Book Review for 01/19/03 by James H. Murphy

Title: "The Winner's Curse: Paradoxes and Anomalies of Economic Life"
Author: Richard H. Thaler
Publisher: Princeton University Press
Length: 230 pages
Price: $18.95
Reading time: 10 hours
Reading rate: 5 (1 = very difficult; 10 = very easy)
Overall rating: 4 (1 = average; 4 = outstanding)

Recently, Vernon Smith and Daniel Kahneman received Nobel Prizes for Economics. As the father of experimental economics (the application of experiments to economic questions), many economists considered Smith's award long overdue. Kahneman is a more intriguing Nobel Laureate. He is not an economist by training; rather, he is a cognitive psychologist who has spent a significant portion of his career critiquing economists' theories. In reconciling these critiques with the empirical evidence, Kahneman and his colleagues have created a new branch of economics, behavioral economics. Richard Thaler, a collaborator of Kahneman's, has compiled "The Winner's Curse," a collection of articles spanning a number of topics in behavioral economics.

The book is divided into 15 chapters, which include 13 papers on economic anomalies in addition to an introduction and epilogue. An anomaly is "a fact or observation that is inconsistent with the [economic] theory" (p. 2). Thaler's approach is to describe the apparent inconsistency, then incorporate ideas from psychology, sociology or anthropology to explain the seeming inconsistency, and, finally, draw some analytical or policy conclusions.

The result can be both timely and powerful. For example, Chapter Nine ("Savings, Fungibility, and Mental Accounts") discusses contradictions of the prevalent macroeconomic theory of consumption, the life-cycle theory. The life-cycle theory holds that individuals lump together the present value of all their assets (which could include cash, future income, pension benefits, or other tangible or financial assets like homes or stocks). Yearly consumption is the annual return from an annuity purchased with this lumped asset sum spread over the individual's expected life span. The model predicts if an individual receives an unexpected $1,000 in cash, this is thrown into the lumped sum and apportioned over the entirety of the consumer's life span. Thus, for an individual with a long life expectancy, the increase in consumption in the year the $1,000 is received would be relatively small.

Unfortunately, these predictions don't square with observed behavior. A small, cash increase in wealth (for example, $10 found on the sidewalk) might be devoted exclusively to consumption; meanwhile, a large increase in wealth (for example, a large tax refund) might be invested rather than consumed. Thaler explains this contradiction of the life-cycle theory using the notion of 'mental accounts', where the type of wealth largely determines the use of the proceeds. Most importantly in explaining the anomaly, the different accounts are not readily substitutable as the life-cycle theory would suggest. An increase in pension benefits does not necessarily lead to an increase in consumption today.

This controversy directly impacts the current debate over the specifics of a stimulus package. To be effective, consumption spending (which accounts for two-thirds of gross domestic product) must be stimulated. If the life-cycle theory holds, any increase in wealth, no matter its source, will increase consumption, albeit at a reduced level (the consumer apportions this incremental wealth over his entire life span's consumption). However, if the mental accounts approach is correct and the stimulus package is aimed at wealth sources that consumers do not target for current consumption, then little economic stimulus will result.

Thaler also discusses economic paradoxes concerning the stock market, auctions, and individual contributions to public goods (such as public radio or TV pledge drives). In each case his style is straight forward, but a familiarity with college economics is a useful, but not essential, tool in grasping the book's finer points.

James H. Murphy is an Assistant Professor of Economics in the College of Business at Western Carolina University. His research interests include microeconomics, behavioral economics, and environmental economics.