Nudge: Improving Decisions About Health, Wealth, and Happiness

Richard Thaler, an economist at the University of Chicago School of Business, is one of the founders of modern behavioral economics, along with economists Amos Tversky and Daniel Kahneman. Cass Sunstein is a legal scholar at Harvard University, and has been at the forefront of applying the results of experimental economics to social problems, especially in the field of law. This book has one Big Idea, and it is a very important one. The idea is called "status quo bias," meaning that in many choice situations, people value the status quo (what they currently have), and will forgo the opportunity to switch to an alternative unless the alternative is significantly more attractive than the status quo. In situations where it is difficult to evaluate the exact benefits and costs of what one has over what one could only obtain with some conscious effort, people will tend to stick with what they have. For example, in the United States, the default condition with respect to organ donation is "no donation," so if people want to donate their organs upon death, they must explicitly state this preference. In France, the default condition is “donation,” and an individual who does not like this default condition must expressly indicate a desire not to donate. Consequently, the rate of organ donation is France is several times higher than it is in the United states.

While policies that exploit status quo bias may be called “paternalistic,” they cannot be said to violate individual rights, and in a democracy, many may be termed “self-disciplining” for most individuals. For instance, by law there is a little bell that
rings incessantly in my car when someone has failed to attach a seat belt. I can easily disable this bell, but I welcome it as an aid to overcoming my inertia in enforcing automobile safety procedures. The idea behind *Nudge* is that the choice of a default condition can both allow individuals to choose as they please in a democratic market society, while at the same time improving social outcomes by providing default conditions that lead to socially useful choices. Thaler and Sunstein call this “libertarian paternalism.” While one might think that this minimal sort of market intervention can have only a limited impact on social outcomes, the organ donation example suggests otherwise. Perhaps the most important policy of this type would be a mandate that employers make contributions to retirement savings, in the form of 401(k) and other plans be the default, so that individuals who do not wish to save would have to register the desire to opt out of the plans. A related idea developed in the book is that employees commit to saving a certain fraction of future raises they are awarded by employers, the idea being that it people do not want to reduce their “status quo” income in order to save, but they may be willing to accept a lower new “status quo” when the status quo changes.

This is a very sensible idea. The justification of the assumption that one default condition is preferable to another is generally the assertion that individuals are systematically prone to overstate the value of immediate gratification and understate the value of future payoffs. This is often called “hyperbolic discounting” in the literature, but the real issue is excessive present-orientation, which can occur just as easily with exponential, time consistent, preferences, as with hyperbolic, time-inconsistent preferences. For instance, making retirement saving the default can serve as a counter to the tendency to undersave, which is itself a response to the overvaluation of current as compared to retirement consumption. A second
justification is the tendency for individuals to ignore low probability events, such as having an automobile accident. I consider the irritating bell sounding in my car a present pain that offsets the present pain of fastening my seat belt, given that I cannot really experience the pain of great bodily injury with infinitesimal probability 0.00001.

A second sort of libertarian paternalism takes the form of having the government require firms reveal with clarity and salience the full terms of contractual agreement with consumers. For instance, the nutritional content of restaurant food might be required on the menu, or the precise interest rate on a mortgage might be required to be posted, or all the charges of a broker might be required to be itemized on a monthly statement. These measures are “paternalistic,” because if consumers were fully aware of the situation, they might demand this information from firms, and market competition would then lead to compliance. The role of the government in this situation would then be the more traditional one of enforcing “truth in advertising”---firms are not allowed to misrepresent their offerings. This form of social policy may also not be really paternalistic. If there are sufficiently high transactions costs, I may tolerate the restaurant’s practice of not revealing nutritional content even though I would be willing to pay to have this information revealed, but I would not be willing to pay enough to offset the restaurant’s revenue loss due to my eating smaller portions of healthier food. If my unwillingness to pay is due to my excessive present-orientation, and if I recognize this, I prefer the government regulation for myself.

Thaler and Sunstein, like other behavioral economics policy analysts, are widely criticized for their paternalism, which flies in the face of free market ideology. While some suspicion is warranted, the idea of a market economy with no governmental correctives is just a libertarian fantasy they people neither want, nor
with which they could comfortably live. Policies of the sort discussed in this volume are a welcome addition to the policy-maker’s toolbox. Libertarian paternalism, of course, is not a panacea, and will not replace the price system as the central mechanism for allocating goods and services, and will not obviate the need for legislation that corrects market failures, such as the tendency for excessive energy use to undermine the natural environment, and perhaps even partially offsets such “human frailties” as the tendency towards undersAVING and abusing illegal substances. However, libertarian paternalism is attractive as a first line of attack on even these problems, and should be part of the policy-maker’s toolkit.

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