Book Reviews

Richard H. Thaler: The Winner's Curse. New York: Free Press, 1991. ISBN 0-02-932465-3. 230 pp., USD 22.95.

The Winner's Curse is the name of an anomaly of economic theory regarding bidders' behaviour at auctions. The theory implies that if there are many bidders, one should bid less aggressively because the probability that the winning bid is higher than the value of the item auctioned increases. Empirical research has shown that the bids frequently exceed the theoretical predictions, and in that case the winner is cursed.

The author defines an anomaly as a fact or observation that is inconsistent with theory (p. 2). The book describes 13 of these anomalies, published separately in the *Journal of Economic Perspectives* during 1987 to 1991. According to the author, these problems belong to the field of behavioural economics: "(. . .) a combination of cognitive psychology and microeconomics" (p. 62). Hence, beside the fact that the anomalies are interesting in themselves, they give an impression of this interesting scientific discipline. Obviously, behavioural economics covers a wider range of problems than those considered in this book.

Three of the anomalies deal with game theoretic issues: The winner's curse, ultimatum bargaining, and cooperation. Ultimatum bargaining refers to the experimental task of dividing an amount of money between oneself and another individual. Typically, the allocator proposes a distribution of the money which can either be accepted or rejected by the other. If it is rejected, both get nothing. The game theoretic prediction is that the allocator offers a very small amount to the other and keeps the rest for her/himself. The other should accept any amount greater than zero. However, empirical research has shown that many allocators even offer a 50–50 split and many 'others' refuse small amounts allocated to them. The author partly explains this behaviour by a taste for fairness. In my opinion, subjective expected utility models including perceived probabilities of the other's behaviour may provide an alternative explanation. Furthermore, the allocator may also value the utility of the other (altruism).

Cooperation deals with altruistic behaviour in the prisoner's

dilemma game. I was not surprised by the fact that not all people are free-riders, even if they play against strangers. An interesting observation is that players who use the game theoretic strategy obtain less pay-off than those who use Rapoport's tit-for-tat strategy. Also, in ultimatum bargaining experiments, the game theoretic strategy does not earn the highest pay-off. Clearly, economic theory does not do a good job here. It appears that new models explaining this type of behaviour are needed. Another interesting observation is that the behaviour in ultimatum games does not alter if the pay-offs are increased.

Two other anomalies deal with economic assumptions: Preference reversals and the endowment effect. Preference reversals occur when people evaluate two bets: a high chance of winning a small prize (H bet) and a lower chance of winning a larger prize (L bet). If they are asked to choose, they prefer the H bet. After ruling out other explanations, the author suggests that compatibility of the stimulus (the bets) and the response (either valuation or choice) may explain this behaviour. In valuation, people tend to give more weight to the prize, whereas in making a choice they tend to give more weight to the probability of winning. The author makes an interesting application of this idea to the valuation and choices regarding intertemporal prospects.

The endowment effect deals with inconsistencies in the valuation of an item to be obtained, e.g., a bottle of wine, and the valuation of giving it up. Economic theory assumes that the value is the same in both cases but empirical research shows that the pain of giving it up is greater than the pleasure of obtaining it. The author explains this effect by proposing a value function, differing from the utility function in its location and shape. An interesting implication of the effect is a preference for the status quo. In my opinion, the process of endowment is related to the psychological theory of cognitive dissonance which assumes that people adapt their cognitions to the facts. Once an item has been obtained, people find arguments favouring the item and arguments not favouring alternatives. The process of endowment is not considered in the book, however.

Two chapters deal with the process of saving: Intertemporal choice and savings, fungibility, and mental accounts. Economic theory assumes that the process of discounting future amounts is independent of the sign and the size of the amount and the length of the time period. However, empirical research shows that this is not the case. This raises

the question of which discount rate is the true one – which is not answered. An interesting finding is that people tend to prefer an increasing flow of utility, e.g., they prefer an increasing income stream to a constant or a decreasing income. This seems to be inconsistent with the life-cycle theory of savings, too.

Other violations of the life-cycle theory of savings are described. Basically they are explained from the assumption that there are different mental accounts: an income checking account, an assets account, and a future income account. Contrary to economic assumptions, the marginal propensity to consume from these accounts is different. Whether these accounts really exist psychologically remains an open question.

