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NUDGING US INTO THE THIRD WAY?

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A feature of 20th-century political economy was a recurrent search for a 'third way', a blissful combination of the best of capitalism and the best of socialism. When in 1997 the British Labour Party returned to power after 18 years in opposition, it committed itself to a 'third way' that could be summarised, neatly if tendentiously, as 'Thatcherism plus social justice'. Our Labour government – particularly Helen Clark and Steve Maharey – picked up the idea and talked the 'third way' talk around the same time (recently they seem to have gone silent on it). Its true inspiration was the Swedish model, which combines a relatively free and open economy with a high-tax welfare state that consumes or redistributes around half the national income.

In practice, however, policies that redistribute income reduce the size of the potential economic pie. High tax rates and big tax burdens damage economic growth, and even the most efficient economies cannot be milked indefinitely to expand the welfare state. Accordingly, in recent years Sweden and several other high-tax European countries have been shrinking their public sectors. My guess is that they will have to shrink them much further if their economies are to compete successfully with rising economic giants like China and India.

Now a new attempt at a third way has come along in the form of a book titled *Nudge*.¹ It has already attracted a lot of attention (including some criticism) and is influencing public policy. Its two co-authors are Richard Thaler, a professor of economics, and Cass Sunstein, a professor of jurisprudence, both at the University of Chicago at the time the book was written. Their basic idea is very simple and familiar. By 'nudging' they mean slightly tilting the playing field to make it easier for us to choose certain things in preference to others. But full individual freedom of choice is retained. So when the government intervenes by way of nudging, it doesn't reduce our freedom of choice: advocates of government

¹ Richard H Thaler and Cass R Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Yale University Press, 2008.

intervention and advocates of *laissez-faire* can both be satisfied at once. A third way indeed!

Is this too good to be true? The position I argue for is that, if nudging operates within the proper limits of government, it can play a legitimate role. But it may encourage the belief that principled limits on government are unnecessary, precisely because it may enable a government to intervene wherever it likes without appearing to reduce individual freedom. If so, it raises a host of problems, which I'll come on to later.

I've just said that we are familiar with nudging. In commerce, we encounter it all the time: it's what firms do to sell more of their products. An advertisement is a nudge: it provides information that entices us to buy a particular product in preference to any competing products, while leaving us completely free to buy a competing product or not to buy anything. But Thaler and Sunstein are more interested in techniques that help us overcome our slowness to act on our own preferences.

A simple one is the automatically renewable journal subscription. If we have to actively renew a subscription annually, even for a journal we want to read, we may never get around to it. But if we authorise a journal to collect a subscription annually from our credit card until further notice, we can ensure uninterrupted delivery of the journal, and both we and the journal gain. (Of course, if we no longer want the journal but never get around to cancelling it, the journal gains but we don't, though we can hardly complain.)

It's this sort of 'inertia selling' that has attracted the interest of governments. Michael Cullen's original KiwiSaver scheme is pure Thaler and Sunstein. Enrolment in a KiwiSaver scheme is compulsory for new employees, but they are able to opt out within a month. That is, the scheme is not compulsory but the default position is to be enrolled. Thaler and Sunstein show that the take-up of such schemes is far greater where people are free to opt out than where they have to opt in, and they infer from this that many more people really want to increase their saving for retirement than actually

get around to doing so. Of course the KiwiSaver scheme is now so larded with subsidies that it is more like a honey trap than a nudge. Many people would be foolish not to join and its burgeoning fiscal cost means it is unlikely to be sustainable for long.

Another policy area to which Thaler and Sunstein devote a chapter that has attracted the attention of governments is organ donations. In countries where a market in organs is prohibited but organs may be donated, the demand for organs typically far outstrips the supply. Thaler and Sunstein report the results of an online survey conducted in 2003 in which respondents were asked whether they would be willing to register as organ donors, in three ways: if they were free to opt in, if they were allowed to opt out (that is, the default was to be registered as a donor), and if they were required simply to choose whether or not to be a donor (which the authors call the 'neutral' condition). The authors report this result:

As you will now expect, the default mattered – a lot. When participants had to opt in to being an organ donor, only 42 percent did so. But when they had to opt out, 82 percent agreed to be donors. Surprisingly, almost as many people (79 percent) agreed to be donors in the neutral condition (p 178).

So it looks as if up to 40 percent of the respondents had a preference to register as organ donors but would not actually do so without being nudged. If surveys like this are reliable, nudging can clearly have a dramatic impact.

However, the claim that people have preferences that they don't necessarily act on unless nudged is actually more controversial than it may at first seem. It challenges the mainstream view of 'economic man' according to which, in order to make rational choices, we need as much information and as many options as possible. The authors of *Nudge* certainly believe in freedom of choice, but Richard Thaler is a founder of so-called behavioural economics, a branch of economics that has been influential in some circles. Behavioural economists claim that economic actors in practice depart from the orthodox model of rationality in several crucial ways.

