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**Combining the Contributions of Behavioral Economics
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and Tax Reform**

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Behavioral Economics**

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Abstract

This paper extends previous work presented at the SABE/IAREP conference at St Mary's University, Halifax (James, 2009). In the earlier paper it was shown that conventional economic theory is used to make the case for tax reform but does not always adequately incorporate all the relevant factors. However, an approach based on behavioral economics can make the difference between success and failure. In this paper the contributions of other social sciences are also included. Taxation is a particularly appropriate subject to explore the integration of the social sciences since they have all devoted considerable attention to it. It can be seen that different social sciences suggest a range of variables that might be taken into account in addition to those included in mainstream economics. Other social sciences also offer different methodological approaches and consider the possibility of different outcomes of the fiscal process. The paper concludes that it is not easy to integrate the social sciences in a single approach to the study of tax and tax policy. There may also be the risk of encouraging inappropriate integration - researchers operating outside their expertise can produce results that are not helpful. However, comparing the contribution of behavioral economics with those of the social sciences more generally, it can be seen that behavioral economics can offer a framework within which these areas can be examined. Indeed, it may be a useful channel to add the contributions of other social sciences to mainstream economic research.

1 Introduction

At the London School of Economics on 5 November 2008 the Queen attended a briefing by economists on the credit crunch and was reported as asking why no one saw the credit crunch coming. Her Majesty's question was debated by economists and others at a forum at the British Academy and their response indicated the importance of factors not normally included in mainstream economic analysis – such as 'wishful thinking', 'a psychology of denial', and 'the psychology of herding' (Besley and Hennessy, 2009, pp. 2-3). Furthermore, the Queen was advised that 'Everyone seemed to be doing their own job properly on its own merit. And according to standard measures of success, they were often doing it well' (*ibid.*, p. 3). This seems to fall seriously short of what was needed. In contrast, two leading economists in their book entitled *Animal Spirits* – a term used by John Maynard Keynes – drew on the emerging field of behavioral economics to provide a different approach to understanding such events (Akerlof and Shiller, 2009).

Taxation is also of considerable importance, with tax revenue varying from around a fifth to a half of GDP in OECD countries (James and Nobes, 2010). Apart from raising revenue to fund public expenditure, tax systems are also used as a potentially powerful instrument to further government policies more generally, encouraging some activities and discouraging others. Furthermore, the costs of operating tax systems – both the administrative costs to the government and the costs to individuals and businesses of complying with tax requirements – are substantial, possibly around four per cent of tax revenue (Sandford *et al.*, 1989).

Mainstream economics has a considerable contribution to make to the design of tax systems, the development of tax reforms and even in the administration of tax system, for example in countering tax evasion and encouraging compliance. Behavioral economics also has an important role to play (see, for example, James 2009). The purpose of this paper is to explore the possibilities of combining the contributions of behavioral economics with other social sciences in understanding taxation and tax reform.

Progress in this area may not necessarily be easy. There may well be good reasons for the development of the academic division of labour in the twentieth century – Adam Smith's (1776) eloquence on the benefits of the division of labour is well known though it may not necessarily follow that the gains to be made from specialization in Adam Smith's pin factory are quite the same with respect to academic research and its application. However, it is quite likely that specialization is often necessary to achieve profound research results and that trying to take too broad an approach prevents progress in depth. It is also true that there are examples where researchers have strayed into unfamiliar areas in other disciplines with unfortunate results. Nevertheless, sometimes too narrow an approach has led to bad decisions when applied to important policy issues. The example used in this paper is the reform of local government finance which, although based on sound economic principles, was such a disaster that it was a factor in the fall of Margaret Thatcher as Prime Minister., Social sciences generally have a great deal to offer taxation, and taxation is a very useful area of research for all of them. The preliminary conclusion

to emerge from this exercise is that behavioral economics does offer a framework within which these areas can be examined and, indeed, may be a useful channel generally to add the contribution of other social sciences to mainstream economic research.

The structure of the paper is that section 2 describes the contribution of behavioral economics in general. Section 3 briefly summarises the approach of other social sciences with respect to fiscal issues – dealing in turn with fiscal history, fiscal geography, fiscal psychology, political science, fiscal sociology and the ‘new fiscal sociology’. Section 4 turns to tax and tax policy and Section 5 draws some conclusions.

