PART 6

Concluding Remarks

CHAPTER 12

Behavioral Welfare Economics, Libertarian Paternalism, and the Nudge Agenda

12.1 Introduction

Although behavioral economics was already firmly established as a subdiscipline of economics by the first decade of the twenty-first century, the enterprise appears to have received a boost from the economic crisis that struck around then. As David Brooks put it in the *New York Times:* "My sense is that this financial crisis is going to amount to a coming-out party for behavioral economists and others who are bringing sophisticated psychology to the realm of public policy." Brooks is frequently described as a conservative, but commentators across the political spectrum have blamed the crisis in part on inadequate economic models. The former chairman of the Federal Reserve Alan Greenspan is known as a follower of Ayn Rand's objectivism, which celebrates the value of rational self-interest. Yet, in 2008 Congressional testimony, Greenspan said: "I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms." Similarly, the Nobel laureate and liberal economic commentator Paul Krugman argues:

> [Economists] need to abandon the neat but wrong solution of assuming that everyone is rational and markets work perfectly. The vision that emerges as the profession rethinks its foundations may not be all that clear; it certainly won't be neat; but we can hope that it will have the virtue of being at least partly right.

Brooks, Greenspan, and Krugman all seem to agree that economic theory can have a substantial impact on policy and therefore on the quality of people's lives. They also seem to agree that this impact can be better or worse depending on the appropriateness of the theory for the task.

Armed with a set of economic theories and a desire to influence policy and improve lives, behavioral economists have developed a doctrine variously referred to as **libertarian, light/soft**, or **asymmetric paternalism**, and a series of policy proposals collectively referred to as **the nudge agenda**. To its advocates, the nudge agenda allows us to improve people's choices and thereby their well-being on their own terms at minimal cost and without interfering with their liberty or autonomy. To its critics, the nudge agenda represents an ineffective and dangerous intrusion into the sphere of personal decision-making by bureaucrats who may be no better at making decisions than the people whose choices they are trying to improve. In this chapter, we will review what libertarian paternalism and the nudge agenda are, how their foundations differ (or not) from those of neoclassical economics, and what their promises and limitations might be.

12.2 Behavioral welfare economics

There is nothing unusual about the fact that behavioral economists wish to change, and not only to understand, the world in which they live. Neoclassical and other economists do too. As Hayek put it in 1933:

> It is probably true that economic analysis has never been the product of detached intellectual curiosity about the why of social phenomena, but of an intense urge to reconstruct a world which gives rise to profound dissatisfaction. This is as true of the phylogenesis of economics as the ontogenesis of probably every economist.

Since behavioral (like neoclassical) economists take their central normative concern to be welfare, and perhaps its distribution, this work is often discussed under the heading of **behavioral welfare economics**. Behavioral welfare economics subsumes **behavioral law and economics**, which incorporates behavioral economic theories into law and economics, as well as **behavioral public economics**, which relies on behavioral economics to describe and evaluate the effects of public policies.

Welfare-enhancing policies take many different forms. Some remove barriers to mutually beneficial interactions, as when free-trade agreements permit coffee growers on one continent to sell their beans to coffee drinkers on another. Some policies ban harmful actions, which is why it is illegal to steal other people's property and to sell your children to the highest bidder; some mandate beneficial actions, which is why some countries and states require you to vaccinate your children against preventable diseases. Other policies impose incentives that encourage people to engage in more beneficial actions or fewer harmful ones. Thus, tax incentives for environmentally friendly construction serve to encourage people to build in a more environmentally responsible way and cigarette taxes (other than bringing in cold, hard cash for the government) serve to discourage smoking. (It can reasonably be argued that bans and mandates are just another set of incentives, where the (dis)incentive takes the form of fines or jail time, but the distinction between bans/mandates on the one hand and incentives/disincentives on the other is useful nonetheless.)

