

# Book Review

## Behavioural Economics and Experiments, by Ananish Chaudhuri

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### Book details

*Behavioural Economics and Experiments*  
Ananish Chaudhuri

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In his well-written and engaging book, *Behavioural Economics and Experiments*, Ananish Chaudhuri introduces the reader to much of what we know about how behavioural economic ideas affect individual decision-making, business decisions, and market dynamics. While the topic can get complex, the book is intended to allow those without a substantial background in economics to understand. In most parts of the book, this is accomplished, in part because of the plethora of examples presented and in part because of the lucid writing.

Basic concepts, relevant theories, and market applications are spread over fifteen chapters. As the various examples demonstrate how behavioral economics applies to many aspects of life, they attractively motivate discussion of concepts and theories. The research literature is discussed, but thankfully the discussion does not bog down the reader. Rather, it gives the reader opportunity to become familiar with the evolution of behavioral and experiment economics.

Chapter 1 of the book is entitled, "How we decide." In it, Chaudhuri presents a useful discussion of how economists and psychologists approach decision making differently. Economists typically assume we humans are rational, meaning we calculate the benefits and costs in an effort to maximize well-being. Psychologists, alternatively, tend to recognize that we have limits to our cognitive abilities. They also recognize emotions often play a role in our decision making. Using the guessing game, Chaudhuri illustrates the usefulness of infusing psychology into economics. The reasoning associated with the economics approach is often superior to a choice motivated by emotion, but emotional input can facilitate reason in some contexts. As economics has become more behavioral

by blending the tools of economics and psychology, it has been enriched because decision making has become more fully understood.

Chapter 2 focuses on experimental economics and how it complements the objectives of behavioural economics. Chaudhuri explains why studying the decisions of suitably motivated individuals in the lab can help develop and test theories. Differences between economists and psychologists in conducting the experiments are discussed, as are the criticisms of experimental economics. In spite of the criticism, Chaudhuri notes that using incentivized decision-making experiments to understand human behavior, which was once mostly limited to psychology, has become standard in economics.

Chapter 3 discusses how we humans have different ways of responding when faced with decisions and how those differences can create systematic decision bias. System 1 thinking does not involve much thinking. It describes rather automated response to stimulus decisions that often result from decision heuristics. System 2 thinking is deliberate and effortful and is especially useful in certain situations. Because effective decision makers use heuristics to economize on decision resources, decision making can be biased by a number of factors, including priming, framing, anchoring, hindsight bias and present bias.

Chapter 4 discusses expected utility theory and its weaknesses, and Chapter 5 discusses probability specifically. The St Petersburg Paradox is presented as a useful example. The ability of prospect theory to explain expected utility theory anomalies is well presented. The reader is exposed to important concepts of loss aversion, mental accounting and the

endowment effect. Interesting applications of system 1 versus system 2 thinking are used to examine applications where outcomes are uncertain. A particularly interesting example is the use of the film '*12 Angry Men*' in which a juvenile boy stands accused of killing his father and jurors must decide whether the boy is guilty or not.

Chapter 6 focuses on strategic thinking, doing so by providing an introduction to game theory. The Prisoners' Dilemma is presented as an important example, but many fundamental game theory concepts are introduced and well-illustrated. The difference between a simultaneous and sequential game is explained. The reader receives clear descriptions of dominant strategy, backward induction, and Nash equilibrium.

Chapters 7 and 8 focus upon the ultimatum game and its market implications. Bargaining is ubiquitous and often ends with a take-it-or-leave-it offer, an ultimatum. Citing the results of various experiments, Chaudhuri notes that a primary finding is that people tend to care about the fairness of outcomes, in addition to maximizing their own outcome. People also care about intentions. Experiments have demonstrated that a variety of factors, including punishment, fear and embarrassment can move people away from the most self-serving bargaining offer toward a fairer offer. Moving from the lab to reality, Chaudhuri usefully explains that the desire for fairness identified in experiments probably translates into fairness norms that constrain the day-to-day pricing decisions of producers so profit-making is not entirely unfettered.

Trust and trustworthiness in everyday life and in markets is discussed in chapters 9 and 10. An example of trust game is used to explain how trust and reciprocity can impact economic transactions. The trust game illustrates that the expectation of reciprocation is a motivator in addition to material self-interest. Reciprocity not only can support trust, but also it can support productive cooperation. Chaudhuri reviews "gift exchange" theory and uses it to explain why paying higher wages may be beneficial to the employer. (Knowing the higher wage is a gift that other employers do not provide, the employee is motivated to reciprocate and provide work effort other workers do not provide.) Similar reasoning explains why avoiding pay-cuts in a recession are probably not wise. (The blow to morale leads employees to reciprocate with less work effort.) Thus, an incomplete "trust contract" may be preferable to a complete "incentive contract." Appealing to the worker's sense of fair play and civic mindedness may motivate productivity more so than dollars.

Chapters 11-13 cover cooperation in social dilemmas and resolving cooperation failures in organizations. The public goods game is a focal point. A general finding is that most people are conditional cooperators. They increase their contributions with an increase in the average contribution for the group. Experiments demonstrate cooperation can be sustained by punishments for free riding, and there is discussion of how the efficacy of such punishments is impacted by non-punitive mechanisms. The impact of beliefs on outcomes is discussed. In particular, creating optimistic beliefs regarding the actions

of one's peer, while perhaps easier said than done, is one way to enhance cooperation.

The book concludes with chapters 14 and 15 focus on how markets work. Many basic standard market concepts are covered, but then some behavioral challenges to the conventional workings of markets are presented. Of particular interest is the discussion of the role cognitive biases can play in the creation of asset bubbles in financial markets. The discussion offers some ideas for how we can prevent the creation of asset bubbles that cause damage when they burst.

While one could always nitpick and point out ideas that have been left out or subtleties that have not been discussed, it is difficult to identify any major problem with the content of this book. It is a fine introduction to the current state of behavioral economics. The most significant fault for us as we read the book is the exceptionally small font. The nice graphics and coloured pictures are good publications features, but the small font tires the eyes quickly.

In summary, we highly recommend this book to all who want exposure to behavioral economics. The book provides a wonderful broad brush, and readers interested in diving deeper will find the list of references valuable.