

Economic Psychology: An Introduction

Economic Psychology is the only up-to-date, English-language textbook that provides a comprehensive overview of theoretical topics in economic psychology and their relevance in applied fields. Written by two leading psychologists, the book looks at how people make decisions on the use of scarce resources, in particular money, from a psychological perspective. Starting with decision-making and lay theories as basic building blocks of economic behaviour, the authors go on to explore three major markets where economic behaviour occurs as an interaction between individuals and companies or institutions – consumer markets, labour markets and financial markets – before considering the challenges of collective cooperation and economic prosperity. Featuring numerous applied examples throughout, each chapter also includes an overview, a summary, figures, key terms, student questions and suggestions for further reading. This introduction is an essential resource for advanced undergraduate and postgraduate courses on economic psychology, behavioural economics and social psychology.

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PREFACE

The purpose of this book is to give an introduction to economic psychology. We are confident that the book will stimulate further interest in an emerging interdisciplinary field of research and application.

Economic psychology builds bridges between the disciplines of economics and psychology. Based on their common research focus on human behaviour, both economists and psychologists early on showed an interest in each other's fields. However, both disciplines developed their own 'languages', their specific research paradigms and methodological toolboxes, hence conducting separate research on similar topics. In the past decades, economic psychology has gained significant momentum, especially with the recognition of the research by Daniel Kahneman and Amos Tversky by the Nobel Prize Committee in 2002. At the latest since then, research in economic psychology and behavioural economics has significantly increased. It has gained visibility and relevance both in scientific discussions and in the applied fields. Specifically, economic psychology has been recognised in institutions regulating human behaviour, in applied economics, law and politics. We present an introduction to the theoretical topics of economic psychology and their relevance in applied fields.

We cover questions about how people decide over the use of scarce resources, in particular money, from a psychological perspective. After giving an overview of the field, we start out with three chapters discussing the basic building blocks of economic behaviour: decision-making from a normative and a descriptive perspective as well as lay theories. We then move on to three chapters addressing the major markets on which economic behaviour occurs as an interaction between individuals and companies or institutions: consumer markets, labour markets and financial markets. We close with three chapters focusing on society-level topics: collective cooperation, collective production and collective prosperity.

In Chapter 1, we present economic and psychological approaches towards the study of human behaviour. We also give an overview of the history and the current fields of economic psychology that we use as the guiding structure of this book.

In Chapter 2, we present normative decision-making theories, starting out with classical decision theory and empirical studies on its predictions. We give an overview on decision anomalies that arise from information processing, emotions, time and heuristics.

In Chapter 3, we present descriptive decision-making theories. First, prospect theory as a highly influential approach that can explain several systematic deviations from rationality in people's decisions is addressed. We move on to descriptive models of individual, organisational and political decisions. Finally, we discuss nudging as a strategy to regulate citizens' behaviour.

In Chapter 4, we present lay theories about economic concepts. Laypeople often have a different view from experts, and build their actions on these views. We discuss that economic knowledge, motives and behaviour develop with age, but that even adults often have limited financial literacy. We close with subjective views on money that become particularly apparent in currency reforms and in the perception of prices.

In Chapter 5, we present selected processes on consumer markets. We first cover purchase decisions by individual consumers and discuss models explaining these decisions. We move on to purchase decisions in private households, focusing on the specific challenges in these settings.

Finally, we discuss credit decisions of individuals and households, as nowadays more and more purchases involve the borrowing of money.

In Chapter 6, we present selected processes on labour markets. We start with the notion that labour markets can be viewed as an interplay of supply and demand for work power and that specific aspects of labour markets can be studied experimentally. We further discuss wages as a motivating factor as well as perceptions of wage fairness. Finally, we review entrepreneurship including relevant determinants in founding one's own company.

In Chapter 7, we present selected processes on financial markets. We discuss economic and psychological perspectives on the stock market and some common errors and biases that occur. We present findings on over- and under-reaction to news and the disposition effect. Investor decisions are influenced by heuristics, emotions and social processes. Finally, we discuss the role of trust in financial institutions.

In Chapter 8, we present collective cooperation as the question of how individuals cooperate within a large-scale economic system such as a nation. We start with a view on the shadow economy, in particular tax evasion, and move on to findings on attitudes towards taxes and on tax behaviour in general. We then present different approaches relevant in the understanding of tax behaviour and tax evasion. Finally, we discuss how the interaction climate between taxpayers and tax authorities shapes cooperation.