Four chapters deal with anomalies in financial economics: Calendar effects in the stock market, mean reversions in stock prices, closed-end mutual funds, and foreign exchange. Economic theory assumes that stock prices are not related to past events. However, stock prices turn out to be related to the time of the year (in January, stock prices increase), the time of the month (on Mondays, stock prices decrease), holidays (the day before holidays, stock prices increase), and the time of the day (in the first 45 minutes after opening of the market, stock prices increase, except on Mondays). Although the effects are significant, they are too small to be profitable. These effects are not only found in historical analyses of the NYSE, but also in experimental stock markets.

Mean reversions have been found regarding stocks in loser portfolios (they tend to increase) and in winner portfolios (they tend to decrease). The author suggests some explanation by assuming faulty risk perceptions in parts of the investor population. It would be worthwhile studying risk perception of investors empirically to test this assumption.

Economic theory assumes that the price of a security equals the intrinsic value. However, the stock prices of closed-end funds appear to be significantly lower on average than the intrinsic value. Neither agency costs (management fees) nor restrictions on the stocks in the fund's portfolio can account for the deviation from the intrinsic value. A possible solution to the problem is the assumption of two different type of investors: rational investors, and noise traders whose decisions are partly irrational. The noise traders buy the shares when they are optimistic, and sell when they are pessimistic (for some reason). The rational investors only buy the shares at a discount because they

want to be compensated for the risk associated with the noise trader's behaviour. I like this type of explanation, and an empirical study of investor sentiment would be worthwhile in this respect.

Economic theory assumes that an interest differential between two countries leads to a devaluation of the currency with the highest interest rate. However, systematic deviations from this assumption have been found, and according to the author no satisfactory explanation for the results are provided by the rational efficient markets paradigm.

Two chapters contain miscellaneous issues: Wage differentials, and betting at racetracks and lottery games. Economics assumes one price for similar goods sold at different places (apart from transaction and transportation costs). However, wages for similar jobs in different industries are found to be consistently different. For example, in the mining, petroleum, and car industries, wages are substantially above average, whereas in the leather industries and educational services they are substantially lower. Furthermore, large firms tend to pay more than small firms. No satisfactory explanation seems to be available. The author points to the lack of empirical information regarding the process of wage allocation. Personally I am surprised that economists do not simply ask employers why they pay the wages they do.

The chapter on betting at racetracks and lottery games is exciting. It seems really possible to make profits in these events, although one should invest a fortune and be prepared to wait indefinitely for satisfactory results.

It appears that many facts do not fit economic theory. In my opinion, this even casts doubt on the theories that seem to fit the facts. How can we be sure that economic theory really explains economic life? In all of the chapters, each of which gives a concise overview of a problem area, effort is made to show the existence of the anomalies rather than to develop models to cope with them. Furthermore, alternative explanations are derived primarily from the rational economic model without attempts to include insights from other disciplines. In my opinion, knowledge of psychological processes could be used to make economic models more realistic. However, the author seems to have an eye for the human way of reasoning, frequently considered irrational by economic theory.

Personally, I enjoyed reading the book. Its style is precise and concise, it provides insights without using mathematical formulae, and

it covers a wide range of problems. It does not contain a list of other possible anomalies, although they should exist. For example, why are people not always happier when they have more income, why do some people like risk even when not compensated, why are prices not always related to quality, or why is so much money spent on advertising when preferences are assumed to be stable?

In his epilogue, the author states that theoretical changes (concerning the financial market) are to be expected from behavioural economists, not from psychologists or sociologists because the latter have yet to propose a behavioural alternative to the capital asset pricing model. Since I expect more from an integration of models than from alternatives, I do not share this idea. Rather, psychologists and sociologists should learn to understand economic theories, and economists should learn from the other social sciences and be less reluctant to accept the value of experimental research and interview methods. This should clear the way for interdisciplinary research which could lead to a better understanding and prediction of economic behaviour.

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Thomas Wilhelmsson: Critical studies in private law: A treatise on need-rational principles in modern law. Dordrecht/Boston/London: Kluwer, 1992. ISBN 0-7923-1659-2. 255 pp., NLG 165.00, USD 98.00, GBP 57.00.

