Nobel prize integrates economics with psychology – a pity that it has not been yet applied to executive pay

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The 2017 Nobel prize in economics went to Richard H. Thaler of the University of Chicago. Prof Thaler incorporated psychologically realistic assumptions into analyses of economic decision-making. He explored the consequences of *limited rationality, social preferences*, and *lack of self-control* and showed how these systematically affect individual decisions as well as market outcomes. The predictable behaviours arising from these predispositions have remuneration applications. Indeed, there have been several innovations in how to pay people in diverse settings, for example, for better sales and education outcomes. While Guerdon Associates occasionally suggests executive pay alternatives based on these constructs, they may a bit too different for ready stakeholder acceptance without sufficient advice, engagement and demonstration.

Limited rationality: Thaler developed the theory of *mental accounting,* explaining how people simplify financial decision-making by creating separate accounts in their minds, focusing on the narrow impact of each individual decision rather than its overall effect. We suspect that this explains many proxy adviser and investor remuneration report voting behaviour. He also showed how aversion to losses can explain why people value the same item more highly when they own it than when they don't, a phenomenon called the endowment effect (see an application on this in education HERE). This concept has been the theoretical basis of "malus" systems advocated by the Financial Stability Board and Australia's APRA after the GFC (see HERE for one of its first applications). It is unfortunate that this valuable construct has not been as effectively applied in executive pay as it could be.

Social preferences: Thaler's theoretical and experimental research on *fairness* has been influential. He showed how consumers' fairness

concerns may stop firms from raising prices in periods of high demand, but not in times of rising costs. Thaler and his colleagues devised the *dictator game,* an experimental tool that has been used in numerous studies to measure attitudes to fairness in different groups of people around the world. While there are many aspects of this for remuneration purposes, a key one is that it is okay to have an unequal world, where someone receives a lot more pay than another, providing that the basis for it is fair. (See HERE)

Lack of self-control: Thaler has also shed new light on the old observation that New Year's resolutions can be hard to keep. He showed how to analyse self-control problems using a *planner-doer model,* which is similar to the frameworks psychologists and neuroscientists now use to describe the internal tension between long-term planning and short-term doing. Succumbing to short-term temptation is an important reason why our plans to save for old age, or make healthier lifestyle choices, often fail. In his applied work, Thaler demonstrated how *nudging* – a term he coined – may help people exercise better self-control when saving for a pension, as well in other contexts. In executive pay, this has application in the sort of performance measures applied and paid for, and the application of equity.

In total, Richard Thaler's contributions have built a bridge between the economic and psychological analyses of individual decision-making. His empirical findings and theoretical insights have been instrumental in rapidly expanding the *behavioural economics* field. This has already had an impact on many areas of economic research and public policy. It therefore seems a pity that few of these great insights have been effectively applied to executive pay and governance.