In Chapter 9, we present collective production as another aspect of how individuals interact within large-scale economic systems. We discuss how the meaning of work has changed over time and introduce current views on work and leisure. We present findings on unemployment, in particular psychosocial consequences and the differential impact of unemployment.

In Chapter 10, we discuss collective prosperity and the questions surrounding the connection between wealth and happiness. We start with conceptual considerations of life satisfaction, well-being and happiness. We move on to findings on the association between these concepts on the individual level and on the aggregated level within a nation. Finally, we discuss the role of economic prosperity, as for example measured by the Gross Domestic Product, regarding the happiness of citizens within a nation.

We have written this book based on our enthusiasm for the field of economic psychology, in both research and teaching. With colleagues from psychology and economics, we have ourselves published on many of the topics covered in this book. We are committed members of the International Association for Research in Economic Psychology (IAREP) and regular participants of its conferences, as well as being editors of the *Journal of Economic Psychology* (2010–15). We have taught courses in economic psychology since 1982 (Erich Kirchler) and 1996 (Erik Hoelzl) in various settings – most prominently at the universities of Vienna and Linz, Austria, and Cologne, Germany. This book builds on a successful German-language textbook by Erich Kirchler that is now in its fourth edition.

Our students only partly come with a psychology background – some have never had any psychology courses before. Therefore, our goal was to make the field accessible for non-psychologists, while at the same time providing a state-of-the-art overview. The specific features of this book are the following:

- Textbooks in economic psychology have a long tradition, but the more influential English-language textbooks now date back some decades. There are current textbooks, but those are – to our knowledge – all edited books by several contributors, whereas this book comes ‘all of a piece’. We believe that our long research and teaching experience enables us to give a comprehensive

overview that ensures the linkage between theories and applications. This helps students to see the connections in a large and ever-growing field.

- We provide explanations of basic theories from social psychology, general psychology or developmental psychology as well as economics to ensure a comprehensive understanding of the thematic empirical findings.
- We provide examples and explanations of several empirical approaches in economic psychology, such as experiments (with individuals or groups), experimental markets, economic games, surveys, diary methods or analysis of spontaneous associations.
- We provide extensive and detailed references to sources, covering both classical works and recent developments, to enable students to pursue the topics in more detail.
- We start each chapter with an overview and close with a summary linking back to the overview to help students in their acquisition of a general framework for the topics presented.
- At the end of each chapter, we provide questions that allow students to check their understanding of concepts and their learning progress.
- We provide further readings at the end of each chapter, which in many cases include recent books written for a general audience.

This book is written for scholars across various disciplines, for students at different stages of their education, for practitioners interested in economic psychology and behavioural economics, for journalists and policy advisors, and for the general public with or without psychology background. It can be used for bachelor-level or master-level courses in business administration (marketing, consumer behaviour, finance or corporate development), economics (microeconomics, behavioural economics), social sciences (sociology, political science) and psychology, where students should get a basic knowledge about the foundations of economic psychology. Practitioners can benefit from insights in consumer decisions, investment decisions or taxpaying decisions.

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This textbook on economic psychology originated from initiatives taken by Cambridge University Press, especially from Hetty Marx in her role as commissioning editor for psychology. She encouraged us to collect our experiences as joint editors of the *Journal of Economic Psychology* from 2010 to 2015 and suggested we review economic psychological knowledge for the English-language market, starting with the collection published in the German-language volume *Wirtschaftspsychologie: Individuen, Gruppen, Märkte, Staat* by the publishing house Hogrefe in Göttingen, Germany. We analysed the contents of the *Journal of Economic Psychology*, categorised them, and developed a content structure for this book. Many of our colleagues and students helped in reorganising, selecting and updating the contents in the German textbook, corrected the text, added new literature and insights, and commented on weaknesses and shortcomings. They inspired us in many discussions about economic psychological topics: many thanks to Sebastian Beer, Michael Blens, Martina Brandtner, Linda Dezsö, Janina Enachescu, Barbara Hartl, Marc Heise, Eva Hofmann, Tobias Kapferer, Matthias Kasper, Christoph Kogler, Michail Kokkoris, Gregor Kracke, Stephan Muehlbacher, Jerome Olsen, Richard Schlicht, Jennifer Stark, Raik Thiele and Laura Winter. Without their efforts, we would not have been able to write and complete this book. We are most grateful to Elisabeth Dorfinger who with great patience drew the figures, checked the tables and completed the references list. We thank Keri Hartman for translating parts of the text from German and improving the English parts. We also thank Rosemary Crawley, Frances Brown and Maree Williams-Smith from Cambridge University Press for their support in the production of the book.

Erich Kirchler and Erik Hoelzl