

MISBEHAVING
THE MAKING OF BEHAVIORAL ECONOMICS
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Richard Thaler was awarded the 2017 Nobel Prize for Economics for his work on behavioral economics. He is the author of Nudge and Misbehaving.

Here are some definitions of behavioral economics:

A method of economic analysis that applies psychological insights into human behavior to explain economic decision-making.

The field of behavioral economics blends insights of psychology and economics, and provides some valuable insights that individuals are not behaving in their own best interests. Behavioral economics provides a framework to understand when and how people make errors.

Behavioral economics studies the effects of psychological, social, cognitive, and emotional factors on the economic decisions of individuals.

Or summed up more succinctly:

The study of why people make bad financial decisions.

When I took the CFP exam, there were 101 sections: Taxes, insurance, estate planning, investing, and other subjects dealing with financial planning. There were no questions related to behavioral economics.

But when started my practice, I soon realized that behavioral economics was my biggest challenge. I could tell people how to reduce their taxes, how much insurance they needed, why estate planning was important, what to think about when choosing investments, and what they needed to do to become financially secure and stay that way.

What I wasn't prepared for was how few people were inclined to do the things I recommended.

Actually, this realization extends back to when I opened my tax practice. I would explain to someone how to reduce their taxes in the coming year. A year later, I found that very few clients followed my advice. I estimated that my clients – collectively –were overpaying their taxes by at least a million dollars a year. They still are!

Thaler's books are fascinating if you want to truly grasp how irrational people are when it comes to money. He divides people into two groups: Humans and Econs.

Econs are people who behave the way economists predict people will behave. If you have studied economics, you have studied the behavior of Econs.

The problem is that Econs don't actually exist. People fall along the spectrum from Human to Econ, but no one is a pure Econ, despite what you might have been taught in economics 101.

Far too many people are closer to the Human end of the scale rather than the Econ end of the scale. In *Nudge*, Thaler describes practical solutions to "nudge" people a little farther from the Human end of the scale toward the Econ end of the scale. He won the Nobel Prize for his work in applying behavioral economics to the real world.

The book – 358 pages long – is full of examples, experiments, and studies of Humans misbehaving. My favorite study was the Marshmallow Study. Children were left alone in room with a single marshmallow. The experimenter would tell the child as he left the room that, if the child would refrain from eating the marshmallow until the experimenter returned, the child could have a second marshmallow and eat both of them. Many children waited (future Econs),

but many (future Humans) ate the marshmallow as soon as the experimenter left. The children were followed for several decades. Those who had waited for the second marshmallow were much more financially secure than the children who had not waited.

What does the Marshmallow Study tell us? All of us are who we are. And we really don't want to change. If we can't defer gratification at age 8, we won't be able to defer gratification at age 50. But if we understand the importance of deferred gratification at age 8, we are well on our way to creating a happy, secure, and fulfilling financial future.

In my many decades of working with people and their money, I see other behaviors that puzzle me but which Thayer addresses.

For example, why are people OK with overpaying their taxes if they don't see the overpayment (by not funding a 401K for example), but would be quite distressed if they were asked to actually write a check for the same amount? The effect is the same; the emotions are not.

Why do people who have large cash balances in the bank take out loans rather than taking money from their accounts? The effect is that they are paying the bank to borrow their own money.

Why do unmarried couples with children stay unmarried when there are hundreds of laws (such as social security) that provide huge financial benefits and security for married couples and their children?

In an emergency, why do people withdraw money from retirement accounts (with half of it going to taxes and penalties, effectively a 100% rate of interest) instead of using a credit card or a line of credit (with a much lower interest rate)?

Why do people fudge (cheat) on their tax returns while failing to take advantage of perfectly legitimate methods of reducing taxes (such as funding retirement accounts and health savings accounts).

Why is this important for me? I learned long ago that I can't change Humans and that I was wasting my time and theirs when I tried. Rather, I had to focus on would-be Econs whose behavior I could nudge closer to that required for long term financial security.

Although *Misbehaving* is a long book, you don't need to read every page. Much of it is autobiographical. You don't need to follow Thaler's life as he moves around the country. And each chapter is on a different aspect of behavioral economics. For example, chapter 6 deals with why people make bad investment decisions.

Misbehaving (the book, not the activity) is unlikely to change your life. But it will help you to become more self aware as you make financial decisions. If you understand that all of us – including you – have certain biases that cause us to make unwise financial decisions, you might find yourself making fewer of them.