

Nobel Prize in Economics

Why in news?

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Recently Richard.H.Thaler, an American received Nobel Prize for his behavioural Economic theory.

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What are economic theories based on?

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- Most economic theories are based on a certain set of assumptions without which it would be difficult to talk in a coherent fashion about any theory.

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- These assumptions simplify the complex everyday reality.

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- So an economic model could assume that economic agents have perfect information or that the transaction costs are zero.

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- In a similar vein, one of the dominant assumptions has been about economic agents being rational.

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- That is to say, they only act in self-interest, but often there are gaps between the behaviour as predicted by the model and as it is in reality.

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What is the finding of Thaler?

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- He has refined economic analysis by taking into account three psychological traits

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- **Limited rationality** - It underlines that it is not realistic to assume that individuals could be completely rational and think of all possible effects of their choices.

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- Thaler built on this insight to come up with his theory of mental accounting, which describes how people organise, formulate and evaluate financial decisions.

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- For instance, this tendency to create separate mental accounts for day-to-day expenses and holiday expenditure explains why individuals might not dip into their long-term savings and instead use a credit card to tide over some imbalances in daily expenses.

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- **Perceptions about fairness** - Full rationality assumption of traditional theories cannot explain behaviour when it deviates to accommodate an individual's sense of fairness.

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- Through large experiments, Mr Thaler shown how people can set aside personal gain and concern themselves with questions of fairness.

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- For instance, Consumers judge negatively a company which is seen to be unjustly raising prices in times of pressure.

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- **Lack of self-control** -Actual human behaviour has shown that people may, contrary to notions of rationality, choose something that goes against their interest.

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- For instance, a smoker who chooses to yield to an immediate temptation instead of favouring better health in the longer term.

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Why is Thaler's contribution significant?

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- His contribution goes to the very heart of economic modelling and has a profound impact on many areas of economic research.

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- Since field of economics concerns itself with how human behaviour explains the deviations from the established theoretical model, it has wide-ranging impact.

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- Studying the so-called "irrationalities" has implications for

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1. Financial behaviour - Something like unjustified market volatility
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2. Marketing - The “buy two get one free” schemes providing a sense of having gained.
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3. Public policy making - Wherein politicians “nudge” individuals towards a societal improvement.

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Source: Business Standard

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