2 Behavioral Economics

Behavioral economics supplements and sometimes questions standard economic analysis by examining a wider range of contributions than is always considered in mainstream economic research. An indication of this approach comes from the Statement of Purpose of the Society for the Advancement of Behavioral Economics (SABE) and which appears on the front of its *Newsletter*:

SABE is an association of scholars who are committed to rigorous economic analysis and are interested in learning how other disciplines – for example, psychology, sociology, anthropology, history, political science, and biology - further our understanding of economic behavior. An important function of SABE is to serve as a forum for research which may not find either comprehension or acceptance in conventional economics societies. SABE also aims at facilitating communication between economists and scholars trained in related disciplines.

There is an increasing body of academic literature on behavioral economics. Introductions to the field have been produced by both Schwartz (2008) and Wilkinson (2008). Collections of papers on behavioral economics have been edited by Altman (2006), Camerer *et al.* (2004), Loewenstein, (2007) and Maital (2007). There is a collection of readings specifically on behavioral public finance edited by McCaffery and Slemrod (2006). There have also been specific applications to taxation – for example, Reeson and Dunstall (2009) examined the implications of behavioral economics and complex decision-making for the Australian tax and transfer system. In a different context, the book *Nudge* by Thaler and Sunstein (2008) became ‘required reading’ on a 2008 summer reading list for Conservative MPs. Apparently this was because the authors’ argue that sometimes voters need a gentle push to do the right thing, a view apparently consistent with the Conservative Party’s tax and welfare policies. Of course, in 2010 the Conservatives became the largest party in the UK’s coalition government.

Although it is clear that classical economists such as Smith, Ricardo and Mill drew on behavioral factors in their views on taxation, later academic economic research developed a much narrower approach to both taxation and economic matters in general (James, 2006). An important aspect of this is methodology. In his classic paper on the methodology of positive economics, Friedman (1953) argued that the ‘assumptions’ on

which a theory is based should not be judged on their ‘realism’ – they must necessarily abstract from the complexities of everyday life - but how well the resulting economic hypothesis works. This approach has been subject to important discussion – see for example Altman (2004) - and it has been frequently argued that basic assumptions of mainstream economics deviate consistently from reality in significant ways. DellaVigna (2009) summarized deviations from the standard model as non-standard preferences, non-standard beliefs and non-standard decision-making. Furthermore, there is considerable evidence regarding specific areas such as the importance individuals place on fairness in taxation, the endowment effect, framing of decisions, limited attention, loss aversion and mental accounting. As Camerer and Loewenstein (2004, p. 3) put it: ‘Behavioral economics increases the explanatory power of economics by providing it with more realistic psychological foundations’. It does this by modifying ‘the standard economic model to account for psychophysical properties of preference and judgement, which create limits on rational calculation, willpower and greed’ (Camerer and Malmendier, 2007, p. 235). In terms of taxation, as Congdon *et al.* (2009, p. 375) described the situation: ‘the implications of behavioral economics ...for public policy, including tax policy, have yet to be systematically explored, and ...this oversight leads to both mistaken policy and missed opportunity’.

3 Social Science Contributions

In addition to behavioral economics, the other social sciences have also made important contributions to the study of taxation. In the development of the social sciences distinguished scholars were often involved in academic disciplines which subsequently have been seen as distinct areas of study. Important figures such as Pareto made outstanding contributions to both economics and sociology. Schumpeter made seminal contributions not only to economic theory but also to sociology and economic history. Indeed he tried to connect theoretical economics, sociology and history into a broader grouping of ‘social economics’ (Swedberg, 1991) but economics, of course, still moved away from the other social sciences in the twentieth century.

Such cross-disciplinary contributions have always been present, if not always properly recognised. For instance, following his role in the establishment of fiscal psychology Schmolders (1959) continued to develop the use of psychological factors in economics as shown, for example, in *The Psychology of Money and Public Finance* (2006) but his contribution was not fully appreciated by economists during his career. Since the social sciences study human society there are natural overlaps in many areas – including public finance – for example Downs’ (1957) *Economic Theory of Democracy*, Tullock’s (2006) *Vote Motive* and Niskanen’s work on bureaucracies (for example, Niskanen, 1994). However, it is worth describing some of the main strands of different social sciences and their contribution to understanding the main issues relating to taxation. This brief review indicates a range of variables that might be taken into account in addition to those included in mainstream economics, different methodological approaches and different outcomes of the fiscal process.

