# Nobel work divines psychology of money

Economics 101

Richard Holden

The Nobel prize in economic sciences has been awarded to Richard Thaler of the University of Chicago, Booth School of Business, "for his contributions to behavioural economics". He tried to introduce the study of human irrationality into a discipline that prides itself on rationality.

This is an excellent choice that reflects an important shift in economics over the past three decades, to take human psychology seriously when thinking about economic decision-making, and the implications for everything from basic individual choices, to retirement savings, to the operation of financial markets. (Disclosure: I was a colleague of Thaler's at Chicago Booth.)

Outside the teaching rooms at Chicago Booth, there is a number of large posters of various luminaries and their contributions (including other Nobel laureates).

On his, Thaler perhaps summarised his own approach best. His quotation reads: "I think it is possible to strengthen economics by incorporating the idea that some people behave like humans, at least some of the time." Witty, but also deep.

And, beginning in the 1980s, Thaler did just that.

In a first set of contributions, Thaler showed that people systematically deviate from the standard "expected utility theory" of von Neumann and Morgenstern that is the workhorse economic model of how people make choices.

A now classic example is the so-called "endowment effect":

*"(a) Assume you have been exposed to a disease which, if contracted, leads to a quick and painless death within a week. The probability you have the disease is 0.001. What is the maximum you would be willing to pay for a cure?*

*(b) Suppose volunteers would be needed for research on the above disease. All that would be required is that you expose yourself to a 0.001 chance of contracting the disease. What is the minimum [amount of money] you would require to volunteer for this program? (You would not be allowed to purchase the cure.)"*

A typical answer from respondents is about $200 for (a) and $10,000 for (b). Yet the standard model says the answer should be precisely the same. People, it seems, are willing to pay a relatively small amount to "buy health" compared to what they require to be paid to "sell health".

This turns out to be a pervasive phenomenon. Thaler showed it is consistent with people valuing losses and gains differently ("loss aversion") as in the "Prospect Theory" of former laureate Daniel Kahneman and his collaborator, Amos Tversky. And he showed that firms take advantage of this commercially – they often frame things as "cash discounts" rather than "credit card surcharges". Moreover, it holds in experiments with real stakes, not simply survey questions.

A recent meta-study showed that in more than 337 estimates in 76 different experiments, the willingness to accept is more than triple the willingness to pay.

Thaler's concept of "mental accounting" holds that people put expenditures into distinct categories (e.g. food, housing, clothing, etc). This also has strong empirical support, and far-reaching implications.

When people behave like this they do not take advantage of the ability to smooth decisions across categories, and they can behave in ways that are not optimal.

One well-documented example is that taxi drivers routinely set a target amount of earnings and stop once they have reached it. This "satisficing" behaviour – rather than optimising – has broad implications for the labour market generally.

Now, one might think that all these defects in individual decision-making wash out in large markets. Indeed, this was the routine critique of behavioural economics in seminars in the early 2000s.


Professor Richard Thaler has changed the way economists look at the world. PHOTO: AP

*Thaler also pioneered the concept of "social preferences" where people care about fairness, and that fairness can be a vital consideration in economic settings.*

A huge body of scholarship in "behavioural finance" has shown that this is not the case. Psychological factors and limits to arbitrage can have huge implications for the operation of financial markets – creating mispricing and excess volatility.

Thaler also pioneered the concept of "social preferences" where people care about fairness. In an elegant experiment – the "dictator game" – one subject is given $20 and can propose a split with the other subject. If the other accepts the offer then that's what they both get. If they reject, both get nothing. Subjects routinely reject an $18/$2 split – or often even $15/$5 – and prefer to get nothing.

This both contradicts the standard model, and shows that fairness can be a vital consideration in economic settings.

Finally, the self-control problems Thaler documented in other work mean that individuals can benefit from a kind of "soft paternalism" in everything from quitting smoking to the management of their retirement savings.

With *Nudge* co-author Cass Sunstein, Thaler has been the driving force behind designing public policy in a way that recognises and remedies this. Default options in retirement savings are a good example. From the US to Britain and now Australia, "behavioral insights units" have been set up in government to guide public policy in diverse areas on the basis of Thaler's work.

Thaler has enriched our understanding of economics by introducing psychological factors within a coherent and tractable framework.

And his work continues to have far-reaching implications for how we get people to make better decisions.

*Richard Holden is professor of economics at UNSW Sydney Business School and visiting professor of economics at Harvard University Economics Department.*

# Rear Window

From back page

First thing on Tuesday morning, the UBS institutional trader was sent an email from Colonial First State senior dealer **Andrew Briscoe** containing the fund manager's global holdings list. Which Kanaan then proceeded to send, attachment included, to his entire distribution list. So a couple of hundred fund managers and analysts were privy to his unfortunate error (and, go figure, we quickly got wind of it).

