

## **A Nobel Memorial Prize laureate in Economics who has inspired me.**

Innovation. Passion. Creativity. Determination. Excellence. Proficiency. These are just some of the values which compel me to be inspired by a certain individual. All of the above characteristics and many more honourable traits are found in Daniel Kahneman, the joint winner of The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2002. I have chosen this laureate due to his ground breaking research in to psychological economics which has pioneered a new dimension in economic research. I shall lay down some background foundation about the laureate himself before moving on to attempt to briefly summarise his work and contributions to economics in the most understandable way before relating and drawing inferences to explain why his work and his life has brought a profound impact and inspiration to me.

Daniel Kahneman was born on the 5<sup>th</sup> of March in 1934 in Tel Aviv (Kahneman, 2017). He spent his early years residing in Paris with his parents, who were Lithuanian Jews. His life took a hard turn in 1940, when the Nazi Regime invaded France, and swept through Paris (Kahneman, 2017). Despite the persecution his family faced, they escaped from the Nazis on several occasions (Kahneman, 2017). In his biographical, he accredits his early interest in psychology to his Jewish culture, in which his environment would be made up of people and words and usually people talking about other people (Kahneman, 2017). Nevertheless, ever since his childhood years he was bright and always had an aptitude and keen interest in philosophy and psychology (Kahneman, 2017).

Kahneman decided to pursue a degree in psychology and later graduated from the Hebrew University in Jerusalem with a major in psychology and a minor in mathematics(Kahneman, 2017). He had a brief spell with the military where he was transferred to the psychology branch of the Israel Defense Forces with the responsibility of assessing recruits and so on (Kahneman, 2017). After his time in the military, he proceeded to continue his graduate studies in America to obtain his PhD (Kahneman, 2017). It was during this time that he experienced many things and met a number of new people who later strongly influenced his work (Kahneman, 2017).

Daniel Kahneman collaborated with his fellow colleague Amos Tversky to publish several articles (Kahneman, 2017). It was through this collaboration that the concept of the prospect theory would later be founded (Kahneman, 2017). Kahneman spoke fondly of Tversky

and accredited him with a lot of his successes. Kahneman expressed his feelings of enjoyment during their time spent collaborating and spoke of his own revered respect for Amos (Kahneman, 2017). Unfortunately, Tversky was unable to accept the Nobel Prize due to his death in 1996 as the award is not awarded posthumously (Kahneman, 2017).

Even without considering his amazing contribution to modern economics, his life story and background itself is nothing short of inspiring. To have grown up as a Jew during the peak of the Nazi reign, yet being able to achieve everything he has today, is a true testament of how success is achievable no matter how slim the odds are and the incredible obstacles that are in your way (Kahneman, 2017). Another aspect of his life that I have a great admiration for is how he fostered such close relationships, especially the one he had with the late Amos Trevesky. In his biographical, he talks about his deep relationship with Trevesky and how the close bond allowed them to achieve so much through research and development (Kahneman, 2017). Their collaboration truly shows how much more can be achieved when people put aside their differences and work together towards a common goal.

Before prospect theory can be discussed, it is necessary to explain a preceding theory. Utility theory was first introduced by Daniel Bernoulli (“Utility”, 2017), this theory explains that economic agents will always act rationally to maximise personal utilities when making decisions (“Neoclassical Economics”, 2017). Utility refers to the measure of satisfaction derived from individuals from a certain outcome. Under utility theory, individuals will always choose the result which helps them gain more utilities. This concept has been a strong focal point for the assumptions of Neoclassical Economics which has been widely used over time.

However, Trversky and Kahneman’s contributions to prospect theory has provided strong contradictions to the widely acclaimed utility theory, and has also questioned many underlying economic assumptions. Firstly, under prospect theory Kahneman has explained and shown how individuals tend to make irrational decisions when faced with uncertainty. He points out that individuals also judge an outcome based on their current reference level as compared to absolute terms (Advanced information on the prize in economic sciences 2002, 2002).

For example, let’s say there are two individuals. The first individual gains 50 dollars, and the second one gains 100 dollars but then loses 50 dollars. Under the assumptions that govern traditional economics you would expect both agents to gain an equal amount of utilities as they both receive a net gain of 50 dollars. However, in reality we understand that the first

individual will be much happier than the second. The first individual has a reference level of nil and thus the gain of 50 dollars is quite favourable. However, the second individual, after gaining the 100 dollars has a reference level of a 100 dollars, and thus, if he ends up with anything less than a 100 dollars, it will be viewed as a loss to the individual.

