The Economic Club of New York

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Dr. Richard Thaler
Charles R. Walgreen Distinguished Service
Professor of Economics, and Behavioral Science
at University of Chicago's Booth School of Business

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Webinar

Moderator: Greg Mankiw
Robert M. Beren Professor of Economics
Harvard University

Introduction

President Barbara Van Allen

Good afternoon and welcome to the 696th meeting of The Economic Club of New York. I'm Barbara Van Allen, President and CEO of the Club. The Economic Club of New York is known as being the nation's leading nonpartisan forum for discussions on economic, social and political issues. We've had more than 1,000 prominent guest speakers appear before the Club over the last century and have a strong tradition of excellence, which continues to today's event.

I want to extent a warm welcome to students from Mercy College, the Gabelli School of Business at Fordham, Harvard University, and Columbia, who are joining us virtually today. We also have some members of our largest-ever class of 2023 ECNY Fellows – a select group of diverse, rising, next-gen business thought leaders. I believe this year is actually going to cross the 70 mark, so a new high for us.

I'm really truly honored to welcome our special guest today, Nobel Laureate Richard Thaler, the Charles R. Walgreen Distinguished Service Professor of Economics and Behavioral Science at the University of Chicago's Booth School of Business. This is a day we've been working toward for a couple of years so we're thrilled to have this come true.

Prior to coming to Chicago in 1995, Richard was a professor at Cornell's Johnson School of Management. He is also a Research Associate at the National Bureau of Economic Research. His research lies in the gap between psychology and economics. He's considered a pioneer in the fields of behavioral economics and finance. He's the author of numerous academic articles and the books, including *The Winner's Curse, Nudge,* and *Misbehaving.*

In 2015, he served as the President of the American Economic Association, is a distinguished fellow of the American Finance Association, a fellow of the Econometric Society, and a member of the American Academy of Arts and Sciences and the National Academy of Science. In 2017, he was awarded the Nobel Prize in Economic Sciences. Richard is a founding partner of Fuller Thaler Asset Management located in San Mateo, California, which invests in U.S. equities via mutual funds and separate accounts.

The format today will be a conversation, and we're delighted to have Club Trustee and the Robert M. Beren Professor of Economics at Harvard University, Greg Mankiw, with us today doing the honors of moderating. In addition, we're going to use the chat box for the conversation. You can enter questions directly there for their consideration if time permits. As a reminder, this conversation is on the record as we do have media on the line, actually quite a bit of media. So, Greg, if you're ready, I am happy to pass the mike over to you.

Conversation with Richard H. Thaler

GREG MANKIW: I'm ready, Barbara. Thank you very much for that introduction. Richard, it is such an honor to be with you. I've been one of your fans for many, many years. I'm really delighted that we have this time to chat.

When I was a student, there wasn't such a field as behavioral economics. And when I first heard the term, I wasn't even quite sure what it meant because I thought all of economics was about behavior. So for some in the audience that are old like me and don't know what behavioral economics is, can you sort of define it for us?

DR. RICHARD THALER: Yes, you know, Herb Simon, who was sort of a pre-behavioral behavioral economist, had a line in an encyclopedia where he defined behavioral economics. And he posed the same question you did, he said, one might ask what other economics could there be? He said the phrase is a neo-pleonasm, which means redundant phrase. And he said the answer lies in the assumptions of economics. So we wouldn't need behavioral economics if economics had followed the path starting with Adam Smith and leading to Keynes, all of whom I call behavioral economists.

And then there was a turn after World War II in which economics became much more mathematical and mathematical models are easier if you have rational agents. And if they're subject to human frailties, then it gets harder. And since everyone, including economists, have bounded rationality, it's easier to do economics with rational agents who are unemotional and have no self-control problems. And fortunately there are bright, young people like your colleagues, David Laibson and Matthew Rabin and so forth, who are up to the challenge of doing the hard kind of economics, which includes humans.

GREG MANKIW: Yes, we actually have a big program now in behavioral economics, including David Laibson and Matthew Rabin plus several others. So it's really a big deal at Harvard right now, thanks to you and Kahneman and Tversky and other people who really got this field going. Now, you're now in Chicago, which I think of as really the home of rational economics. I think of Gary Becker as being the sort of pinnacle of a rational man who is applying it to all sorts of models. Did you talk to Gary about behavioral economics? I'm sure you must have. How did that conversation go?