Fiscal History

Fiscal history can use taxation to reveal more about society than is usually appreciated. 'The history of taxation reveals many social, political, and economic characteristics of a society' as described by the Centre for History and Economics (2005) at the Universities of Cambridge and Harvard in introducing its project on 'International exchanges of ideas about taxation since 1750'. Schumpeter (1918, p. 101) wrote that fiscal measures:

In some periods...explain practically all major events, and in most periods they explain a great deal...But even greater than the casual is the symptomatic significance of fiscal history. The spirit of a people, its cultural level, its social structure, the deeds its policy may prepare...all this and more is written in fiscal history. He who knows how to listen to its message here discerns the thunder of world history more clearly than anywhere else (quoted by Musgrave, 1992, p. 90).

Given the rich potential of fiscal history, the contemporary literature is surprisingly sparse – perhaps historians know insufficient about taxation or tax scholars know insufficient about history or both. Certainly taxation was an important topic for leading scholars in previous times. O'Brien (1999) presents the contributions of authors such as Jeremy Bentham, Edwin Cannan, John Stuart Mill, Sir William Petty, Adam Smith, and from the late seventeenth century to around the end of the nineteenth century. However there are some important recent contributions such as Bonney (1999) who analyses the fiscal history of Europe over six centuries, Daunton (2001 and 2002) who is concerned with the development of tax policy in Britain and Webber and Wildavsky (1986) who provide a history of taxation over 5,000 years.

Fiscal Geography

'Economic geographers study the principles governing the spatial allocation of resources and the resulting consequences' (Krumme, 2010). There are relatively few publications based on fiscal geography though Cameron (2006) examines the 'geographies of taxation' and the 'evolving relationship between the prevailing form of taxation and the economic geographies of the state (Cameron, 2008, p. 1146). There are also examples of links between fiscal geography and other disciplines – for example Archer (1983) explores the geography of federal fiscal politics in the USA.

Fiscal Psychology

Fiscal psychology is concerned with psychology, taxation and public expenditure. It includes the relationship between taxpayers and the government. It also includes the 'familiar approaches in social psychology including equity, intergroup relations and attribution theory and debates about attitude structure and the attitudes/behaviour link' (Lewis, 1982, p. 151).

Fiscal psychology has developed enormously following the seminal contribution of Schmolders (1959). Particularly important ideas include ‘tax morale’ (Torgler, 2007) – citizens’ attitudes towards the tax system – and the effects this may have on tax compliance. A related idea is the psychological tax contract which sees tax morale as a complex relationship between taxpayers and the government and that taxpayers may be more willing to comply with a tax system if they perceive the political process to be fair and legitimate (Feld and Frey, 2007).

The overlap with other disciplines has sometimes been formalised. For instance, Kirchler (2007) integrated psychological and other factors affecting tax compliance in a model based on the interaction between the tax authorities and taxpayers.

Political Science

Political science is concerned with the principles, processes and institutions of government. One approach to this subject has been the use of economic analysis to understand political behaviour. Examples include Downs (1957) already cited with respect to political decision-making, Olsen (1971) on collective action and Tullock (2006) in examining the behavior of politicians, civil servants and voters. Gould and Baker (2002) review work on the relationship between democratic institutions and taxation. Political factors also include inertia as Rose and Karran (1987) indicate with particular reference to taxation. As they put it: ‘if keeping out of trouble is a basic law of politics, then not making decisions about taxes is one way to avoid trouble - in the short run at least.’

Fiscal Sociology

Fiscal sociology has received significant attention in recent years but its origins may be traced back to Goldscheid and Schumpeter who related the development of taxation to the social sciences. Schumpeter (1918) wrote that:

we may surely speak of a special set of facts, a special set of problems, and of a special approach...in short, of a special field, fiscal sociology, of which much can be expected. Of these approaches...there is one which is of particular interest to us: the view of the state, of its nature, its forms, its fate, as seen from the fiscal side (quoted by Musgrave, 1992, p. 90-1).