For a start, we are typically confronted with more information than we can understand or process, and in any case there are many other calls on our time. So we all use rules of thumb to help us cope, but these may be systematically misleading. Our risk assessments may be distorted by events; a recent terrorist attack prompts us to exaggerate the risk of future such attacks. As investors we tend to treat a firm's past performance as a good guide to its future performance, and so we may easily set ourselves up to lose money. We can be misled by the way information is framed: if told that a food product is 90 percent fat-free, we think it's healthier than if told that it's 10 percent fat. We are 'loss averse': that is, we value things twice as much when we possess them than when we don't, which means that the pain of losing something is twice as great as the pleasure of gaining it.

All of this results in inertia, which is compounded by a general 'status quo bias', or a tendency to adopt arbitrary routines and to stick to them for no obvious reason. Perhaps operating against inertia are 'social norms': we are more likely to do something if we believe most other people are doing the same thing. Commercial advertisers and politicians know this, and so send out messages (accurate or otherwise) to the effect that 'everyone is rushing to buy this product' or 'everyone agrees with me'. This intellectual background is important because Thaler and Sunstein use it to justify their belief that nudging is truly liberating rather than manipulative or coercive; that is to say, nudges are devices to overcome the unreliable rules of thumb or irrational biases that inhibit us from acting on our own genuine preferences, and are not instruments to make us realise the preferences of others.

There is no doubt that freedom of choice, to be valuable, requires information to be relevant and simple. This is clear from what is perhaps the most useful empirical chapter in the book, on the topic of school choice in the United States. This is a system, sometimes called an education voucher system, whereby parents can send their children to any school – public or private – of their choice with equal or comparable government funding. Some examples of school choice introduced a few years ago were

failing because parents were deterred by the amount of information supplied or the complicated procedures involved in transferring their children to different schools. In Charlotte, North Carolina, for example, parents received a 100-page booklet with descriptions of 190 schools written by representatives of the schools themselves, emphasising each school's positive features. When information is so voluminous and inappropriately framed, status quo bias tends to take over and most parents, especially low-income ones, stick with the default option of the neighbourhood school. But a recent experiment, also in Charlotte, has shown the way to go. The authors write:

A random sample of parents was selected to receive an abbreviated 'fact sheet' about the schools . . . Printed on each sheet was a complete listing of average test scores and acceptance rates, from highest to lowest, at schools available to a given child (p 202).

As a result, parents, including low-income ones, selected better schools. The authors explain:

The parents who received the fact sheets made decisions implying that the weight they assigned to school quality (as measured by test scores) had doubled. The schools they selected had, on average, 70 percent higher test scores than the scores of their neighbourhood schools (p 202).

Thaler and Sunstein support school choice. Strangely, local 'third way' advocates like Helen Clark and Steve Maharey, perhaps more concerned with the interests of teacher unions than those of parents and children, don't.

Nudge recommends regulation requiring producers generally to provide information annually setting out details of all their products and their prices, and in a spreadsheet format that the public could easily use. In this way genuine freedom of choice would become a practical reality, as opposed to the theoretical possibility presented in abstract models of market economies populated exclusively by perfectly rational 'economic man'.

Thaler and Sunstein apply their ideas to several other areas, but you will have grasped the general idea by now. How should we evaluate it?

One way to do so is by examining the term that the authors use to describe their approach, namely, 'libertarian paternalism'. In fact, 'Libertarian Paternalism' was apparently the authors' preferred title for their book. But I think Yale University Press did them a favour in rejecting it, since it is muddled and misleading in a way that brings to light my misgivings about the book. To use the word 'paternalism' in this context is certainly odd. Paternalism means being made to realise someone else's preferences for our own good, like a child being made by its parents to swallow some unpleasant medicine. Yet Thaler and Sunstein insist that nudging helps people realise their *own* preferences. I assume that by 'paternalism' they really mean 'interventionism', that is, imposing nudges like default options and disclosure requirements.

The real problem is with the word 'libertarian'. Thaler and Sunstein use it to refer to 'freedom of choice'; and libertarians and classical liberals certainly believe in that. But libertarianism is first and foremost a doctrine about the role of the state. Some libertarians favour no role at all, and are in effect anarchists. Probably most people who call themselves 'libertarians' favour a role for the state but a strictly limited one, involving internal and external security and perhaps a few other public goods like elementary education. Thaler and Sunstein are certainly not libertarians in this sense, and indeed no advocate of any 'third way' could be. This is not just a verbal quibble. It's necessary to clarify the context and the limitations of the authors' commitment to freedom of choice if we are to gain an idea of how intervention by nudge could evolve.