DR. RICHARD THALER: Well, I'm sure you met Gary. He was a very friendly guy, very soft-spoken and never took anything personally. So we got along quite well and had lots of interesting discussions. We had an interesting exchange about self-control. So he and Kevin Murphy have a paper about rational addiction, in which people get addicted rationally. They anticipate it.

And I mentioned that alcoholics sometimes take the drug Antabuse, which has the effect of making them vomit if they ingest alcohol. And I pointed out that that would never happen in his model because it would have the effect of raising the price of the thing to which they're addicted. And he said, well, we could incorporate that but it wouldn't be very interesting. So we had lots of exchanges like that over the years. But I think his goal was to export the rational economic model to other social sciences, and I had the goal of importing useful bits of social science into economics.

GREG MANKIW: Right. So Kahneman and Tversky were trained as psychologists even though they got the Nobel Prize in Economics, because they, along with you, imported a lot of psychology into economics. What other examples do you use to convince people to be skeptical of the rational model? I like that example with the alcoholics. And there others that you find particular persuasive?

DR. RICHARD THALER: Well, you know, I've done a lot of work on what I call the economics of self-control. And there's a famous story I tell about being in graduate school and hosting a bunch of economics graduate students for dinner and putting out a bowl of cashews and cocktails. And after a few minutes, half the bowl was gone and I grabbed the bowl and hid it in the kitchen. And I came back and people thanked me, and then since we were all economics graduate students, we commenced to have a discussion about how we were happy but we weren't allowed to be happy because in any economic model more choices can't make you worse off. And we had one fewer choice than we used to.

So that eventually led to an interest in retirement savings and the design of retirement plans. And we know, and your colleague, David Laibson, has done much of the work in this area as well, that if you simply make the default, joining the 401K plan for example, 90% of people join immediately. And which box is pre-checked should not matter in any economic model where hundreds of thousands of dollars potentially are at stake, but it does.

And I will say that the surprising thing is that I think the sub-field of economics where behavioral approaches have had their biggest impact is finance. And if you had asked me in 1985, I wrote my first finance paper in 1985, and I also wrote a marketing paper, and if you had asked me which I would bet on as having an impact, I would have put all my money on marketing. And that turned out not to be a big deal, but finance has become more and more behavioral, both in academia and in the world. I mean, you know, Matt Levine has a full-time job at Bloomberg telling funny stories about the financial market. And the idea that the financial markets would be funny enough to support a full-time columnist is not something we would have anticipated 30 years ago.

But, you know, the first principle of financial economics is the law of one price. And everything, all of the formal theories start with that, and it's very easy to find counter-examples to that. Right now there's an amusing one going on with AMC, the movie theater chain, that has set up another kind of stock that they call APEs, which is named after...it's a meme stock and the people who follow those call themselves apes. And they created another ticker symbol that you and I would consider to be identical, but they don't trade for the same price. So there are dozens of those, and I challenge you to think of a rational story to explain them.

GREG MANKIW: You know I recently saw an interview with Cliff Asness, the founder of the hedge fund, AQR Capital Management. And he was, as you probably know, he was a PhD from the University of Chicago, a Fama student. And he said on this call that when he left the University of Chicago, he was 75% Fama, 25% Thaler. And that, having worked now in financial markets for several decades, he's now 75% Thaler and 25% Fama.

DR. RICHARD THALER: Well, he's an active hedge fund manager and I think the 25% he gives to Gene is a courtesy to his beloved adviser.

GREG MANKIW: And his trades are very much looking for anomalies along the lines that, it's easier to understand from a behavioral standpoint than from sort of a rational, efficient market standpoint. Does this change how you invest your own money for retirement? I mean I was a student of Burton Malkiel so I put all my money in index funds. I have a little bit of Cliff Asness actually but very little, but most of my money is in index funds. Do you do something different than that?

DR. RICHARD THALER: Well, not with my retirement money so much. But as the intro mentioned, I'm a partner in an asset management firm, not as big as Cliff, but we...

GREG MANKIW: Do you guys outperform; most active managers don't outperform the market – that's what I learned from Burton Malkiel – do you guys systematically outperform the market?