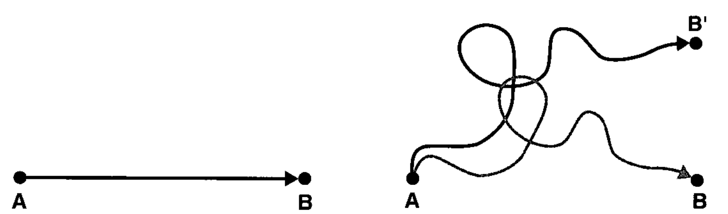
Based on their research, behavioral economists have proposed a whole other form of welfare-enhancing policy intervention. To the extent that people's actual choices deviate in significant and systematic ways from what they would have chosen if they had been fully rational, informed, etc., it is at least in theory possible to *improve* people's choices in the sense of making their actual choices conform more closely to the rational ones. On the assumption that people are made better off by whatever they would choose if they were fully rational, etc., improving people's choices in this manner means making them better off. And they are better off *by their own lights*, that is, as defined by their own rational and informed preferences. Making people better off in this manner is, in a nutshell, the goal of libertarian paternalism and the nudge agenda.

The project is illustrated in Figure 12.1. The person in Figure 12.1(a) is rational and informed. Her preferences tell her she wants to go from A to B, and so she does. The person in Figure 12.1(b), if he were rational and informed, would also want to go from A to B. Unfortunately, he is not. Doing as well as he can under the circumstances, he goes from A to B′ instead. The libertarian paternalist, noticing that the person on the right is not as well off as he could be in terms of his own rational, informed preferences, aspires to change the conditions under which he makes his decision so that his actions take him along the shaded line to B instead of B′.

12.3 Libertarian paternalism and the nudge agenda

The fact that we sometimes make suboptimal decisions might suggest that it would be best if people's choices were made for them by a third party: a disinterested bureaucrat, perhaps, or an enlightened despot or Leviathan. Yet, no behavioral economist advocates a dictatorship as a solution. There are many obvious reasons: bureaucrats and despots will be ignorant about people's preferences and the circumstances of their lives, less than fully benevolent, and on the average no more rational than the people whose choices they are trying to improve. Moreover, the very act of making decisions ourselves might enhance our welfare; even making mistakes, if the consequences are not too severe, can be edifying.

Libertarian paternalism says that it is legitimate to help people make better decisions themselves, by their own lights, if it is possible to do so without interfering with their liberty or autonomy. The approach is described as "paternalistic" because it aims to make people better off, but "libertarian" because it tries to make people better off in a manner that respects their liberty and autonomy. Others call it soft or light paternalism, to distinguish it



(a) Rational, informed behavior

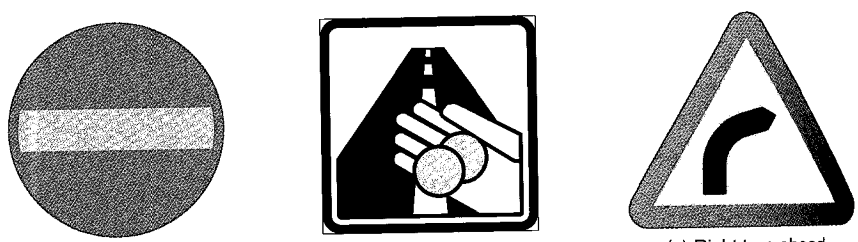
(b) Irrational, uninformed behavior

Figure 12.1 Two kinds of behavior

from more heavy-handed kinds of paternalism. The term **asymmetric paternalism** is sometimes used to underscore that soft paternalistic interventions are expected to impose little to no cost on individuals who are fully rational and informed, while having potentially large benefits for those who are not. Interventions designed to have this effect are called **nudges**. A paradigmatic nudge has several properties. (i) It aims to help people make better decisions themselves, rather than making decisions for them. (ii) It imposes little to no cost on those who are exposed to it. (iii) It has little to no effect on the choices of those who are already rational and well-informed. (iv) The effect on the choices of those who are not already rational and well-informed is potentially beneficial for them, by their own lights.

Figure 12.2 illustrates the manner in which nudges differ from other forms of policy. What the three traffic signs have in common is that they try to reduce the number of people who drive straight ahead. But they do so in very different ways. The do-not-enter sign in Figure 12.2(a) represents a ban. It signals that it is illegal to drive straight ahead, and that doing so is punishable by fines or jail time. The congestion-charging-zone sign in Figure 12.2(b) represents a disincentive. It signals that it is legal to continue on, but that anyone who does so will incur an additional charge. By contrast, the right-turn-ahead sign in Figure 12.2(c) represents a nudge. The sign does not say that it is illegal to drive straight ahead; nor does it say that there is a charge associated with doing so.

