



ECONOMIC PSYCHOLOGY

AN INTRODUCTION

Erich Kirchler and Erik Hoelzl

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. This introduction is an essential resource for advanced undergraduate and postgraduate courses on economic psychology, behavioural economics and social psychology.

FEATURES

- Chapter overviews and summaries.
- Questions and suggestions for further reading.
- Glossary of key terms.
- Numerous examples throughout.
- Avoids complex mathematical formulae.

Erich Kirchler is Professor of Economic Psychology at the Faculty of Psychology, University of Vienna, Austria.

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"A valuable resource for all students and researchers in the fields of economic psychology, behavioural economics and social psychology."

Ernst Fehr, *University of Zurich*

"From two intellectual heavyweights in economic psychology ... it is a must-read for everybody in the profession."

Martin Kocher, *University of Munich*

"A splendid, accessible and up-to-date resource for advanced undergraduates and postgraduates."

Alan Lewis, *University of Bath*

"An excellent book ... one of the best introductions to economic psychology in the English language."

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and Hoelzl

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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.

Erich Kirchler is Professor of Economic Psychology at the Faculty of Psychology, University of Vienna, Austria. He is the author of many papers in edited collections and journals and of *Conflict and decision making in close relationships* (2001) and *The economic psychology of tax behaviour* (2007), and was co-editor of the *Journal of Economic Psychology*, with Erik Hoelzl.

Erik Hoelzl is Professor of Economic and Social Psychology at the Faculty of Management, Economics and Social Sciences, University of Cologne, Germany. He has published many papers in edited collections and journals, for example in the *Journal of Applied Social Psychology*, the *International Journal of Psychology* and the *Journal of Applied Psychology*.

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.

ACKNOWLEDGMENTS

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

CONTENTS

List of Figures	page x
List of Tables	xiii
Preface	xv
Acknowledgments	xviii
1 Economic Psychology: History and Application	1
Overview	1
Introduction	2
1.1 Markets	2
1.2 Economics and Psychology	6
1.3 Economic Psychology	14
1.4 Topic Areas within Economic Psychology	19
Conclusion	23
Summary	24
Questions	24
Further Reading	25
2 Decision-Making: Normative Models and Anomalies	26
Overview	26
Introduction	26
2.1 Decisions under Uncertainty	27
2.1.1 Certainty, Risk and Ambiguity	28
2.1.2 Classical Decision Theory	30
2.1.3 Economic Games	31
2.1.3.1 Ultimatum and Dictator Game	31
2.1.3.2 Prisoner's Dilemma	32
2.2 Decision Anomalies	34
2.2.1 Information Processing	36
2.2.1.1 Problems in Information Processing	36
2.2.1.2 Information Processing Paths	38
2.2.2 Emotions	42
2.2.3 Time	44
2.2.3.1 Delayed Gratification	44
2.2.3.2 Time Preferences and Discounting	45
2.2.3.3 Distributed Choices: Melioration	45
2.2.3.4 Distorted Memories	49
2.2.4 Heuristics	52
2.2.4.1 Availability Heuristic	52
2.2.4.2 Representativeness Heuristic	54
2.2.4.3 Anchoring and Adjustment Heuristic	56

2.2.4.4 Affect Heuristic	57
2.2.4.5 Fast and Frugal Heuristics	59
Conclusion	60
Summary	61
Questions	61
Further Reading	62
3 Decision-Making: Descriptive Models and Choice Architecture	63
Overview	63
Introduction	63
3.1 Prospect Theory	64
3.1.1 Endowment Effect	70
3.1.2 Sunk Cost Effect	72
3.1.3 Mental Accounting and Hedonic Editing	74
3.2 Descriptive Decision Models	76
3.2.1 Individual Decisions	76
3.2.2 Decisions in Organisations and in Politics	78
3.3 Designing Decision Architectures	80
3.3.1 Logic of Successful Decisions	81
3.3.2 Nudging towards Desirable Behaviour	84
Conclusion	90
Summary	91
Questions	92
Further Reading	92
4 Lay Theories: Knowledge and Money	93
Overview	93
Introduction	93
4.1 Lay Theories	94
4.1.1 Theory of Social Representations	94
4.1.2 Social Representations about the Economic System	97
4.1.3 Social Representations about Poverty and Unemployment	99
4.1.4 Social Representations about Money and Currency	102
4.2 Economic Knowledge	103
4.2.1 Development of Economic Understanding	103
4.2.2 Development of Economic Motives	107
4.2.3 Development of Economic Behaviour	108
4.2.4 Financial Literacy	111
4.3 Money	113
4.3.1 Subjective Meanings of Money	113
4.3.2 Subjective Value of Money	115
4.3.3 Currency Reforms and Currency Changeovers	118
4.3.3.1 Lay Beliefs and Representations about a Currency Changeover	119
4.3.3.2 New Money and New Prices	121
4.3.4 Subjective Interpretation of Prices	127