DR. RICHARD THALER: Let me see if I can find some wood, but our two largest funds both outperformed their benchmarks by more than 10% last year and have long-term track records. Not like that, but significantly outperforming. And all of our strategy are explicitly behavioral in the sense that what we're trying to do is identify the mistakes that other people make.

And here's an example, if you go into a restaurant that's sort of dimly lit and somebody at the front desk is leading you to your table and there's a little step down at some point, he or she will say, watch your step. And that's because they know that that's a place where people trip. And similarly, in financial markets, you can anticipate the mistakes that people make and when they are mistakes that leave stocks undervalued, those are the ones that we try to buy.

GREG MANKIW: Are there systematic biases, like factors that you look for or are you looking really for more idiosyncratic kinds of situations like that, that AMC situation that you mentioned a moment ago?

DR. RICHARD THALER: The AMC thing is just weird. And it's an example where rational theory says it can't be that there are two ticker symbols that have the same economic value and have different prices, but those are not arbitrage opportunities because you can't convert one into the other. And if you try to be smart and go long, the cheap one, and short the expensive one, you can find them diverging, which is exactly what happened to long-term capital management back in the day.

GREG MANKIW: That's what Keynes said, the market can be irrational longer than you're solvent, right?

DR. RICHARD THALER: So basically what we try to do is find a class of situations that, as my partner used to say, are good fishing ponds. And then among those, we use some proprietary methods to say which of those. So, for example, firms that have earnings surprises, we've known for 40 years, tend to have subsequent earnings surprises. And if you can predict that analysts will get more optimistic in the future, you're going to make money. So we start with that, which is common, everybody knows that. But we...

GREG MANKIW: That's related to momentum trade, isn't it?

DR. RICHARD THALER: Well, no, because what we're trying to do is forecast future momentum. Right? So if today you announce an earnings surprise, yeah, the price went up today, but there's no six or twelve-month momentum yet. So what we're trying to do is find the situations where the earnings surprise today isn't fully incorporated by the market yet and that over the next year or two, it will have better than expected. And, you know, if you can be right 55% of the time on judgments like that, then you beat the market.

GREG MANKIW: I always thought the best evidence for the efficient markets team was the fact that index funds outperform 85% of active managers. Isn't that just because 85% of them are as rational as the day traders sitting at home?

DR. RICHARD THALER: No, I agree with you. And I think that it's perfectly rational to invest your money in index funds. I have all of my money in index funds or funds managed by Fuller & Thaler. But the fact that the average, look, the average golfer is lousy, but Tiger Woods is good. Right? So the fact that the average golfer is lousy doesn't tell you that it's impossible to be good. It's hard. And I think efficient market hypothesis is approximately true, but it's not impossible to beat it.

GREG MANKIW: Let's move from finance to public policy. How do you think about the role of behavioral economics in helping formulate public policy?

DR. RICHARD THALER: Well, you know, another one of your colleagues, my former colleague, Cass Sunstein, and I wrote a book back in 2008, called *Nudge*. And the idea was is it possible for us to design policies that make it easier for humans to make better decisions? And the retirement idea that we talked about briefly before of automatically enrolling people into the plan but giving them the option of opting-out is an example of such a policy. We call our philosophy libertarian paternalism, which was designed to annoy as many people as possible. Libertarians are angry that we stole their word and everybody hates paternalists.

But there are now so-called nudge units, somebody counted 400 around the world that have been started since we wrote that book. And the way I describe it is, the world has gotten a lot easier in the last 20 years because of GPS. I have a terrible sense of direction, but I have a map in my pocket, and I get lost way less than I used to. And what our sort of dream is making the world more like walking around in a strange city with Google Maps in your pocket. And we can do that with lots of things. And the question is, where can you find them?

And we recently revised this book, and in a commitment strategy similar to moving the cashews, I insisted on calling this new version, *Nudge, The Final Edition*, because my co-author has been known to write books in an hour or so. So I needed to tie him to the mast to make sure he didn't revise it. But one thing we did in that book is we introduced a new term that we call sludge, which is, you know, our goal is make it easy. Whatever you're doing, make it easy if you want people to do it. And there's lots of sludge in the system that makes stuff hard, like life without GPS.