The right-turn-ahead sign works differently from the other two. (i) The sign aims to help people make better driving decisions themselves, rather than making decisions for them. (ii) The sign imposes no cost on people exposed to it beyond the trivial amount of time it takes for experienced drivers to scan it as part of the environment, and this is true whether they intend to stay on the road or not. (iii) The sign has no effect on the decisions of drivers who are rational and informed: with or without the sign, a rational, informed driver who intends to stay on the road would bear right at the curve, and a rational, informed driver who intends to drive straight ahead and off the cliff would do that. (iv) The sign can, however, have an asymmetric and potentially large beneficial effect (by their own lights) on drivers who are irrational or ignorant of the upcoming turn. To the extent that the sign



(a) Do not enter (b) Congestion charging zone (c) Right turn ahead

Figure 12.2 Three kinds of traffic sign. © The Swedish Transport Agency. Used with permission changes the behavior of drivers it is because it "nudges" them into adjusting the speed and turning the wheel as appropriate.

Exercise 12.1 Traffic signals What kind of policy is represented by (**a**) a stop sign; (**b**) a lane-ending sign; (**c**) a red light; (**d**) a yellow light; (**e**) a parking meter labeled "¢25 per hour"; and (**f**) a no-parking sign?

Behavioral welfare economists have proposed a number of specific interventions that they believe are welfare-enhancing, and which are motivated by theoretical developments in behavioral economics. Here is a small sample:

- **Default options** are options that will be selected in case the decision-maker fails to make an active choice. Insofar as people are prone to status quo bias, they will exhibit a tendency to stick with the default even when it would be virtually costless to make an active decision. By having a choice architect carefully determine what option should be the default, in light of people's own interests, behavioral economists believe that more people will end up with the option that is best for them.
- The **Save More Tomorrow (SMarT) Program** encourages workers to save more for retirement by giving them the option of committing in advance to allocating a portion of their future raises toward savings. Because committing a future raise feels like a foregone gain whereas committing money in the pocket feels like a loss, prospect theory predicts that workers will find it easier to save future salary increases than money in the pocket. The SMarT program is designed to increase savings rates by leveraging this effect.
- **Cooling-off periods** are periods of time following a decision during which decision-makers have the option to reverse their choices. Cooling-off periods are based on the idea that people in a transient "hot" emotional state sometimes make suboptimal decisions. Behavioral economists argue that cooling-off periods offer people the opportunity to reevaluate their decisions from the perspective of a "cool" state, which is likely to lead to a better decision.

As always, the devil is in the details. If the burden imposed on rational, informed decision-makers by cooling-off periods, etc., is non-trivial, the intervention would no longer constitute a nudge – whether or not it succeeds in enhancing total welfare.

Exercise 12.2 Apples or fries? US hamburger chains have started serving apple slices instead of French fries with their "meal" options. Fries are still available, but the customer has to ask to have fries substituted for apples. Preliminary reports suggest that as a result, customers end up eating more apples and less fries. What kind of intervention is this?

Since the definition of a nudge has some vagueness built into it, we should expect there to be a grey area where reasonable people can disagree. Yet, it is easy to think of examples that do not constitute nudges. The weather is not a nudge, for example, since it is not an intervention. Subliminal advertising

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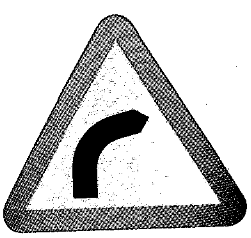

(c) Right turn ahead

ı Transport Agency. Used

is not a nudge, since if it is effective it may interfere with the choices of the rational and irrational alike. And as we saw above, stop signs and parking bans are not nudges.

Exercise 12.3 The Bloomberg ban As part of a 2013 public-health initiative spearheaded by then-mayor Michael Bloomberg, New York City banned the sale of sodas larger than 16 ounces (or about 0.5 liters) in restaurants, movie theaters, and the like. (The law was later struck down by the state's highest court.) Explain why the "Bloomberg ban" does not constitute a nudge.