Compounding the mistake was the fact that Kanaan didn't even blind carbon copy that list, but put all the addresses in the "to" field. Kanaan's distribution list is a who's who of Australian high finance, but we already knew that because Kanaan made a similar error in March.

George Kanaan

Lucky for Kanaan, it appears the list of holdings he forwarded on wasn't strictly speaking confidential. Though you'd imagine plenty of confidential information does pass Kanaan's desk, so give it another six months and who knows what he might email out ...

## Why is Chris Bowen offering the AICD $3 million?

Australian Institute of Company Directors chair **Elizabeth Proust** is certainly right when she bemoans our board rooms as "male, pale and stale" – and full credit to her work, and to the organisation's, in their pursuit of greater diversity on the top floor of Australian business.

Meanwhile and relatedly, **Chris Bowen** is a sensible fellow – and was the Commonwealth's greatest Labor treasurer since **John Dawkins**. He's one of the few sensible senior shadows taking the edge off **Bill Shorten**'s populism.

Elizabeth Proust

All of that being the case, what on earth was Bowen thinking pledging $3 million of public money to the AICD for "a pilot program to mentor Asian-capable potential board directors" if the ALP wins the next federal election?

It's the worst kind of policy tokenism. I mean, really? **Paul Keating** was proselytising the country's place in a pan-Asian economy 20 years ago! If in 2017, the professional directors' union wants to fly (in the pointy end) a whole lot of mid-career Mosman accountants and Toorak lawyers (and their mentors, naturally!) to Asia to look at Asian people, and maybe even eat some lemon chicken, why the hell should we all pay for it?

As if Proust's flock can't afford to pay its own collective way. According to its last annual report, the AICD is sitting on a cash balance of $9.3 million and a short-term investment account with $10.2 million in it. With net assets of $20 million, can't they develop their members' Asian capabilities? Imagine the indignation emanating from the Melbourne Club's fireside chesterfields if Bowen had proposed a seven-figure "training fund" for the ACTU. There'd be a Royal Commission!

## $3500 to visit Olympic Dam? No thanks, investors tell BHP

Major BHP investors hand-picked to attend a November briefing on the company's Olympic Dam operations in South Australia have balked at the $3500 price tag, forcing the Big Australian to increase its subsidy for the trip.

The company's investor relations team on Monday advised investors that the trip would now set them back only $2000. "Despite the costs involved in arranging this event, we have received some reservations about the amount being charged. As a result, BHP has decided to increase our subsidy." Which means of course that it's all investors subsidising the trip out of BHP's general revenues rather than having more of the cost borne by those lucky enough to be given one of the non-transferable invitations.

The three-day trip involves two dinners with BHP management, a full day's management briefings, three nights' accommodation at Adelaide's InterContinental Hotel (which hasn't had a soft furnishings upgrade since **Don Dunstan** was young), along with a day trip to Olympic Dam that promises surface and underground tours. BHP has been known to conduct tours lasting several days on the site for journalists, but the accommodations at nearly Roxby Downs, which is hardly a picturesque part of South Australia, aren't quite what you'd expect investors to put up with. Much less those paying (part of) their own way there.

## Australian execs network in Tokyo

With the Japanese economy heating up (from the deep freeze), a bevy of Australian corporate leaders have jetted up to Tokyo this week for the 55th Japan-Australia joint Business Conference, which has been the best attended in some years.

The conference, which is driven by co-chair **Rod Eddington** on the Australian end, is being attended by investment banker **John Wylie**, Woodside's **Peter Coleman** (who used his session to announce the group's Wheatstone project had begun to produce LNG), Whitehaven Coal's **Paul Flynn,** and Austrade's **Stephanie Fahey**. Also attending was BHP's chief commercial officer **Arnoud Balhuizen**, Rio Tinto's iron ore boss **Chris Salisbury**, and the head of Maquarie Asset Management **Shemara Wikramanayake.**

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**Editor in Chief**
Michael Stutchbury, afreditor@afr.com.au
**Editor** Paul Bailey, pbailey@fairfaxmedia.com.au
**News Director**
Fiona Buffini, fbuffini@afr.com.au
**Political Editor** Laura Tingle, ltingle@afr.com.au
**Companies & Markets Editor**
James Thomson, j.thomson@fairfaxmedia.com.au

**Customer Service**
help@afr.com.au, 1800 646 990
**Sydney**
Editorial 9282 2822 Fax (edit) 9282 3137 Advertising 9282 3415. Box 506 GPO, 2001
**Canberra** Editorial 02 6240 4000 Fax (edit) 02 6240 4011, Press Gallery, Parliament House, 3600

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