Musgrave (1992, p. 90), a former student of Schumpeter’s six decades previously and arguably the greatest public finance theorist of the twentieth century, certainly saw Schumpeter’s (1918) essay *The Crisis of the Tax State* as a foundation for a new discipline – fiscal sociology. Although Schumpeter continued to add to this original contribution, not least in his treatise *Capitalism, Socialism and Democracy* (Schumpeter, 1942), the basic argument remained much the same as in 1918. Schumpeter examined the fiscal causes involved in the decline of feudalism and the development of the ‘tax state’. However, Schumpeter’s view was that there were forces, such as attitudes towards

property and demands for social expenditure that could lead to the collapse of the tax state.

There was also an Italian contribution to the development of fiscal sociology as described by McLure (2005 and 2006). One particularly relevant view of Pareto was his reservations about the applicability of the assumption of hedonism to public finance:

Limits of hedonistic theories: To us the defect [of treating everyone as a perfect hedonist]...seems most serious when one wants to turn the principles of the new science to studies of phenomena that are not exclusive economic. As an example, the science of public finances, in many cases, and governments, in nearly all cases, fall into gross errors. When these are combined with postulates of the kind that concern the character of State ethics...they become fairy tales (Pareto, 1892, 88, quoted by McLure, 2005, p. 610).

Pareto's important contributions to economics are well known though he did not develop his analysis of public finance as fully and formally as he might have done. However, in studying Pareto-Griziotti and Pareto-Sensini correspondence on fiscal theory, McLure (2005) was able to clarify further Pareto's influence on the development of fiscal sociology in Italy.

There have been a variety of views of fiscal sociology, for example that it 'deals with the ramifications of the fiscal activities of the state into areas which are not their primary target', Backhaus (2004, p. 143) and 'Tax sociology investigates the fundamental relationship between taxation, state and society' Leroy (2008). Wagner (2006) examined the influence of fiscal institutions. Campbell (1993, p. 164) points out that fiscal sociology provides a distinct contribution to the analysis of taxation and public finance because it is concerned with how taxes and public expenditure affect and are affected by a wide range of cultural, economic, historical, institutional and historical factors. There are many forces in society that can affect fiscal policies and their results and fiscal sociology focuses explicitly on the complex social interactions involved.

There have been many further contributions to fiscal sociology, for example, Backhaus (2002) presents a glossary of issues of fiscal sociology. There have also been contributions bridging different disciplines. Marques (2004) argued that a sociological approach was not complete without consideration of fiscal issues and the state and Leroy (2008) linked tax sociology with economics. Campbell (1993, p. 180) suggested that fiscal sociology 'provides an excellent vehicle for examining competing analytical frameworks'.

In his book on fiscal sociology and the theory of public finance, Wagner (2007) argued that the relevant process was not one where a market equilibrium was established and then the government intervened to move society to some other position. Instead, with public finance as an aspect of social theorizing, the relationship between the economy and the state must exist in a social context. Furthermore, in another theme found

elsewhere, the focus of analysis is on the ‘emergent processes of development’ and not on the existence of states of equilibrium (p. viii).

The New Fiscal Sociology

In introducing their collection of readings on the New Fiscal Sociology, Martin *et al.* (2009, p. 1) state that a ‘new wave of multidisciplinary scholarship’ on the sources and consequences of taxation ‘is poised for a significant intellectual breakthrough’. They argue that the new fiscal sociology could potentially challenge conventional understanding and is currently already doing so with respect to racial inequality, gender and family, the origins of western democracy, the welfare state and many other areas. These authors suggest that fiscal sociology may be about to rewrite conventional accounts of modernity – which refers to the social relations linked to the rise and development of capitalism - by focusing on the social relations of taxation in historical or comparative accounts of social change.

Martin *et al.* (2009, p. 3) claim that what is new about the new fiscal sociology is that it recognises that taxation has a ‘theoretical or causal – and not just a symptomatic or methodological - importance’. For those who have focused their research on taxation itself it may not be very clear what is new about this. However, what taxation specialists may agree with is that the study of taxation has become too fragmented between different narrow academic disciplines. Martin *et al.* refer to the forces of professionalization and academic specialisation that were removing public economics from history and the other social sciences and so obstructed the development of Schumpeter’s idea of fiscal sociology. This scholarly division of labour resulted in most historians, sociologists, legal scholars and political scientists not investigating the social and institutional contexts or the effects of taxation because they had left the study of public economics to economists. Similarly economists tended not to investigate the social or institutional contexts of taxation because they left that to other social scientists.