Any argument to the effect that some intervention is or is not welfare-enhancing presupposes a welfare criterion: a rule that (at least in principle) allows us to determine who is well off and who is not. Neoclassical economics relies on a preference-based criterion, according to which people are well off to the extent that their preferences are satisfied. Given the neoclassical understanding of "utility," this is equivalent to saying that people are well off to the extent that their utility is high. It has been argued that behavioral economics entails that this criterion is inadequate and that we must instead accept a happiness-based criterion, according to which people are well off to the extent that they are happy. Notice that these criteria are substantially different, since it is possible to have satisfied preferences without being happy and vice versa. Others maintain that it is possible to maintain the preference-based criterion by assuming (as some neoclassical economists already do) that the preferences that count are not the preferences actually revealed in people's choices, but the preferences that they would have if they were perfectly rational, ideally informed, and so on.

12.4 Criticism

The appeal of libertarian paternalism and the nudge agenda is obvious: Would it not be wonderful if people could be helped to make better decisions themselves, even by their own lights, without interfering with their liberty and autonomy? Proponents are enthusiastic indeed. They point out that nudges can be cheap to administer, that results can be immediate, and that the effects can be large. The right-turn-ahead sign in Figure 12.2(c) is a case in point: presumably these signs are so common because the cost of putting them up and maintaining them is low, they begin to operate immediately, and expected benefits in terms of reduced car crashes are high. Harvard Law professor Cass R. Sunstein, one of the names most strongly associated with the nudge agenda, writes:

> In the context of retirement planning, automatic enrollment has proved exceedingly effective in promoting and increasing savings. In the context of consumer behavior, disclosure requirements and default rules have protected consumers against serious economic harm, saving many millions of dollars. Simplification of financial aid forms can have the same beneficial effect … as thousands of dollars in additional aid (per student) … In some cases, nudges have a larger impact than more expensive and more coercive tools.

It is worth pointing out that nudging is not limited to governments. Corporations, charities, religious organizations, managers, teachers, and parents can all use nudges to help people make better decisions, by their own lights. And many of them already do.

Example 12.4 Google Google wants to encourage its employees to eat healthily. *Fast Company* reports: "In pursuit of that healthiness, happiness, and innovation, the software giant has turned to 'nudges': simple, subtle cues that prompt people to make better decisions." Borrowing ideas from behavioral economics, Google is now: (1) putting candy in opaque bins rather than clear dispensers; (2) placing salad in full view to people entering the cafeteria and dessert much further down; (3) encouraging people to use smaller plates by pointing out that people with bigger plates tend to eat more; (4) color-coding foods in accordance with how healthy they are; and more. All these interventions can plausibly be characterized as nudges as we understand the term here.

Problem 12.5 *Identify three features of your car, computer, or any other device that constitute nudges.*

So when it comes to libertarian paternalism and the nudge agenda, what is not to love? Of course, every tool can be used badly. A hammer is a wonderful thing if you have to drive nails, but it can cause a lot of damage if swung in the vicinity of crystal glass or human heads. Similarly, nudges can presumably be inelegant, inappropriate, misguided, mean-spirited, and/or outright harmful. But just like it would be unhelpful to criticize the use of hammers based on the fact that people get hurt if they are whacked over the head, it would be odd to criticize nudges based on the fact that they have harmful uses. For a general critique of nudging to get traction, the critique needs to make the case that nudges are harmful to human welfare (or autonomy, or whatever) even when used correctly.

Critics point out that the people doing the nudging – the "choice architects," in Sunstein's lingo – will themselves be lacking in rationality and information, not to mention benevolence. Yet, the objection misses the point. Behavioral economists are well aware of the fact that policy-makers suffer the same limitations as the rest of us do. Not only is this the reason why behavioral economists rejected the dictatorship solution, but it is part of the reason why they developed the nudge agenda in the first place. And choice architects need not be superhuman. Consider the right-turn-ahead sign again. Posting such a sign does not mean that you pretend to know what is good for people, that you want to impose your vision of the good life on them, or even that you are telling them what is good for them; you can post the sign even if you recognize that some people have reason to drive straight ahead. And posting such a sign does not mean that you are deluded into thinking that you are more rational, better informed, or more benevolent than anybody else. It just means that you think there is a chance that the sign will help some people who want to stay on the road to do so.

