NOBEL PRIZE LAUREATE IN ECONOMICS 2017

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Abstract
Richard H. Thaler was awarded the 2017 Nobel Prize for Economics for the Development of Behavioural Economics. His studies of psychological assumptions of economic decision-making processes and his contribution to the interconnection of economics and psychology were identified as pioneering.

Keywords: R. H. Thaler, Nobel Memorial Prize in Economic Sciences, behavioural economics, rationality
JEL Classification: D90, D91, G40, G41

The Nobel Prize, officially known the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel for 2017 was awarded "for contributions to behavioural economics" to its pioneer – American Richard Thaler (1945) of the University of Chicago. His multidisciplinary approach to solving real problems of interpersonal interactions and exploring people's behaviour was highlighted. His studies of psychological assumptions of economic decision-making processes were identified as a breakthrough and his contribution to the interconnection of economics and psychology was recognised.

The prestigious prize has been awarded 49 times, of which 25 prizes have been given to one laureate only. A total of 79 prizes have been awarded since 1969 and only one awarded to a female laureate. The political scientist and economist E. Ostrom was awarded the prize in 2009 *"for her analysis of economic governance, especially the commons"*. There are altogether 42 living laureates while 58 laureates were U.S. citizens with 13 working at the University of Chicago at the time of the award. The other two most frequent institutions are Harvard University and the Massachusetts Institute of Technology with five award winners.

The 2017 laureate, Richard Thaler, is an internationally renowned scientist and academician who is well-known to the general public and was considered to be a serious candidate for several years. However, in 2017, there was little mention of him. The list of potential winners typically included K. D. Acemoglu, M. J. Melitz, W. D. Nordhaus, and O. Blanchard. The media speculated about E. C. Duflo becoming another woman to receive the Nobel Prize in future. Younger economists (men and women), who are often mentioned in connection with the Nobel Prize, are N. Bloom, M. Dell, E. Farhi, R. G. Fryer, M. Gentzkow, A. N. Finkelstein, and R. Chetty.

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The Behavioural Approach – An Alternative to Neoclassical Economics?

The winner of the most recent Nobel Prize for Economics came as no surprise and his name did not trigger a wave of passionate polemics. The media were full of headlines about an economist who combined the economic and psychological aspects of decision-making and thus *"humanised"* economics. The prize winner considers his greatest contribution to economic science to be that he explained that *"Economic decisions are human and economists need to take this fact into account."* Thaler deals with human behaviour primarily in the sphere of general finance and decision-making psychology. He is considered to be the main contemporary representative of behavioural economics and the founder of behavioural finance. He examines the impact that habits, moods, prejudices, altruism, and other aspects have on economic behaviour and why people do not behave according to the neo-classical concept of homo economicus.

Standard economic theory is still dominated by neoclassical economics, which draws on a model of a person who behaves strictly rationally at all times. However, Thaler is one of those who points to the necessity to integrate psychological aspects and make economic decision-making more realistic. He operates with limited rationality, does not overlook social aspects or a lack of self-control and self-discipline. Thaler shows how character traits of real flesh and bone human beings systematically affect not only their economic behaviour but also entire markets. He distinguishes between the optimal choice of so-called *"econes"* (abstract models of homo economicus monsters, cool calculators of pleasure and misery, without emotions or mistakes, without social bonds, etc.) and the decision-making of real people in everyday life. For instance, for most people, it is very difficult to keep up with their New Year's resolutions and their short-term temptations (and instant gratification) are the reason why plans to save for retirement or to live more healthily often fail to be realised. Real homo sapiens lack power and have problems with self-control.

The concept of bounded rationality is associated with H. A. Simon, an economist, psychologist, and computer expert, who received the economic Nobel Prize *"for his pioneering research into the decision-making process within economic organisations"* in 1978. Simon replaced the neoclassical rational economic man (e.g. for modelling behaviour of companies) by collaborating decision makers who are unable to act rationally in a consistent manner. They have their personal and social ties and their knowledge of the consequences of the decisions made is inadequate. Bounded rationality takes into account the effect of external constraints associated with uncertainty and lack of information, the costs of obtaining and processing information, and the effects of internal constraints arising from a person's gnoseological capabilities.