Perhaps the most important innovation in the State and law in the twentieth century has been the creation of institutions and rules governing the operation of the Welfare State. Both in its social effects and in the role of government, the Welfare State marks a significant change. But has the advent of the Welfare State compelled a corresponding adjustment to the basic doctrinal principles of the law? In particular, how has it affected, if at all, the basic principles of private law such as tort, contract, and property law? Thomas Wilhelmsson, an outstanding Finnish scholar, addresses these puzzling and interesting questions in one of the most fascinating books about private law which I have ever read.

Leaving out all the subtleties and rigour of Wilhelmsson's analysis, his central thesis consists of the claim that the values underlying the Welfare State have affected the basic doctrines of private law. The

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values which he associates with the Welfare State concentrate on the concept of need-rationality. Under this concept, the purpose of an action such as conferring a benefit like health care should be governed by the need of the citizen rather than any right acquired through contractual and property entitlements. Although this concept of need-rationality directly conflicts with the traditional stance of private law, which directs itself exclusively by reference to claims of rights and entitlements, Wilhelmsson discovers many modern developments in the law which he argues reveal a switch towards need rationality even in private law. A simple example is the transition in family law away from the distribution of property rights between spouses according to contractual and property entitlements towards the distribution between the spouses according to claims based upon need. Where this thesis becomes more controversial is when Wilhelmsson discerns a similar transformation in values and legal doctrine in fields such as contract and tort.

How does the switch towards need rationality reveal itself in contract law? In the first place, contract law becomes differentiated, so that particular rules apply to contracts made with needy parties, such as tenants, employees, and consumers. Secondly, the legal rules applicable to these transactions permit the courts to respond to the needs of the weaker party in a variety of ways. The intensive regulation of consumer credit transactions, for instance, both informs the consumer about the nature of the transaction, and permits the court considerable powers of adjustment through delaying payments and invalidating unfair contract terms in order to respond to the needs of the particular consumer.

To these points it may be objected that, although specific statutory regulation of transactions such as consumer credit may respond to considerations of need rationality, this does not compromise the basic stance of contract doctrine which remains committed to a rationality based on rights and entitlements. Whilst Wilhelmsson is cautious in his claims in this respect, he does argue that in various ways the basic legal principles of contract law have revealed signs of a switch towards need rationality. In particular, he advances the concept of "social force majeure" as an instance where general contract doctrine has responded to claims based upon need rationality. The doctrine of "social force majeure" suggests that judicial revision of contracts is permitted when it responds to the needs of citizens to escape contractual obligations when confronted with crises affecting income

caused by such matters as illness, unemployment, and old age. He supports this interpretation of how contract law doctrine is developing by a study of Nordic law and comparisons with other EC countries. An English example of the principle of "social force majeure" might be *Patel* v. *Ali* [1984] 1 ALL ER 978 (Ch), where a court refused an order for specific performance of a contract of sale of land because the vendor had suffered compound social force majeure: her leg had been amputated, she had become pregnant, and her husband had become bankrupt and ended up in prison. The method adopted here is the familiar one of picking out numerous exceptional instances of judicial revision based upon statute and doctrine, then repackaging them around a general principle which makes the best moral sense of the legal rules.

I find the work as a whole immensely impressive, but I have a few reservations. As Wilhelmsson acknowledges, the linkage between welfarism and consumerism cannot be drawn tightly, for the protection of the consumer can be justified on many different grounds as well, such as market failure or unexpressed entitlements, which probably have nothing to do with the advent of the Welfare State. Nor am I entirely convinced that general fairness provisions in contract law, in so far as they exist, respond to a logic of need-orientation so much as a logic which suggests that people should receive value for money out of market transactions. But these reservations aside, the book is a strikingly original examination of private law, informed by prodigious learning, and the arguments are developed in a persuasive, scholarly fashion. For scholars interested in contract law in particular, this is a book not to be missed at any price.

Hugh Collins, London

BOOK NOTES

Hermann Bartmann & Klaus Dieter John (Eds.): Präventive Umweltpolitik. Wiesbaden: Gabler, 1992. ISBN 3-409-16008-6. 118 pp., DEM 28.00.

An environmental policy which is preventive in nature is called for by the authors of the five articles published in this reader. They argue that under certain circumstances prevention instead of reparation is needed: