoclassical framework in economics, the complaint that it does not generate refutable hypotheses, and is therefore vacuous, is most easily rejected. A growing body of empirical data challenges key neoclassical theories. There are many labor market anomalies: large interindustry wage differentials persist, wages grow faster than productivity, and markets fail to clear. Researchers have documented violations of the life-cycle model of savings such as increases in saving following retirement, excessive consumption smoothing, and failures to offset discretionary savings by mandatory savings. The most basic predictions of bargaining theory have been called into question in experiments by Roth and in recent work on ultimatum games and sequential bargaining. The expected utility model, although still used in most analyses of decision making under uncertainty, has come under withering attack. Even the fundamental axioms of choice are challenged by such phenomena as large discrepancies between willingness to pay and willingness to accept compensation, systematic preference reversals, and self-binding behavior where people pay to limit their own future options. In financial markets, the setting which most closely approximates the ideal of perfect competition, anomalies abound, such as excess volatility of stock prices, mean reversion, and uneven distribution of returns over days of the week and parts of the month and year.

Many of these anomalies have been pointed out by psychologists or by economists influenced by psychology. These same scholars have also proposed explanations for the anomalies based on psychological research on information processing and human motivation.

The economist seeking an introduction to these developments, or an overview of the current state of psychological economics, will not find it in *Psychological Economics*. Its chapters touch on only a few of these phenomena, and no new theories are proposed to account for them. Instead, the book consists of a series of essays on the potential value of psychology for economics and the historical interplay between the two fields.

With notable exceptions, some of which are discussed below, the editor intentionally solicited articles from economists with little familiarity with psychology or its application to economics:

> I decided that it would be particularly instructive if I commissioned many of the chapters from economists whose normal areas of interest seemed to have an obvious interface with psychology which they had so far not tended to exploit. They would be invited to explore some of the unfamiliar literature . . . (p. 2)

The lack of familiarity with current psychology or its influence on economics is evident in many of the essays. Seven of the book's fifteen chapters discuss George Kelly's 1955 theory of "personal constructs" which, while a noteworthy contribution, does not occupy a central position in modern psychology. Other authors seem to view behavioral economics as synonymous with lexicographic choice rules, a view few behavioral economists would embrace. The authors informed about psychology and its applications to economics do offer significant contributions, but the new entrants to the field lack the expertise to evaluate either the potential for or status of current cross-fertilization.

Several chapters, particularly the historical ones, are thought provoking. For example, in light of the decisive rejection of introspectionism by 20th century psychologists, it is interesting to learn from Runde's informative chapter "Subjectivism, Psychology, and the Modern Austrians," of the Austrians' unambivalent advocacy of introspection as a source of core assumptions. On the negative side, I found unpersuasive Runde's prediction that modern Austrians, despite historic antagonism, will ultimately be forced by the logic of their own perspective to borrow from psychology.

Another important contribution is Mason's chapter on the economics of conspicuous consumption, which he defines as a positive dependence of demand on price. Mason traces the spotty history of economists' concern with conspicuous consumption and contrasts their perspective with the sharply divergent view of marketing researchers. The latter is of particular interest: it should disturb economists that their view of human behavior and motivation is so much at odds with those who make a living understanding it.

A third significant historical chapter, by Coats, reviews the turn of the century debate about the appropriate relationship between psychology and economics, and traces the subsequent banishment of psychology to the advent of the ordinal revolution. Coats argues, in my opinion convincingly, that the current surge in psychological economics is likely to be more influential and enduring than the last, both because the limitations of orthodox economics are more apparent, and because psychology has advanced considerably during the century.

Finally, Hey's provocative chapter "Prospects for Mathematical Psychological Economics" discusses the relationship between economic models and the information processing that underlies decision making. Economists typically assume that decision making is deterministic, but more complex (dependent on a larger number of variables) than depicted by economic models. Random error is assumed to result from the decision maker's response to variables not incorporated in an analysis. The desire to reduce random error fuels the development of increasingly sophisticated models (e.g., search models that assume the individual estimates higher order moments of the relevant distribution). An alternative interpretation of randomness, one supported by experimental studies of behavior cited by Hey, is that it arises from information processing limitations which prevent decision makers from optimally adjusting behavior in response to all potentially relevant variables. The implication is that advances in modeling decision making will come not from increasing the complexity of models, as is generally believed, but from developing simpler but more realistic models of decision making that recognize cognitive limitations.

Despite its limitations, the book has some refreshing characteristics, among which is the authors' diversity of opinion, as expressed in attacks and rejoinders between chapters. In "Psyching Up Economics" Cross concludes, "Perhaps economists have not traded more with psychology because of the limited gains in content to be had from the trade" (p. 65). Coats, in his essay, criticizes Cross' chapter "as a copybook example of the combination of methodological prejudices, misunderstandings, and unduly exacting demands that has discouraged many mainstream economists from collaborating effectively with psychologists" (p. 216). The work of Kahneman and Tversky on information processing, lauded by Rutherford as "outstanding" in Chapter 3, is summarily dismissed by Heijdra in Chapter 5 with the remark that "there is little . . . [in this work] that would strike a neoclassical economist as immediately impinging on his domain of research" (p. 69).

In sum, while not recommended (and perhaps not intended) as an introduction to the interplay between psychology and economics, several of the chapters may be of substantial interest to those already immersed in the area.

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020 GENERAL ECONOMIC THEORY

Foundations of the theory of general equilibrium. By YVES BALASKO. Economic Theory, Econometrics, and Mathematical Economics series. Boston, London, Sydney and Toronto: Harcourt Brace Jovanovich, Academic Press, 1988. Pp. xiii, 285. $39.95. ISBN 0–12–076975–1. *JEL 88–0631*

In an important paper written in 1970, Debreu used methods of differential topology to