Thaler demonstrates limited rationality on an example of *"possessive effect"*. Loss aversion explains why people value things more when they own them and why they would ask for a higher price when selling them than for what they would buy them for. Neither does he overlook the fact that most people consider themselves to be above-average, for example, when it comes to driving or trading. People who have earned money on the stock market spend it easily and do not regard it as real. Risky investments create bubbles and economic crises. Thaler tries to explain the steps that lead to decisions made not only by investors. The approaches of behavioural finance link economics, finance, and psychology. Behavioural finance is a component of a financial theory, which, unlike traditional finance, assumes that investors and other financial market actors do not always behave completely rationally. Decisions are influenced by how people interpret information and how they actually act. Thaler's *"mental accounting"* method captures the creation of final financial assessments using separate calculations where people concentrate on direct impacts rather than on the overall long-term effect (1985a, 1999).

He sees the meaning of behavioural economics as *"Honest help to people"* who *"remain vulnerable to a wide range of routine prejudices that can lead to an equally wide range of embarrassing mistakes in education, personal finance, healthcare, mortgages and credit cards, happiness or even the planet itself"*. According to Thaler, people can be *"nudged"* by a sophisticated selection method and regulatory techniques, even without orders and restrictions. For instance, by arranging meals on the menu in a certain order (with healthier ones at the top), automatic saving of part of the salary for retirement (unless the person cancels it) or smaller portions of chips (large portions on request only) and thus correcting irrational behaviour and pushing people to good decisions in the spirit of *"libertarian paternalism"*, which Thaler recommends to economic policymakers. This system preserves freedom of choice (or at least the illusion of such), while the paternalistic *"nudges"* in conduct influence good decisions. The question remains how the regulator or choice architect knows what the right choice actually is.

Due to Thaler's activities, behavioural economics is becoming the main school of today's economic science. D. Kahneman (together with A. N. Tversky) is also regarded as a pioneer of behavioural economics. Kahneman, an Israeli-American psychologist, is one of the laureates of the 2002 Nobel Prize in Economics *"For having integrated insights from psychological research into economic science, especially regarding human judgment and decision-making under uncertainty"*. Even lay people interested in the psychological foundations of economic models are recommended to read Kahnemann's book *Thinking: Fast and Slow* (in Czech: *Myšlení – rychlé a pomalé*, Jan Melvil, 2012).

The fact that economic behaviour is never quite rational is also pointed out by New Keynesians. Decision-making is often influenced by psychological responses and is often instinctive. Economic activity is not only determined by rational motifs, measurable variables or mathematically expressible relationships. Powerful psychological powers that J. M. Keynes calls *animal spirits* (trust, justice, dishonesty and evil will, succumbing to monetary illusion or perceiving and experiencing archetypal stories) also play a role. This is summarised in the book by G. A. Akerlof and R. J. Schiller *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism* (in Czech *Živočišné pudy: Jak lidská psychologie řídí ekonomiku a proč je podstatná pro celosvětový kapitalismus.* Argo/Dokořán, 2010). Since 1992, R. J. Schiller and R. Thaler have led the *Behavioural Economics* project at the National Bureau of Economic Research. Schiller also develops the sphere of behavioural finance and is one of the 2013 Nobel laureates in economic sciences *("For their analyses of markets with asymmetric information").* G. A. Akerlof is one of the 2001 laureates *("For their analyses of markets with asymmetric information").*

Behavioural economics is one of the fastest developing schools of current economic science although it is also very fashionable as it combines economics with psychology and also, due to Thaler, psychological aspects are being reintroduced in textbook economics. At the same time, close links between microeconomic considerations and psychology are mentioned by A. Smith and J. Bentham, which resulted in a standard model of a strictly rational homo oeconomicus. However, many traditional economists used more sophisticated psychological framing (F. Y. Edgeworth, V. D. Pareto and I. Fischer).