Some critics argue that all forms of paternalism are objectionable (offensive, illegitimate) and that, therefore, libertarian paternalism is too. But this criticism equivocates on the meaning of the term "paternalism." If by "paternalism" we mean the disposition or desire to make others better off, there is nothing objectionable about it; paternalism in this sense is what is otherwise known as "benevolence" and it is widely considered a virtue. In this sense of "paternalism," increasing total welfare by removing trade barriers is a paternalistic intervention and virtually every welfare economist is a paternalist. The sense in which paternalism is objectionable is the sense in which it entails a violation of people's liberty or autonomy, and libertarian paternalism by definition does not. In fact, when Sunstein notes that nudging may be more effective than more coercive forms of policy, he is raising the possibility that the same or better results can be attained by substituting the former for the latter. If so, nudging would actually *increase* people's freedom of choice. Libertarian economist Bryan Caplan has endorsed the nudge agenda to the extent that it substitutes softer for harder forms of paternalism. He writes:

> "Nudging" is a great idea. We should start by ending existing hard paternalism in favor of gentle (or even subliminal) persuasion. Instead of prohibiting drugs, we should allow anyone who wants to use currently illegal drugs to go to a government website to request an Authorized Narcotics User Card … Analogous opt-out rules should be devised for government health care programs, worker protection laws, consumer protection laws, and so on.

At any rate, to the extent that we are concerned with objectionable forms of paternalism, it would be more motivated to target policies that actually do interfere with people's liberty and autonomy – such as the bans and mandates represented by Figure 12.2(a) and the (dis)incentives represented by Figure 12.2(b) – and there are plenty of them already.

Other critics allege that the nudge agenda is dangerous because there is a slippery slope from perfectly innocuous nudges to more coercive forms of policy. If we allow policy-makers to nudge us at all, even in ways that do not violate our liberty and autonomy, the argument goes, policy-makers will soon engage in more coercive forms of policy. It is quite true that all policy interventions (even those that aim to remove barriers to mutually beneficial interaction and to enhance freedom of choice) can have unintended and unanticipated adverse consequences. It is also true that the wolf of hard paternalism may appear in the clothing of soft-paternalist sheep. But there is something odd about the slippery-slope argument. Note that it does not say that there is anything wrong with libertarian paternalism or nudging *per se*, but rather with the harder forms of paternalistic intervention that will likely follow. But why should we think that they will? Consider traffic signs of the third type. The critic alleges that allowing the use of signs of the third type will necessarily or likely lead to a proliferation of signs of the first two kinds. But there seems little reason to think this is so. Indeed, to the extent that signs of the third kind work, they may obviate the need for signs of the first two kinds. This is the thought underlying Caplan and Sunstein's hope that soft paternalism will lead to an expansion of personal freedom. Again, given that signs of the first two kinds are already in widespread use, to the extent that we are concerned about limitations of liberty and autonomy, our time would be better spent arguing against them instead. Considerations like this have encouraged philosophers to reject all slippery-slope arguments. Moral philosopher Simon Blackburn, for example, writes: "'Slippery slope' reasoning needs to be resisted, not just here but everywhere."

A very different kind of criticism comes from within behavioral economics itself. Some behavioral economists have cautioned that nudging has sharp limitations, and that other forms of policy may be necessary to solve many policy challenges. Thus, George Loewenstein and Peter Ubel have argued that a wide variety of problems – including the obesity epidemic, conflicts of interest in medicine, and the challenge of energy preservation – are best addressed using more traditional forms of policy. They continue:

> As policymakers use it to devise programs, it's becoming clear that behavioral economics is being asked to solve problems it wasn't meant to address. Indeed, it seems in some cases that behavioral economics is being used as a political expedient, allowing policymakers to avoid painful but more effective solutions rooted in traditional economics.

In terms of traffic signs, the point here is that there are conditions under which signs of the first two kinds in Figure 12.2 are called for, and that signs of the third kind (though potentially effective under a limited range of conditions) cannot be expected to replace them. Loewenstein and Ubel could bolster their claim by pointing out that more heavy-handed policies often serve not to benefit the decision-maker, but to prevent him or her from harming others. To deal with things like theft, assault, and murder, outright bans – not nudges – are particularly appealing. Either way, unlike Caplan and perhaps Sunstein, then, Loewenstein and Ubel think the nudge agenda should be seen as a complement to, rather than a substitute for, traditional forms of policy.