Take retirement saving. Thaler and Sunstein discuss examples of both compulsory government-run and voluntary employer-run schemes, both of which they say could be improved by more freedom of choice enhanced by nudges to help people give effect to their genuine saving preferences. What they don't properly discuss is whether government should be involved in people's saving decisions: that is, whether individuals should be free to save nothing at all at different points of their lives, and whether employers should be free to offer their employees nothing in the way of saving schemes. They do briefly discuss whether people save 'too much' or 'too

little', and observe that in retirement dealing with too much saving is easier than dealing with too little. But a genuine libertarian would argue that decisions on how much to save – how much income to consume today rather than in the future – should be left to individuals; and it's not irrelevant to point out that not everyone of working age lives to retirement age. Moreover, in respect of savings nudges, I'm not convinced by the argument that nudging would make 40 percent of the population better off if 60 percent do not actively opt out of a default scheme when only 20 percent would opt in. An alternative proposition is that many of the 40 percent might be unaware of what the government has done or lack the information or time to form a view about the matter.

Perhaps more importantly, a libertarian should be concerned about the impact of the welfare state on individuals' saving decisions. One reason governments are involved in policies promoting individual saving is that the welfare state reduces both the means and the incentive to save; welfare reform would allow the tax burden to fall and also give people the incentive to attend more to their own retirement needs. Of course, any saving scheme like KiwiSaver can arrange for a choice among schemes, complete with the appropriate nudges, but such 'freedom of choice' exercised against a background of financial inducements would not impress the genuine libertarian. Those who decide not to take part are effectively forced to subsidise those who do through the higher taxes needed to finance the scheme.

This issue of the proper role of government crops up even more starkly in the chapter on organ donations. Thaler and Sunstein propose nudges like making registration as a donor the default option or requiring citizens to make an explicit choice one way or the other. They accept in a footnote that the 'simple' solution is to permit a market in organs (p 175); and we might add that that is the genuinely libertarian solution (which would not, of course, preclude donations of organs). But Thaler and Sunstein continue:

Although the idea has obvious merit, it is also spectacularly unpopular for reasons that are not well understood . . . Although explicit markets appear to be politically infeasible now, a type of barter exchange does seem to be acceptable (p 175).

A truly groundbreaking contribution to the issue of the organ shortage would have suggested ways of expanding barter exchange and then developing markets for body parts.

The same chapter has attracted the further criticism that default options set by governments are not neutral in relation to other permitted options but carry a burden of normative implications – what we all ought to do – precisely because the government has set them. A default option to be registered as an organ donor implies that the government exercises some kind of prerogative or ownership over our bodies, which individual citizens who don't like that idea have to argue their way out of. And imagine the grief of a family with religious beliefs opposed to organ donation on discovering that a loved one who died had forgotten to override the default option. In fact considerations like this probably explain why a recent opinion survey in the United Kingdom found that medical doctors were much less keen than the general public on nudging more people into being organ donors. Several of the doctors surveyed expressed the fear that doing so would undermine trust between themselves and the public.

Again, if nudging became a regular tool of policy, a future government might apply a similar default option to military service, that is, announce that all able-bodied citizens of appropriate age are assumed to be ready and willing to be called up for national service, unless they indicate otherwise. Over time, such a policy could generate a climate of presumption that would allow a government to quietly drop the right to opt out. That would emphatically be against the spirit of the Thaler and Sunstein's book, but all policies have unintended consequences. Yet some unintended and undesirable consequences can be foreseen, and those who put forward new policy ideas have some responsibility to anticipate and try to deal with them. Michael Cullen has always opposed compulsory superannuation but we are already seeing some politicians arguing that KiwiSaver should be made compulsory.

Proponents of nudges are shifty in other ways. In an employment context, a default term of a contract sometimes suggested is 'for cause' dismissal,

with the option to make it a contract at will. This sounds good, if both parties can opt out. But at that point it is pointless because employers will always prefer the contract at will option, unless they can offset the costs and risks of a for cause dismissal term with lower wages.

To be fair, the authors of *Nudge* do devote a chapter to ‘objections’. But their lack of interest in the proper limits of government is truly telling in their response to the caution expressed in a review of their ideas in *The Economist*. The review said this:

From the point of view of liberty, there is a serious danger of overreach, and therefore grounds for caution. Politicians, after all, are hardly strangers to the art of framing the public’s choices and rigging its decisions for partisan ends. And what is to stop lobbyists, axe-grinders and busybodies of all kinds hijacking the whole effort? (pp 239–40).