Economic psychology appears in the works of sociologists and social psychologists such as G. Tarde, G. Katona, and L. Garai. Decision-making has been gradually tested with regards to uncertainty, risk, and intertemporal choice (M. F. Ch. Allais and others). In the 1960s, psychological models by D. Kahneman, A. N. Tversky, and W. Edwards emerged. In the context of psychological aspects of economics, the approach by C. Manger, etc. should not be ignored. After all, the Austrian and Viennese School is referred to as the subjective psychological school.

The trends outlined above also include the rapid development of experimental economics, sometimes considered to be part of behavioural economics. The pioneers of experimental economics are D. Kahneman and V. L. Smith (who were awarded the Nobel Prize in 2002 *"For having established laboratory experiments as a tool in empirical economic analysis, especially in the study of alternative market mechanisms".* Behavioural economics systematically studies the logic of human irrationality while trying to understand man through a wide range of experiments.

The prestige of behavioural economics is growing and it often refers to changes to the "face" of economics but not usually to its essence. Behavioural economics complements more realistic assumptions about behaviour and focuses on interesting psychological aspects that contradict traditional models. It enriches mainstream economics with psychological realism and institutional settings. Nevertheless, it remains questionable whether it significantly outstrips the mainstream boundaries and whether it really represents a major alternative to the neo-classical. Behavioural economics does not offer a fundamentally new economic paradigm although there are also very optimistic expectations for the further development of economic science. However, even R. H. Thaler himself does not reject simplified traditional economic models (depicting the "ideal" world) and tries to improve them on the microeconomic level. Appropriate changes in macroeconomics are, according to Thaler, still to occur.

R. H. Thaler's education and career

Richard H. Thaler was born on 12 September 1945 in East Orange, New Jersey. He studied at the Case Western Reserve University in Ohio (B.A., 1967) and the University of Rochester, New York (M.A., 1970 and Ph.D., 1974) where he defended his dissertation *The Value of Saving a Life: A Market Estimate* (thesis adviser S. Rosen). He taught in various positions at the University of Rochester (1971–1978) and Cornell University (1978–1995). He undertook stints at the University of British Columbia (1984–1985), at the Russell Sage Foundation (1991–1992), and the Massachusetts Institute of Technology (1993–1995), and worked at the Centre for Advanced Study in the Behavioural Sciences at Stanford University (1998). He joined Chicago in 1995 and holds the position of professor of behavioural sciences and economics at the University of Chicago Booth School of Business and is the director of the Centre for Decision Research.

He is a member of the American Academy of Arts and Sciences, the American Finance Association, the Econometrics Society and the American Economic Association. He has received several awards, including an Honorary Doctorate of the University of Economics in Prague awarded in December 2015. Thaler applies the results of his research in practice, both in the private sector and in top economic-political advisory functions. He is a co-founder of Fuller & Thaler Asset Management, whose investment strategy is based on the application of behavioural economics to capital markets. He worked as a formal adviser to D. W. Cameron and informal adviser to B. H. Obama. He has also advised governments on how to make smarter laws that would be more people-friendly. He is a respected intellectual and a successful journalist and writer.

R. Thaler and D. Kahneman researched the *"economic fairness"* of people's behaviour after a snowstorm. People's responses to the fact that vendors took advantage of the situation and immediately increased the prices of snow shovels suggest that this behaviour is not considered fair, although, according to traditional economics theorems, vendors did exactly what a vendor has to do, i.e. raise the price and meet the suddenly increased demand. The authors showed that retailers who behaved like this (i.e. raised prices in an extreme situation) eventually lost their customers. Their customers bought shovels with displeasure for a high price, but the next time they went shopping elsewhere. According to Thaler, showing consideration for fairness toward customers may prevent companies from raising prices in periods of high demand, but not in times of rising costs. His theoretical and experimental research of preferences was mentioned in the official Nobel Prize substantiation. Upon receiving the Nobel Prize on December 8, 2017, R. Thaler gave a traditional lecture on the topic *From Cashews to Nudges: The Evolution of Behavioral Economics.*