The unequal way in which people perceive gains and losses is relevant in this example due to the influence of Kahneman's work. As stated in the example above, the first individual would be far happier than the second individual who lost the 50 dollars although they both made a net gain of 50 dollars. Kahneman and his partner, Tversky, noticed that the dissatisfactions from a loss are far greater than the satisfaction caused by a gain. It is said that the pain of losing can have up to twice the psychological effect as the pleasures of winning. In other words, losses hurt us more than gains make us happy.

This result can be clearly shown as a graph function in figure 1 (Figure 2 in Kahneman and Tversky, 1979). Figure 1, shows the graph function in the losses domain to have a steeper gradient in comparison to the gains domain; this shows how losses have a more severe effect on individuals than gains do.

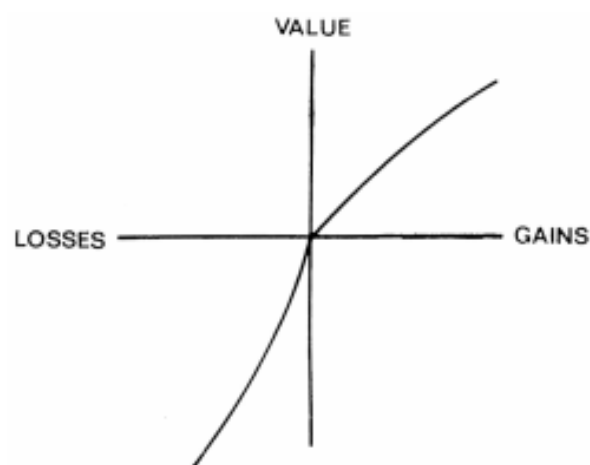


Figure 1

There are many applications of this idea of prospect theory. It gives us a clearer understanding of both financial and economic activity that tend to differ from the normal traditional economic theories. Loss aversion is a common term that is defined as the tendency for individuals to prefer avoiding losses rather than acquiring gains ("loss aversion", 2017). This can explain certain financial occurrences such as the disposition effect. The disposition effect is defined as investors' reluctance to sell assets that have lost value and greater likelihood of selling assets that have made gains (Shefrin & Statman, 1985).

In other words, prospect theory helps us understand why a large proportion of investors tend to sell profitable shares prematurely and tend to hold on to unprofitable shares for a longer period. Shareholders sell off their profitable shares prematurely before the risk of losing the profit gained because the prospect of gains make individuals more risk adverse. Shareholders take longer to sell off shares that are steadily declining and would rather take their chances in the shares to breakeven because losses tend to make people more risk-seeking in order to avoid a loss.

Anything that causes a change and challenges the status quo is something that deserves recognition, what more a theory that contradicts the existing theory to which many of the economic assumptions are based upon. That is exactly why Kahneman's contributions to economics have inspired me greatly. To have established such a theory which is rather contradictory to the norm of traditional economics is something to be recognized. His work brings a greater understanding as to why economic agents act irrationally and why actual real world situations differ from economic models. With this in mind, it will be possible to create more accurate assumptions about economic activities with the actual behaviour of economic agents under consideration.

One thing that has set this laureate apart from the others is the way in which he established his work. A good number of the laureates in economics made their contributions with the use of mathematics and econometrics, by contributing new equations and models of situations and so on. However, Kahneman made his contributions using the psychological side of economics also known as Behavioural Economics. This different approach was what drew my attention to his work initially. It is not to say that Daniel Kahneman was the first to discover or to contribute to Behavioural Economics, but his work and contributions have indefinitely added a whole new depth to this growing side of Economic research and has thus, advanced the field by leaps and bounds.

In conclusion, the life of Daniel Kahneman has truly left a legacy on the next generation. His ability to integrate his ideas in cognitive psychology into economic research has helped to push behavioural economics to a whole new level. His work in prospect theory alone speaks for itself. Given his background, his story, his intellect and his contributions, it is no surprise as to why I have chosen Daniel Kahneman as the laureate who has inspired me the most.

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