12.5 Discussion

The notion that economic theory can have a real impact on worldly events was wholeheartedly endorsed by Keynes, who wrote:

> [The] ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas … it is ideas, not vested interests, which are dangerous for good or evil.

The ideas of behavioral economists are no exception. How exactly behavioral economics will affect "practical" women and men remains to be seen. Yet, it is not too early to draw some interim conclusions.

First off, the terms behavioral economists chose to discuss their policy proposals could probably have been chosen more wisely. The appropriation of the term "paternalism" in particular has invited many misguided responses. It would appear that Thaler and Sunstein had hoped to appeal to the union of libertarians and paternalists, but instead ended up appealing to their intersection – which is a small subset indeed. The discussion might have been less heated if they instead had used an unsexy term such as **ergonomics** or **human-factors engineering**. They could have done so without great loss, since ergonomics is defined as "the scientific discipline concerned with the understanding of interactions among humans and other elements of a system, and the profession that applies theory, principles, data and methods to design in order to optimize human well-being and overall system performance." Economist Raj Chetty has suggested we think of the nudge agenda in terms of model uncertainty: as a solution to a problem that arises when we do not know what model best captures the behaviors of the people involved. Assuming that neoclassical (optimizing) agents are insensitive to nudges while no behavioral agent is harmed and at least one of them is made better off, nudging becomes a weakly dominant strategy. I like to think of the nudge agenda as an effort to make social institutions, retirement plans, health-care systems, etc., robust under predictable variations in rationality. Thus, it is possible to think of the agenda as an effort to make social and other institutions trembling-hand perfect, as it were (see Section 10.4).

Once the conceptual confusion has been cleared up, it seems that the debate has been needlessly amped up. When used correctly and carefully, there is little reason to think that a nudge (such as the right-turn-ahead sign) needs to be dangerous, sneaky, or intrusive, and the fact that choice architects are mere mortals is no show-stopper. We have no reason to fear a slippery slope to harder kinds of paternalism; indeed, the nudge agenda may even expand the sphere of personal liberty. (We do need to be alert to unintended and unanticipated adverse consequences and to wolves in sheep's clothing, but that is true for all policy proposals.) That said, the enthusiasm among the biggest proponents of the nudge agenda is probably unwarranted. When even fellow behavioral economists ask proponents to hold their horses, we should at most be cautiously optimistic.

Most importantly, the debate about libertarian paternalism and the nudge agenda has been unhelpfully framed. The question is not whether people who design cars, phones, retirement plans, and health-care systems should nudge or not. Your car is full of nudges – such as the fasten-the-seat-belt indicator – and it would make little sense to demand that car manufacturers or anybody else cease to use them when they work. The real question, instead, is whether nudges should be used as complements to or substitutes for other forms of policy in the interest of attaining legitimate policy goals. But the answer to this question depends both on what the legitimate policy goals are – which can only be established by means of philosophical analysis – as well as about empirical facts about the efficacy of nudges – which can only be established by means of systematic, empirical research. And on these two questions, the jury is still out.

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FURTHER READING

The quotations in the introductory section are from Brooks (2008), who cites Greenspan, and Krugman (2009, p. 43). Hayek (1933, pp. 122–2) discusses the phylogenesis and ontogenesis of economists. Thaler and Sunstein (2008) is the go-to source about the nudge agenda; Sunstein (2014) helpfully catalogues ten nudges (pp. 585–87) and supplied the block quotation at the beginning of Section 12.4 (p. 584). Welfare criteria in economics are discussed in Angner (2015). Caplan (2013) defends nudges from a libertarian perspective; Blackburn (2001, p. 64) dismisses slippery-slope reasoning; and Loewenstein and Ubel (2010) caution against the over-reliance on nudges. The passage from Keynes appears in *The General Theory of Employment, Interest and Money* (Keynes, 1936, pp. 383–84). The connection to human-factors engineering was suggested by Robin Hogarth (personal communication); the term "ergonomics" is defined by the International Ergonomics Association (2015). Chetty (2015) suggests we think of the nudge agenda in terms of model uncertainty.