He is the author and co-author of numerous papers in prestigious journals including the first and second series of *Anomalies* in the *Journal of Economic Perspective* (1987–2006), in which he documented the cases of economic behaviour that seemed to be inconsistent with standard microeconomic theories. He has published several books including those for the general public. He is co-author (with C. R. Sunstein) of the bestseller *Nudge: Improving Decision on Health, Wealth, and Happiness* (2008), in which behavioural economics practices are used to solve many problems. The authors offer recipes – "nudges" – to improve decision-making concerning health, wealth, and happiness. Thaler's book from 2015 was translated into Czech and published as *Neočekávané chování: Příběh behaviorální ekonomie* (Argo/Dokořán, 2017) and demonstrates irrational behaviour that does not correspond with traditional economic theories. Thaler describes in the book how he developed the basics of behavioural economics and confronts them with standard economic models drawing on strict rationality.

Thaler's book publications

Quasi-Rational Economics (Rusell Sage Foundation, 1991); *The Winner's Curse: Paradoxes and Anomalies of Economic Life* (Free Press, 1991); *Advanced in Behavioral Finance* (ed., Vol. I, Rusell Sage Foundation, 1993, Vol. II, Princeton University Press, 2005); *Nudge: Improving Decision on Health, Wealth, and Happiness* (Yale University Press, 2008 – co-authored by C. R. Sunstein); *Misbehaving: The Story of Behavioral Economics* (Norton, 2015).

Thaler's selected articles and journal papers

An Econometric Analysis of Property Crime: Interaction Between Police and Criminals (*Journal of Public Economics*, August 1977); Toward a Positive Theory of Consumer Choice (*Journal of Behaviour and Organisation*, March 1980); An Economic Theory of Self-Control (*Journal of Political Economy*, April 1981 – co-author H. M. Shefrin);

Mental Accounting and Consumer Choice (*Marketing Science*, Summer 1985a); The Relevance of Quasi Rationality in Competitive Markets (*American Economic Review*, December 1985b – together with T. Russell); Experimental Tests of the Endowment Effect and the Coase Theorem (*Journal of Political Economy*, December 1990 – co-authors D. Kahneman, J. L. Knetsch); Economic Analysis and the Psychology of Utility: Applications to Compensation Policy (*American Economic Review*, May 1991 – together with D. Kahneman); Price Reactions to Dividend Initiations and Omissions: Overreaction or Drift? (*Journal of Finance*, June 1995 – co-authors R. Michaely and K. L. Womack); Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias (*Journal of Economic Perspectives*, winter 1991 – with D. Kahneman and L. Knetsch); Probabilistic Insurance (*Journal of Risk and Uncertainty*, October 1997 – co-authors A. N. Tversky a P. P. Wakker); Mental Accounting Matters (*Journal of Behavioral Decision Making*, September 1999); From Homo Economicus to Homo Sapiens (*Journal of Economic Perspectives*, Winter 2000); How Much is Investor Autonomy Worth? (*Journal of Finance*, August 2002 – co-authors S. Benartzi); Can the Stock Market Add and Subtract? Mispricing in Tech Stock Carve-outs (*Journal of Political Economy*, April 2003 – with O. A. Lamont); Libertarian Paternalism (*American Economic Review*, May 2003 – together with C. R. Sunstein); Anomalies: Utility Maximization and Experienced Utility (*Journal of Economic Perspectives*, Winter 2006 – with D. Kahneman); Heuristics and Biases in Retirement Saving Behavior (*Journal of Economic Perspectives*, Summer 2007 – co-author S. Benartzi); The Nominal Share Price Puzzle (*Journal of Economic Perspectives*, Spring 2009 – co-authors W. C. Weld, R. Michaely and S. Benartzi); Annuitization Puzzles (*Journal of Economic Perspectives*, Fall 2011 – co-authors S. Benartzi, A. Previtero); The Loser's Curse: Decision Making and Market Efficiency in the National Football League Draft (*Management Science*, July 2013 – co-author C. Massey); Behavioral Economics: Past, Present, and Future (*American Economic Review*, July 2016).

Additional information

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Web resources

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