4.3.4.1 Price and Quality	127
4.3.4.2 Price Perception	130
Conclusion	131
Summary	132
Questions	132
Further Reading	133
5 Consumer Markets: Purchasing and Credit Use	134
Overview	134
Introduction	135
5.1 Purchase Decisions by Individual Consumers	135
5.1.1 Typologies of Purchase Decisions	135
5.1.2 Stage and Process Models of Purchase Decisions	137
5.1.3 Goals and Motives in Purchase Decisions	140
5.2 Purchase Decisions in Private Households	142
5.2.1 Models for Describing Purchase Decisions in the Household	144
5.2.2 Methods of Studying Purchase Decisions in the Household	147
5.2.3 Influence Distribution between Spouses	151
5.2.4 Process Analysis of Decisions in the Household	160
5.2.5 Outcomes of Decisions: Fairness and Satisfaction	160
5.3 Credit Decisions of Individuals and Households	164
5.3.1 Credit Use as a Process	166
5.3.2 Mental Accounting in Credit Use	169
Conclusion	172
Summary	173
Questions	173
Further Reading	174
6 Labour Markets: Wages and Entrepreneurship	175
Overview	175
Introduction	175
6.1 Supply and Demand for Labour	175
6.1.1 Experimental Economics and Game Theory	178
6.1.2 Labour Market Experiments	181
6.1.3 Reciprocity on the Labour Market	185
6.2 Wages	192
6.2.1 Wages and Motivation	193
6.2.2 Wage Fairness	196
6.3 Entrepreneurship	199
6.3.1 Characteristics of Entrepreneurs	200
6.3.2 Founding a Company	204
6.3.3 Gender Differences in Entrepreneurship	208
Conclusion	213
Summary	215
Questions	215
Further Reading	216

7	Financial Markets: Risk and Investment	217
	Overview	217
	Introduction	217
	7.1 The Exchange	218
	7.1.1 Economic Perspectives on the Exchange	218
	7.1.2 Psychological Perspectives on the Exchange	219
	7.1.3 Investors' Mistakes	222
	7.2 Over- and Under-reactions to News	224
	7.3 Disposition Effect	228
	7.4 Heuristics	231
	7.4.1 Representativeness Heuristic and Anchoring and Adjustment Heuristic	231
	7.4.2 Recognition Heuristic	232
	7.4.3 Heuristic Risk Diversification	233
	7.5 Emotions	234
	7.6 Social Influences	235
	7.7 Trust in Financial Institutions	240
	Conclusion	241
	Summary	243
	Questions	243
	Further Reading	244
8	Collective Cooperation: Shadow Economy and Tax Paying	245
	Overview	245
	Introduction	246
	8.1 In the Shadow of the Official Economy	246
	8.2 Taxes and Contributions	249
	8.3 Attitudes towards Taxes	257
	8.4 Tax Behaviour: Definitions, Relevant Actors and Research Methods	261
	8.4.1 Definitions of Tax Behaviour	261
	8.4.2 Actors in the Field	263
	8.4.3 Research Methods	264
	8.5 Paradigms of Tax Behaviour Research	268
	8.5.1 Decisions under Risk	269
	8.5.2 The Social Contribution Dilemma	271
	8.5.3 Differences among Taxpayers	273
	8.5.4 The 'Psychological Contract'	275
	8.5.5 Interaction Climate	277
	8.6 Synergistic versus Antagonistic Climates: Recommended Practice	281
	Conclusion	282
	Summary	283
	Questions	284
	Further Reading	284