One example is my colleague, Austan Goolsbee, had an idea that I love, which is that the IRS should send people a pre-populated tax return. And for people who take the standard deduction, which is about 90% of taxpayers now, they could just click yes. In Sweden, you file your tax return by text message. You get a message saying we think we owe you 1,100 kronors. If you agree, click here, and the money appears in your account.

When they tried to get that law passed, instead there was a law passed forbidding the IRS from doing that. You can guess the companies that supported that lobbying effort. And instead, those companies, namely TurboTax, Intuit, and H&R Block, promised that they would do free tax returns, which, of course, good luck finding those. But there's no reason for anybody, on either side of the political aisle, to oppose giving people a pre-populated tax return. People spend hundreds of dollars filling out a return that they needn't do and lots of hours. The number of hours spent doing that stuff is ridiculous.

And this applies in all kinds of things. Think about the institution of a notary public. Why in the world does that institution still exist? I can give you no, you know, during the pandemic one of the good things, there were lots of good things, one was Docu-Sign more or less replaced having to sign some document and scan it and send it back. That's the way the world should be moving. And I think governments should all be striving to get rid of sludge as should employers, by the way. I mean filling in an expense account report shouldn't be a lot of work. It's gotten much better at the University of Chicago, but all of these things can be made easier. And that's one of the things we emphasize in the new version of this book.

GREG MANKIW: I have not read the new version. I had read it when it first came out. It's a wonderful book. I think I assigned it in the class, a seminar that I was teaching for undergrads and they loved it too. I remember one of the things that I thought about was, you know, yes, the government can sort of nudge people in useful directions but the government itself is not a fully rational institution. Right? And I kind of wonder, together with behavioral economics, maybe we need behavioral political science? And sometimes it's a competition between sort of imperfect private decision makers and imperfect public decision makers as to who is more imperfect, or lately who is the creator of sludge? And a lot of sludge is created by the government. Just look at the tax code.

DR. RICHARD THALER: Well, you know, intentionally I chose the example of the government passing a law forbidding itself from providing a free service. Right? That's ridiculous. So I'm not saying that the government knows all. But there are many situations, I'll give you an example. Social Security is a system that requires almost no thinking by participants. You only have to make one decision, which is when to start claiming.

GREG MANKIW: And most people do that wrong. Right?

DR. RICHARD THALER: 97% of people do it wrong. Almost everybody, unless you're sick when you're 62, you should wait until you're 70. Because the annuity, it's an inflation-adjusted annuity, and Social Security provides that at below market prices. So I waited until I was 70. When we wrote that book, we made fun of the Social Security Administration that the only decision people had to make, they offered a little tool, a little calculator to help people do this, and it was online, and it was available Monday through Friday 9 to 5. Now, where they find a computer that only works bankers' hours, I don't know.

Peter Orszag and I, after the book came out, he was Head of the Congressional Budget Office, I think. He organized a meeting with the SSA and asked them about this.

GREG MANKIW: Peter was Head of OMB.

DR. RICHARD THALER: He was at OMB at that point. And their response was to take the calculator down. And so, you know, you and I used to be part of a team at the *New York Times* that wrote columns and I wrote one about that. But I don't have the ability to get them to, I tell people, wait until you're 70 as long as you're healthy.

So, look, you know, if I have a financial decision to make personally, I ask my colleague, Doug Diamond, what to do because he's the smartest guy I know, about financial markets. And there's somebody smart who understands things and the government has access to experts, and they won't always get it right, but certainly Social Security could do better.

I mean here's another very behavioral thing. They have some age that they call the standard retirement age and it's been gradually changing. It's completely meaningless, I think it's 65.7 now or something like that. There's nothing standard about it. There's nothing optimal about it. So even the names they give to various things can be helpful or unhelpful, so let's make them helpful. And they won't always get it right, but there are lots of situations, you know, every once in a while Google Maps makes a mistake, but way less than you and I.

GREG MANKIW: Economists are notorious for disagreeing with one another. Do you think behavioral economists agree more? Let me tell you a story about why I ask the question. Jason Furman once told me that when he was Chairman of the Council of Economic Advisers, the Obama Administration wanted to send some checks out to stimulate the economy after the Great Recession. And they had two ways of sending the same amount of money, either changing withholding or sending special checks.