Martin *et al.* saw traditional fiscal sociology concentrating on three areas. The first was why tax systems took a particular form. The second focused on the ‘non contractual basis’ of the fiscal contract – the institutionalized norms that generated taxpayers’ consent to the ‘fiscal bargain’ – the particular arrangements for taxation and public expenditure. The third area covered the study of the social and cultural consequences of taxation. Economists had developed powerful methods for investigating the economic consequences of taxation but the other consequences often received much less attention.

The new fiscal sociology began to emerge, according to Martin *et al.*, when these three strands started to merge in the late twentieth century and participants concerned within each area began to look to the others for further understanding. Outside pressures encouraged such developments. For example, fiscal crises in the US state and local governments and the property tax revolts in the 1970s prompted renewed attention to fiscal sociology. One development was an institutional approach to tax policy with contributions by authors such as Campbell (1993) and Daunton (2001 and 2002). Martin

et al. also described a shift from general to comparative history. In earlier contributions to fiscal sociology there were attempts to demonstrate that the taxation experiences of different countries illustrated a universal law. With the new fiscal sociology more attention tends to be given to why tax systems differ. This has become an important question. As Campbell (2009) noted, globalization generates pressures for tax systems to converge but there seems to be considerable resistance to such a development and so fiscal sociology scholars often use a comparative perspective to understand such differences rather than attempting to describe universal laws.

The new fiscal sociology, as described by Martin *et al.*, differs from the standard approach of economists in several ways. One is the focus on informal social institutions. Existing studies often incorporate written arrangements – constitutions and laws. Studies following the new fiscal sociology approach examine social relationships that may be just as important as the more visible arrangements even they are not formally written down. A second is to take proper account of the historical sequence and context. Modernization theory saw history as a standard path followed by different societies in the same way from traditional to modern societies. The new approach considers the possibility that critical historical events – such as economic crises – may determine the actual path of development which may then be reinforced by feedback mechanisms. Indeed it is argued that an historical approach is necessary to understand many fiscal and social phenomena. Furthermore, a particular economic or political equilibrium is not sufficient to explain what is happening when multiple equilibria are possible. A third aspect of the new fiscal sociology is to concentrate on phenomena relating to society rather than the individual – ‘macrosocial phenomena’ such as social conventions and religious traditions. The new fiscal sociology is therefore concerned with major issues in the social sciences – the relationship between taxation and the development of the state, the rise of democracy and social solidarity.

As Martin *et al.* (p. 14) point out, the new fiscal sociology has the potential to address the questions raised by Schumpeter nearly a century before – the social influences on tax systems, factors affecting taxpayer consent and the social and cultural impact of taxation.

4 Tax and Tax Policy

Within the huge academic literature on tax and tax policy there are plenty of examples of research outside the mainstream economic framework – see, for example, James (2006) – but there seems to be no obviously useful classification or reliable and universal method of merging the contributions from different social sciences. Before attempting to outline one possibility, however, the matter raised in the introduction should be addressed – the situation where researchers become involved in areas outside their own disciplines with unfortunate results. It is important here because it is evidence that an academic division of labour has benefits in promoting fundamental expertise in a particular area. It might therefore be difficult to integrate different social science approaches in the study of taxation and its application to policy matters.

Anyone who has spent time focusing on taxation as a subject of research will be aware of well-meaning academics from a variety of disciplines who have used taxation as an object of study without the knowledge and expertise to produce a satisfactory outcome. It is not particularly useful to survey tax research that is poor in this respect but one example may provide a useful illustration. This example does not relate to an important area but it does illustrate clearly the dangers involve in working beyond one's expertise. In this example, the author can recall attending a presentation where a university academic graphic design specialist had offered to help the revenue authorities in the UK and redesigned part of a form issued by them. This was before that aspect of the tax system had been computerised and the designer had improved one part of the form only. The result appeared impressive. Text had been moved around the form as well as good improvements made in graphics, layout and presentation. Although they were too polite to say anything in the presence of the academic, it became clear that the officials attending the seminar were having difficulty in suppressing astonishment and mirth. Unfortunately the academic had not taken the trouble to understand the role of the form. In that pre-computerised document the four part form had been designed so that the completion of the top copy by the tax officer would simultaneously produce three carbon copies below - all different because they were designed for different purposes – one for the taxpayer, one for the collector and so on. The academic was very pleased with her work but did not discover that the only purpose of this exercise was public relations - to respond to her lobbying by giving her something to do! Unfortunately her ignorance of the subject she was studying meant the whole project was useless – except as a graphic warning about researching outside one's specialism without the relevant expertise or working with someone who has.