9	Collective Production: Work and Unemployment	285
	Overview	285
	Introduction	285
	9.1 Work	285
	9.1.1 Historical Changes in the Meaning of Work	286
	9.1.2 The Structure of Work	288
	9.1.3 Work and Leisure	291
	9.2 Unemployment	293
	9.2.1 Psychosocial Consequences of Unemployment	294
	9.2.2 Differential Impact of Unemployment	300
	9.2.2.1 Length of Unemployment	300
	9.2.2.2 Subjective Importance of Work	302
	9.2.2.3 Subjective Causes of Unemployment	303
	9.2.2.4 Personality Characteristics	305
	9.2.2.5 Socio-demographic Characteristics	305
	9.2.2.6 Personal Activities	307
	9.2.2.7 Experience with Unemployment	307
	9.2.2.8 Social, Emotional and Informational Support	308
	9.2.3 Determinants of Re-employment	308
	Conclusion	309
	Summary	310
	Questions	310
	Further Reading	310
10	Collective Prosperity: Wealth and Happiness	311
	Overview	311
	Introduction	312
	10.1 Life Satisfaction	312
	10.2 Definitions of Well-being, Happiness, Satisfaction and Quality of Life	313
	10.3 Measuring Satisfaction	316
	10.4 National and Subjective Life Satisfaction	321
	10.5 Life Satisfaction and Gross Domestic Product	328
	Conclusion	337
	Summary	338
	Questions	338
	Further Reading	339
	Key Terms	340
	References	350
	Index	389

FIGURES

1.1 Planning in the market economy	page 3
1.2 Interactions between various stimulus variables and the economic context	4
1.3 United States Consumer Sentiment Index (1952–2016, yearly average)	5
1.4 UK Consumer Confidence Index and retail sales (2004–11)	6
1.5 Production possibilities curve	9
1.6 Relationships between individual and collective behaviour patterns	13
1.7 Model of economic-psychological research topics	20
2.1 Generally formulated payoff matrix in the prisoner's dilemma	33
2.2 Optical illusions	36
2.3 Puzzles	37
2.4 Hypothetical time progression of predicted and experienced emotions	43
2.5 Value of pizza and sandwich lunches as a function of the last ten consumption decisions	47
2.6 Conception and results of Herrnstein's Harvard game	48
2.7 Hindsight bias as a function of time, information on economic developments and actual economic developments that did or did not occur after the introduction of the euro in 1999	51
2.8 Estimated and Correct values	55
2.9 Average price participants are willing to pay to avoid a fine of US\$ 20 or an electric shock, respectively	58
3.1 Value function with a linear relationship between objective and subjective values	67
3.2 Value function with satiation effects in the relationship between objective and subjective values	68
3.3 Value function according to prospect theory. Daniel Kahneman; Amos Tversky, Prospect Theory: An Analysis of Decision under Risk, Econometrica, Vol. 47, No. 2. (Mar., 1979), pp. 263–292. Printed with permission of The Econometric Society.	68
3.4 Weighting function in prospect theory. Daniel Kahneman; Amos Tversky, Prospect Theory: An Analysis of Decision under Risk, Econometrica, Vol. 47, No. 2. (Mar., 1979), pp. 263–292. Printed with permission of The Econometric Society.	69
3.5 Mediofrontal activity following feedback on the accuracy of a choice and the direction of the result	71
3.6 Hedonic separation of gains and integration of losses	76
3.7 Decision model for the satisficing principle	77
3.8 Decision model following the principle of an implicit favourite alternative	78
3.9 RAWFS model for dealing with uncertainty	83
4.1 Sociogenesis of social representations	96
4.2 Part of the 'composite cognitive model of the economy'	98
4.3 Conceptual network of associations	103
4.4 Relative frequency of egalitarian choices in three games	108