In response, Thaler and Sunstein recognise the problem of the capture of public policy by private lobbies, and accept the need for institutional safeguards against it. But they also say this: “But if private-sector interests are just following the invisible hand in furthering the interests of their customers, what’s the problem?” (p 240). However, a key distinction between private and public nudging is that no one in the private sector can impose a default option on us without our consent. We would rightly laugh out of court the proposition that we should automatically become members of the Automobile Association unless we took the trouble of opting out. Where government is concerned, and especially where there are no clear limits on the role of the state, the play of special interests is not reliably led by any ‘invisible hand’ to produce the best public outcome. Thus Helen Clark’s view that “the government’s role is whatever the government defines it to be” leads inevitably to the all too visible greasing of palms. We saw that recently with the handouts to the racing industry engineered by New Zealand First, perhaps the most disgraceful example of special-interest favouritism since the Muldoon days.

At worst, the idea of nudging via default options could degenerate into a wheeze for exploiting inertia and status quo bias so that people realise not their own genuine preferences but those of lobbies. It’s not difficult to imagine how this could come about. The arts lobby, for example, could run a public opinion survey and claim that it has discovered that lots of people

are very keen to see more money spent on the arts, but just never seem to get around to making a donation. Why not impose a 1 percent income tax surcharge hypothecated to the arts, while leaving people free to opt out of it in their tax returns? (If I'm right, the arts lobby may well pick up just this idea and run with it. Apologies in advance.)

I think such misgivings are all the more justified in view of the intellectual background to Thaler and Sunstein's work which, as we've seen, qualifies the model of rational 'economic man' in mainstream economics by reference to the distortions caused by rules of thumb and various biases.

Richard Epstein, another Chicago University professor, argues in a 2005 paper for the Business Roundtable that the insights of behavioural economics actually show that markets work well.² What he means is that the market itself accommodates limited rationality and differences in ability in the sense that we can hire the services of people who are more able than ourselves in relevant ways. Indeed, in relation to employer-run saving schemes, Epstein argues that employers should invest in professional advice for their employees in preference to setting default options.

As well, some rules of thumb actually work, sometimes in situations where there is no time to make perfect calculations even if we could. More generally, it's possible for us to learn from our mistakes and to think or educate ourselves through the distortions caused by our imperfect rationality. There is thus no logic that leads automatically from qualifications of mainstream economics to new kinds of government intervention, as if behavioural economics added up to no more than a catalogue of market failures.

Yet we live in an intellectual climate that is quick to criticise standard economics on any ground that presents itself, and to find new excuses for more government action. Economics courses teach students about market failures but often give unequal attention to government failures. Too much of Thaler and Sunstein's case is based on the naïve assumption that

² Richard A Epstein, *Behavioural Economics*, New Zealand Business Roundtable, 2005.

governments are well-informed, benevolent and not subject to the same biases as the people who vote for and lobby them. Indeed, the speed with which politicians in the English-speaking world have picked up the ideas of *Nudge* is itself rather suspect. We could be witnessing a new policy fashion that will be forgotten as soon as the next one comes along; alternatively, it could hang around and, especially as a result of being simplified in the way ideas are as they spread, result in a new round of ill-conceived policies.

To conclude, *Nudge* contains some good ideas. School canteens might well display healthy food prominently to encourage pupils to achieve their own goal of being fit. To the same end, staff canteens could display healthy dishes at the top of menu lists. This does not preclude self-education whereby people learn to devote more time to their food choices in the pursuit of physical well-being. Employers who want to help their employees achieve their own goal of having an adequate income in retirement are free to try out the various nudges that Thaler and Sunstein investigate – which may or may not be better than, or worth combining with, other possible approaches like buying professional advice, as Epstein suggests. In their chapter on school choice, Thaler and Sunstein show that rational choices require not the maximum possible amount of information and choice but relevant and accessible information – but here too, professional advice could play a useful role. Little of this depends on the agency of government.

But the authors have oversold their approach, as well as misrepresented its provenance, by giving it the rather portentous name of ‘libertarian paternalism’. Where nudging helps people realise their *own* genuine preferences, it is not paternalist; where nudging helps government impose *its* preferences on the public, it may be paternalist but it is certainly not libertarian. ‘Libertarian paternalism’ really is a contradiction in terms: if government really is benevolent and knows best, surely it would be delinquent of it to let people have the freedom to make mistakes? But the authors think they can pass it off as just a cute paradox by using the term

'libertarian' in a limited sense to refer to choices among sets of options weighted towards the preferences of an all-wise government.

The question that genuine libertarianism seeks to answer – namely, what the proper limits of government are – is nowhere addressed in *Nudge*, which aspires to present a new third way in which such a question would be eclipsed by the stress on 'freedom of choice'. My conclusion would be similar to that of former Treasury secretary Graham Scott in a recent address to the New Zealand Institute of Economic Research on the occasion of its 50th anniversary. He said: "We do not need big new ideas – like swapping the current fashion for 'libertarian paternalism' for the intellectual corpse known as the 'third way'." Instead we are better served by using the time-tested ideas of the Enlightenment that ushered in liberal democracies, and the tools generated by modern economics scholarship, to grapple with the public policy challenges we face today.