



Better decisions with nudging

The American economist Richard H. Thaler is rewarded for his groundbreaking contributions to behavioural economics, which have built a bridge between the economic and psychological analyses of individual decision-making. Behavioural economics provides new opportunities to shape courses of action and create institutions that can help individuals to make better decisions and increase societal welfare.

According to traditional economic theory, people are well-informed, capable of thinking rationally, can realise their goals, and only care about their own benefit. Richard Thaler's research shows that deviations from this theoretical *Homo economicus* can be both significant and systematic. People lack rationality and self-control, and they care about fairness and other people.

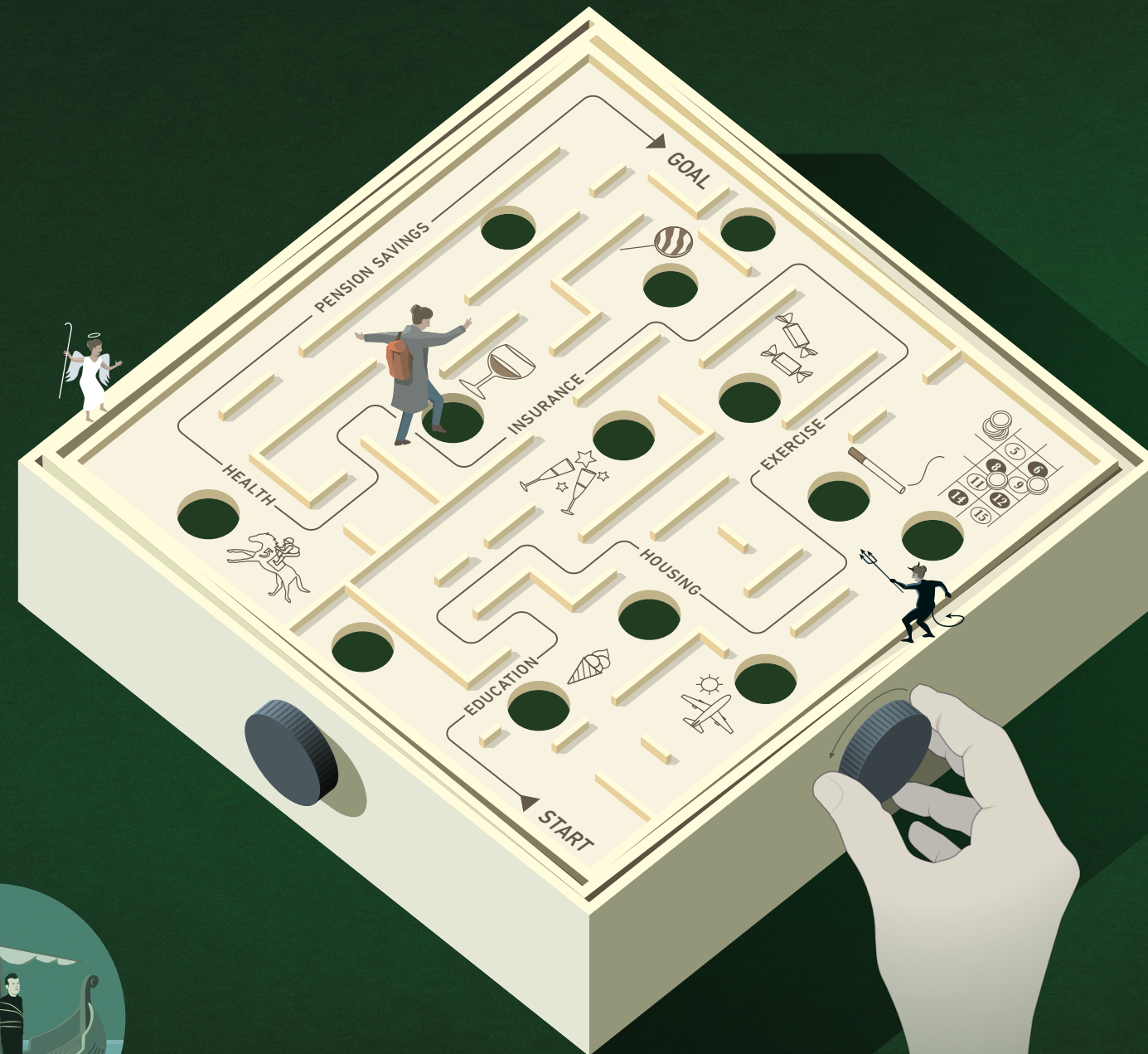
Richard Thaler has contributed to refining economic analysis by considering three psychological traits that systematically influence economic decisions – social preferences, limited rationality, and lack of self-control.

Social preferences include our beliefs about what is fair and just, for example in terms of prices and wages. We are prepared to refrain from material benefits to maintain fairness. We are even prepared to bear a personal cost for punishing others who violate basic fairness norms, not only when we are

affected but also when someone else is treated unfairly.

Limited rationality describes how we simplify our choices and how other than purely rational reasons may lie behind our decisions, which then can seem strange from a traditional economic perspective. However, these decisions can be explained using Richard Thaler's theory of mental accounting, which describes how people organise, formulate and evaluate financial decisions.

Lack of self-control is about giving in to short-term impulses at the expense of a longer term goal. We make the wrong decision, even though we usually know what would be best in the long run. So, our decisions are not always the ones that are best for us. Richard Thaler's theory about how we can be helped to make better choices is called nudging. A nudge in the right direction helps us to save money or work towards a better environment, without being forced to do so.



Nudging

Richard Thaler has developed the theory of nudging, which is an application of behavioural economics. The key idea is to help people exercise more self-control and make more rational decisions. He advocates libertarian paternalism, which means that policies and institutions can be designed so that people are nudged into making better decisions. At the same time, each person should be free to choose and assess whether the chosen option is the best one.

For example, an individual can commit to allocating a share of future salary increases to a pension fund. Sometimes it is about defining the best default option – the one that is the result unless you actively choose something else. There are situations in which many people do not make an active choice; for instance, in the case of organ donations it has been shown that the number of donors is significantly higher if the default option is to donate organs, as opposed to not donating them.

Richard H. Thaler

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Limited rationality

We often simplify everyday financial decisions by creating separate accounts in our minds. Thaler's theory of mental accounting shows the consequences of this. For example, people take expensive loans to put money in one account even though the money is actually available in a different one.



Social preferences

Our desire for fairness and unselfish behaviour can have an impact in some situations. Despite increased demand for umbrellas during an unexpected rainfall, raising the price is perceived as unfair. This may discourage the salesperson from charging more for the umbrellas, in order to avoid losing customers in the future.



Lack of self-control

The myth of Odysseus and the Sirens is about the tension between the long-term, planning self and the short-term, pleasure-focused self. Sometimes it is best to be tied to the mast to avoid temporary temptations on the way to a future goal.

