Some Debates on Behavioral Economics and Policy

January 23, 2012
With the advancement of what is called behavioral economics, there naturally arises a debate over how we should apply its insights to shape economic policies.

Given that we sometimes pick an alternative to the detriment of our welfare, there may be a role for government to intervene and guide us to better choices.

There are largely two problems.

- Imposing choice necessarily implies restricting our freedom of choice. To what extent should an outside authority, such as government, be allowed to invade our freedom of choice?
- The basis of welfare economics hinges on revealed preference. If what we choose is not necessarily what we want, how can we evaluate economic theory and, more importantly, identify the right thing to do.
Cass Sunstein and Richard Thaler argue that “libertarian paternalism” is the way to go.

Libertarians, like many economists, embrace freedom of choice, and so they deplore paternalism.

The idea of libertarian paternalism seems to be a contradiction in terms.

People say that libertarian paternalism is an oxymoron; Sunstein and Thaler argue it is not (“Libertarian paternalism is not an oxymoron,” The University of Chicago Law Review, 2003).
In an attempt to unsettle the conventional wisdom, they propose a form of paternalism, libertarian in spirit, that should be acceptable to those who are firmly committed to freedom of choice on the grounds of either autonomy or welfare. In doing so, they challenge widely held beliefs about freedom of choice and paternalism. Their emphasis is on the fact that in many domains, people lack clear, stable or well-ordered preferences as we assume in conventional economic analysis. What people choose is strongly influenced by details of the underlying context, such as default options and framing effects (the wording of possible options).
Libertarian paternalism

- Their preferred example is on participation in a 401(k) plan.
  - Instead of asking if workers want to participate, several employers adopt a simple strategy where workers will be enrolled automatically unless they specifically choose otherwise.
  - This simple change in the default rule has produced dramatic increases in enrollment.

- One can also influence people’s choice by changing the way events are described.
  - When deciding whether to undergo a risky medical procedure, a doctor can ask “90 percent are still alive after five years” or “10 percent are dead after five years.
  - The two convey the same information but people generally prefer the former.
Libertarian paternalism

- The design features of legal and organizational rules have surprisingly powerful influences on our choices.
- They urge that such rules should be chosen with the explicit goal of improving the welfare of people involved.
- This strategy still retains the flavor of liberalism because people should be free to opt out of specified arrangements, i.e., people should be free to choose.
- It is, however, paternalistic in that institutions, both private and public, should make conscious efforts to steer people’s choices in directions that will improve their welfare – what they call “nudge”.
They challenge the dogmatic anti-paternalism by arguing that it is based on a combination of a false assumption and two misconceptions.

The false assumption: All people, almost all of the time, make choices that are in their best interest or at the very least are better than the choices forced by third parties.

- They claim that it is testable and obviously false.
- So long as people are not choosing perfectly, it is at least possible that some policy could make them better off by improving their decisions.
Libertarian paternalism

- The first misconception: There are viable alternatives to paternalism.
  - In many situations, some organization or agent must make a choice that will affect the behavior of some other people.
  - There is no alternative to a kind of paternalism in the form of an intervention that affects what people choose.
- The second misconception: Paternalism always involves coercion.
  - Changing the way alternatives are presented does not coerce anyone to do anything.
Libertarian paternalism

- To sum up, their stance is that a form of paternalism cannot be avoided and that the alternatives to paternalism (such as choosing options to make people worse off) are unattractive.
- The question is not then whether to be paternalistic or not, which is clearly less interesting.
- The true question to be asked is how to choose among the possible choice-influencing options.
  - Programs should be designed using a type of welfare analysis to measure the costs and benefits of outcomes.
  - Some results from the psychology of decision making should be used to judge when consumers and workers will gain most by increasing options.
Libertarian paternalism

- Some (weak) form of paternalism is simply inevitable.
- People’s choices are clearly affected by default options which must be set by someone.
- Another form of evidence for the absence of well-formed preferences is that “anchors” play a crucial role and starting points, e.g., in an inquiry, have important consequences.
- Our choices are also influenced by framing of alternatives, i.e., how they are presented.
Libertarian paternalism

- Should the planner go beyond the inevitable, when it seems to be warranted in some sense?
- What if an employer places an additional cost to opt out of a 401(k) plan?
- Can it still be libertarian?
- The distinction between libertarian and non-libertarian paternalism is not simple and rigid: there is a continuum rather than a sharp dichotomy.
- The question ultimately comes down to the cost of making choices.
The true question to be asked, according to them, is how a sensible planner should choose among possible systems, given that some choice is necessary.

If feasible, a comparison of possible rules should be done using a form of cost-benefit analysis.