People were getting the same amount of money so our neoclassical economists would say it doesn't matter. So they called a bunch of behavioral economists, which would stimulate consumer spending more? And they got people 50/50 on two different sides. Even the behavioral economists couldn't agree. So are behavioral economists as argumentative about public policy as economists in general? Or is there more consensus?

DR. RICHARD THALER: Well, I think I was one of the people that talked to Jason. I certainly remember talking to Jason about it. It's complicated because my answer was if your goal is to stimulate spending, then change the withholding because the people you care about are sort of living paycheck to paycheck and they'll spend what they have. But I said that method will not be noticed and so it may not be optimal politically. And, in fact, when President Trump had the same situation, he insisted on sending out checks and, in fact, waiting until they could get his famous signature on the checks. So I think he did it the wrong way economically and the right way politically and President Obama did the opposite.

GREG MANKIW: The people who are interested in behavioral economics, I think the younger generation seem to be moving past the psychology. You know, you've imported a lot of psychology into economics. They're now importing neuroscience or genomics into economics. Do you think that's promising? If you were a young scholar, would you be taking neuroscience courses to understand economics better?

DR. RICHARD THALER: I would say so far, you know, if I look at my Magic Eight Ball, I would say the returns are cloudy. Look, why did we borrow from Kahneman and Tversky? They gave me, you know, I claim to have discovered them. Other people seem to think they existed before I met them, but I think that was my big academic achievement was finding them. And what they did was say here are the predictable mistakes. Like what we were talking about in financial markets.

Neuroscience has not really provided this kind of portable tool. So where have we made progress in behavioral economics is in saying, look, people make this kind of mistake and it leads them to make decisions that are different from the predictions that somebody like Greg Mankiw would make based on a standard rational model. So if we can find those, we should use them.

Sociology, for example, has not really provided much.

GREG MANKIW: Why is that?

DR. RICHARD THALER: I don't know the answer to that, and it's not necessarily a criticism of sociology. It's what they produce isn't in a form that's readily borrowable. And, look, that's true of 99% of psychology as well. The judgment and decision-making research that Kahneman and Tversky pioneered was particular useful. And, you know, the kinds of things that clinical psychologists know, that could be useful in trying to understand what Putin is up to. Right? Maybe we would like President Biden to have a consulting clinical psychologist to help him understand Putin. So I don't think, look, let all flowers bloom, but people have been doing neuroscience and trying to use it in economics for 20 years and my challenge to them has always been tell me something that I didn't think I already knew, or tell me something that I thought I knew and is wrong. And so far, they haven't.

GREG MANKIW: Obviously psychology has had a big impact on economics. Has there been any effect in the other direction? Have economists affected how psychologists think at all? I know, getting back to our Gary Becker discussion, he wanted to invade all other social sciences with an economic model. Has your collaboration with psychologists change psychologists? I mean it's profoundly changed economics. I'm wondering how broad it is.

DR. RICHARD THALER: Yes, so I think no. And here's another surprising thing. So when Kahneman, Tversky and I met each other and started working together, we thought that if behavioral economics emerged, it would be interdisciplinary because that's what we were doing. They're two psychologists, I'm an economist, and we work together. That hasn't really happened. Behavioral economics is done 99% by economists. And I think it's because the entry barriers to economics are very high. And other social scientists find what we do to be both technical and boring. And so there maybe are a dozen psychologists that have really engaged over the last 40 years, but most people are happy to let us do it.

GREG MANKIW: Do they have a point? Is what we do a little, are the barriers too high? Are we a little too technical and a little too boring?

DR. RICHARD THALER: Well, you know, I don't think any more than any other technical field. Right? I find physics pretty technical and kind of interesting in a way, like I'd love to know how they do it, but not enough to learn. And so I think, you know, interdisciplinary research, in general, my experience has been, it sounds better than it turns out.

GREG MANKIW: Donors to universities love it. They love funding interdisciplinary work.

DR. RICHARD THALER: Right. And then you create some center for something or other and you have groups of people that never end up talking to one another because, whatever.

GREG MANKIW: So for here, I'm sure there are students in the audience, if there are some prospective behavioral economists, you wouldn't necessarily tell them to go to the Psychology Department. You'd tell them go talk to David Laibson or Richard Thaler.