One way of indicating the additional contribution of other social sciences is to re-examine the tax reforms analysed in the previous SABE paper (James, 2009). That paper drew on Tomer's (2007) six dimensions which may be used to characterize behavioral and mainstream economics in relation to science. The dimensions are narrowness, rigidity, intolerance, mechanicalness, separateness and individualism. Tomer suggests that narrowness might be the most important dimension of comparison of economic disciplines. Narrowness may be said to occur when a discipline restricts its methods or scope of substantive inquiry or both. This might occur, for example, when formalistic mathematical-deductivist modeling is used to the exclusion of other methods such as non-quantitative or scholarly methods of discovery. Rigidity implies a strong attachment to a narrow approach and the discipline is unable to be pragmatic and flexible in its choice of methods. Intolerance may involve a dismissive or even hostile attitude towards other approaches to economics. Mechanicalness describes the degree to which a discipline considers an economy and individuals act in machine-like ways. Separateness relates to the extent to which an economic discipline is not linked to other disciplines and does not, for example, involve interdisciplinary work. The final dimension is individualism – a discipline high on individualism is one that focuses on individual decision-making behavior rather than social and group behavior. It should be clear that there are important overlaps between mainstream and behavioral economics but these six dimensions for assessing the differences.

In the light of these dimensions, the 2009 paper examined two major tax reforms in the UK which were justified on the basis of mainstream economic principles to see if behavioral economics can help explain the gap between mainstream economic analysis of possible tax reforms and the eventual outcomes. In these two cases behavioral economics clearly added to our understanding of why one of these reforms was a disaster and the other was successful.

The first of the reforms examined was a change in 1989 in Scotland and 1990 in England and Wales from a local property to a tax called the ‘the community charge’ which rapidly became known as the poll tax because it was levied at the same rate on each adult in a local authority area. Financing multi-level government is not always straightforward (James, 2004) and in this case, although the reform was based on the theoretically elegant idea of accountability and supported by other mainstream economic arguments, it was such a failure that it was even a factor in the downfall of Mrs Margaret Thatcher as Prime Minister. Analysing this change using Tomer’s dimensions it is easy to see that behavioral economics explains a considerable amount of the gap between the economic theory and the final outcome (James, 2009). It is also easy to see from the account of relevant parts of other social sciences that they reinforce the explanatory contribution of behavioral economics in almost every way.

In the second reform examined – the introduction of value added tax in the UK in 1973 – the issues are described in James (2008) and James and Alley (2008). It is sufficient to say here that some of the key features of the introduction of VAT, particularly flexibility in the face of strongly held views regarding fairness, suggest this reform was more in line with a behavioral approach to tax reform than a mainstream one. Once again, using Tomer’s dimensions as a framework, it can be seen that other social sciences reinforce the contribution made by behavioral economics to understanding the success of this reform.

5 Conclusion

There is no doubt that mainstream economics provides a powerful theoretical framework and research paradigm with respect to tax and tax reform. It is also true that behavioral economics makes a major contribution to the study of tax and tax policy. Although there have always been cross-disciplinary contributions to understanding public finance, in the twentieth century a considerable academic division of labour developed and this has advantages of in terms of analysis in depth. A brief review of contributions to fiscal studies by different social sciences indicates a range of variables that might be taken into account in addition to those included in mainstream economics, different methodological approaches and different outcomes of the fiscal process. However, it is not easy to integrate them in a single approach to the study of tax and tax policy. In practice there may be dangers in encouraging inappropriate integration - researchers operating outside their expertise can produce unhelpful results. Comparing the contribution of behavioral economics with that of social sciences more generally it is concluded that behavioral economics offers a framework within which these areas can be examined and, indeed,

may be a useful channel generally to add the contributions of other social sciences to mainstream economic research.

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