- In the context at hand, the cost-benefit study cannot be based on willingness to pay (WNP) because it is a function of the default rule.
- It must be a more open-ended and inevitably somewhat subjective assessment of the welfare consequences.
- In many instances, though, the planner is unable to make a direct inquiry into welfare because the costs of conducting the analysis are not warranted, in which case she must adopt some rules of thumb.
Libertarian paternalism

- They list some possible objections to libertarian paternalism.
- By advocating libertarian paternalism, we are starting down a very slippery slope.
  - Libertarian paternalism is inevitable
  - The libertarian condition, such as opt-out rights, limits the steepness of the slope.
- There is a deep mistrust of the ability of the planner to make sensible choices.
  - Again, libertarian paternalism is simply inevitable, and when it is so, we might as well let them try to improve people’s welfare.
Debates over libertarian paternalism: Glazer (2006)

- Sunstein and Thaler’s argument ignited a heated debate over paternalism.
- One attempt is provided by Glazer (2006) “Psychology and Paternalism” in the University of Chicago Law Review.
- He first argues that if errors are thought to be endogenous, there are many good reasons why public decision makers are more likely to be flawed.
- He also argues that, even though he generally shares the view that soft paternalism is less demanding and that in many cases some form of paternalism is inevitable, soft paternalism is neither innocuous nor obviously benign.
The case for paternalism is based on two different psychological phenomena: bounded rationality and self-control problems.

The essay focuses on paternalism and bounded rationality, because bounded rationality is quite common and provides a clearer case for real paternalism.

In contrast, self-control problems offer a more limited scope for paternalism, partly because the welfare basis of such an environment is unclear.

The focus on attention is on the endogeneity of errors.
Opinions are influenced in many ways, by peers for instance.

Both in and outside of the laboratory, there is substantial evidence that belief suppliers are able to manipulate beliefs.

This could arise on a larger scale, though the media influences.

If one major source of cognitive errors is the supply of beliefs, errors will in part reflect the costs and benefits faced by belief suppliers.
Debates over libertarian paternalism: Glazer (2006)

- A second source of endogenous error is the effort that consumers take to correct errors.
- Even though private decision makers are faulty, they typically have incentives to reduce cognitive errors.
- There are many reasons to believe that incentive effects are much stronger in the real world than in the laboratory.
- Likewise, incentive effects may be weaker for public decision makers, because errors are more likely in voting than in private decisions.
Debates over libertarian paternalism: Glazer (2006)

- Political beliefs should be particularly erroneous because voters have little incentives to learn the truth.
- This effect is compounded by the fact that politicians have all the incentives to persuade and manipulate beliefs.
- There is substantial evidence to document that political beliefs are in fact particularly prone to error.
Debates over libertarian paternalism: Glazer (2006)

- It is argued that bounded rationality pushes toward a sort of anti-antipaternalism and that issues of paternalism are to a significant degree empirical questions.
- Glazer makes no objection to this claim (on some level): after all, there have always existed plenty of grounds, like market failures and externalities, for government intervention.
- Public policy debate is ultimately an empirical issue.
- He does, however, disputes the view that a richer model of psychology should increase our enthusiasm for government intervention.
- When cognitive errors are in some sense endogenous, economic theory pushes us to think that private decisions will often be more accurate than public decisions.
Debates over libertarian paternalism: Glazer (2006)

- Glazer provides three cases.
  - Consumers face stronger incentives to correct errors that directly impact their well-being than do government bureaucrats.
  - If error comes from the influence of firms or other interested parties, and if it is cheaper to persuade a small number of bureaucrats than a vast number of consumers, then government decision making will be particularly flawed.
  - Consumers have more incentives when making private decisions than they do when voting.
The previous argument is generally directed against paternalism, the view that psychology should make us more confident about paternalistic governments.

Here, he makes an attempt to question the use of soft paternalism.

It is accepted that some form of paternalism is inevitable in many cases.

The question is whether soft paternalism should be generally encouraged or discouraged.
Debates over libertarian paternalism: Glazer (2006)

- Glazer raises seven arguments against soft paternalism.
  1. Soft paternalism is an emotional tax on behavior that yields no government revenues.
     - Creating an impression of danger is similar to a tax for those who continue to engage in that activity.
  2. Soft paternalism can cause bad decisions just as easily as hard paternalism.
     - Government decision making can involve considerable error which would be just as costly as with hard paternalism.
  3. Public monitoring of soft paternalism is much harder than that of hard paternalism.
Debates over libertarian paternalism: Glazer (2006)

4. Although hard paternalism will be limited by public opposition, soft paternalism is particularly attractive because it builds public support.

5. Soft paternalism can build dislike or even hatred subgroups of the population.

6. Soft paternalism leads to hard paternalism.

7. Soft paternalism complements other government persuasion.

   - Soft paternalism requires a skill of manipulating beliefs which can be abused for other purposes.