DR. RICHARD THALER: No, I would say read psychology. And I wish, you know, David Laibson and Matthew Rabin and I read a lot of psychology and now grad students just read Laibson and Rabin. Right? They learn the psychology second-hand. And there are some exceptions, I have a young colleague, Alex Imas, who reads a lot of psychology, but that's not the norm. But what I would suggest to students is that there are lots of fields of economics that behavioral economics could make big contributions to and hasn't yet. And my number one nomination would be macro.

GREG MANKIW: My colleague, Xavier Gabaix, is working in that area.

DR, RICHARD THALER: That's right, but it's, you know, it's Xavier and five others. And Xavier's economics is not particularly easy.

GREG MANKIW: No, it isn't. We have a question here from the audience asking you what do you think about Bob Schiller's work in narrative economics? I think that sort of, that falls within the broad scope of behavioral.

DR. RICHARD THALER: Yes, absolutely. And, you know, it's obviously true that people tend to think in terms of stories. So I think it's right and I don't know exactly how to apply it. But, you know, going back to macro, Bob and George Akerlof had a working group at NBER for like 25 years and ten people would show up. And these are two future Nobel Laureates and they couldn't get a quorum.

GREG MANKIW: I remember when I was a student that people like Tom Sargent were telling people, they weren't telling you to go to the Psychology Department, they were telling you to go to the Electrical Engineering Department and learn these optimal control techniques. So it was a very different advice. I wish I had more advice from people like you. Maybe I could have helped push along behavioral economics.

DR. RICHARD THALER: Talk to me before you write the next revision.

GREG MANKIW: Well, we only have a few minutes left, three minutes I think. So I want to ask you about how did the Nobel Prize change your life?

DR. RICHARD THALER: Not, you know, look, not in a major way. Maybe, you know, there are four Nobel Laureates on my floor at Chicago Booth. So you certainly don't get treated like royalty at the office. You know, okay, another guy.

GREG MANKIW: There's no bragging rights at the Club or something like that?

DR. RICHARD THALER: You know, Becker had a line once, somebody mentioned somebody's name and Becker sneered or something. Well, he did win the Nobel Prize, and Becker said, yeah, but he had to share it.

GREG MANKIW: (Laughter)...That's pretty funny. Well, anyway, Richard, thank you so much for taking this time. I'm going to turn the floor back over to Barbara. This has been an absolute delight. Thank you, Richard.

DR. RICHARD THALER: Thank you, Greg. It was a pleasure.

PRESIDENT BARBARA VAN ALLEN: Many thanks to you both. Wow! What a fun conversation. Really, really a treat for our members and their guests today. So just a quick look forward. Our next event is March 1st. We'll have a Signature Luncheon with the Global CEO of L'Oreal, Nicolas Hieronimus. He is going to be joined in a Fireside Chat with ECNY Chair Emerita, Marie-Josee Kravis. Later in the spring, we have additional luncheons planned. One with Jen Easterly, the Director of Cybersecurity Infrastructure. You can see there on the screen, March 23rd. She's going to discuss why corporate cyber responsibility is more important than ever. That will be followed by Robin Hayes, the President and CEO of JetBlue, March 29th, to discuss recent travel issues and what the airlines are doing to improve customer experiences as well as the strategy behind the planned merger with Spirit Airlines. On April 4th, we have our Annual Women in Business Conference along with the Consul Generals of Canada and France. That will be a morning conference focused on women in business. So stay tuned as we announce speakers. On April 13th, we go to a webinar with Dr. Ella Washington, who is Organizational Psychologist and Professor at Georgetown University's McDonough School of Business. And she will be examining inclusive leadership and the evolution underway in workplace cultures. And then finally for today, in terms of announcements, April 18th, we'll have a luncheon discussion on where the markets maybe going this year with insights on investing, and technology in particular, with Lee Ainslie, Founder and

Managing Partner of Maverick Capital and a member of our board.

Finally, I'd like to take a quick moment to recognize those of our 361 members of the Centennial Society joining us today as their contributions continue to provide the financial backbone of support for the Club and all of our programming. So again, many thanks, Richard and Greg. And thank you to all who have joined us this afternoon. Have a great rest of the day.