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Richard Thaler and Behavioral Economics

In 2017, the Nobel Memorial Prize in Economic Science was awarded to Ricard Thaler, a professor of Behavioral Science and Economics at University of Chicago. The Royal Swedish Academy of Sciences said: "Richard Thaler's contributions have built a bridge between the economic and psychological analyses of individual decision-making." As Richard claimed that, the most important impact of his research is the recognition that economic agents are human and economic model have to incorporate that.

What is behavioral economics on the basic? It's economics that studies how the psychological, emotional, social and cognitive factors influence an individual's or a group's decision making, and then in turn influence the market price, return, and resources allocation.

Richard Thaler brought this idea to a new path by stating that humans are not always rational, and due to the irrationality, people don't always make the best choices. Thus, sometimes necessary polices should be imposed to help people on decision-making. In his research, Ricard showed three ways human systematically deviated from traditional economics models: limited rationalities bounded our ways to make rational decisions; even though our decisions are based on our self-interest, we also have social preferences that influence the choices; Lastly, we sometimes suffer from lack of self-control.

Firstly, in term of limited rationality, Richard claim that all people have mental accounting. He proposed that people would separate their income into different categories, such as food, housing, and vacation etc. When people assign different level of utility to each category, it will affect their consumption decisions. For example, just like people usually have credit card with high interest and saving account with low interest. And, the money from saving account may be used to pay off the debit on credit card. This seems irrational, but that's because people afraid of that as soon as they took the money out they couldn't put it back. Thus, a credit card with high interest rate is a way to prevent excessive spending. As Richard implied, keeping separate mental account is a way to exercise self-control.

Secondly, Richard stated that people also have their own social preferences, and they make social-oriented decisions. For example, umbrella stores can raise price during heavy rain, but the customer will think it's unfair. Similarly, the company can cut reference wages during recession, but the workers will think it's unfair. Thus, people would not only make decision according to the economic models, but based on the social environment they lived in. And so, based on of fairness of judgment, he explained relative ability of wage levels even during the bad time.

The third area is about people's limited self-control. Sine people always face the conflict of desire for present versus hope for future, people can easily fall prey to temptation and deviate from their long-term plans. In this case, Richard sets up a model called "planner-doer model". The planner is the one who value future greatly, and the doer is the one caring only about current situation. Thus, to solve the conflict, the planner can either force the doer to do something that will benefit his/her future, or planner can set up some rules to nudge the doer to make better decisions.

By putting these theories into appellation, Richard and his colleagues advocated libertarian paternalism, which states that it is both possible and legitimate for private and public institutions to affect behavior while also respecting freedom of choice, as well as the implementation of that idea. The concept of paternalism specifically requires a restriction of choice, and libertarian means people can have freedom to "opt out" of specific arrangement. One example is the "save more tomorrow program", which asked individuals commit to allocating a share of future salary increases to saving as exercising self-control, and the participants can opt out anytime. At the end, barely had people opt out and the saving was increased.

All in all, in Richard co-authored book "Nudge", he helped uncover the endowment effect: a tendency to value something more highly just because you own it. So that, in turn, the way choices are framed, by firms or governments, can influence how people respond. As stated by Wall Street Journal that, "the behavioral economics movement, in pushing against the idea of efficient markets, led some researchers to argue against the idea that government itself should minimize its imprint in the economy." However, some other economists still believed that the debate over whether markets are truly rational or irrational will continue.