

# **Libertarian Paternalism and Asymmetric Paternalism**

**Behavioral Economics**

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# Paternalism

**Governments may intervene in markets for a variety of reasons:**

- 1) Redistribution – Tax the rich and give to the poor. This hurts some and helps others, presumably for a net gain**
  
- 2) Counteract externalities – taxing negative externalities or subsidizing positive externalities. This may hurt at the individual level but still yield net social benefits**  
**I'd prefer not to pay a tax and have everyone else pay it, but I'd prefer everyone paying taxes to no one paying taxes**
  
- 3) Paternalism – Designed to help on an individual basis**  
**Parents restricting kids from choosing to skip school or eat candy for dinner**

# Paternalism

**Economists are deeply skeptical of the need for paternalism. Part of it stems from the lack of need at the group level due to the “invisible hand”**

**No need for the government to allocate goods – the market already ensures that the lowest cost sellers make the goods and highest valuation buyers get the goods**

**At the individual level, economists assume full rationality, which implies:**

- 1) People have well-defined preferences or goals, and make decisions to maximize those preferences**
- 2) Those preferences accurately reflect the true costs and benefits of the available options**
- 3) People have valid beliefs about risk and uncertainty, and appropriately incorporate new information according to Bayes' rule**
- 4) Time-consistent preferences and choices**

# Paternalism

**Given these full rationality assumptions, then there is no need for paternalism, both because the paternalism is costly and unnecessary, and restricting choices could only lead to lower utility.**

- Vast majority of economists have a libertarian view**

**If people choose to maximize utility, then any behavior must be utility-maximizing. However, as we've seen in this class, people are not fully rational in the way economics typically assumes.**

**Some of these “errors” are not really a problem for welfare:  
Non-linear probability weights, loss aversion, social preferences**

**But some are:**

**Dynamic inconsistency, self-control, framing effects, status quo bias**

# Paternalism

**If decisions are a function of framing effects, starting points, and default rules, the very meaning of the term “preferences” is unclear.**

**Given these problems, government intervention may be beneficial, even when there are no third-party effects.**

**As we saw with dynamic inconsistency, commitment devices will be welfare improving for the long-run self. As such, appropriate interventions of “thou shall choose x” or “thou shall not choose y” may be welfare improving**

# Examples

**Time Inconsistent Preferences and Self-Control:**

**Rates of U.S. obesity are approaching 20% and over 60% of Americans are either obese or overweight**

**Standard health economics says that people are choosing optimally, and that this increase is due to either the relative price of food falling or changes in insurance structure**

**How many people do you know that are choosing their diets optimally? Or are smoking their optimal number of cigarettes?**

# Examples

**Choice: How much do investors like their own portfolios?**

**Employees volunteered to share their portfolios**

**They were then shown 3 portfolios, simply labeled A, B, and C.**

**Unbeknownst to them, the 3 portfolios were their own portfolio, the mean portfolio, and the median portfolio.**

**Subjects rated the mean portfolio about equally to their own, and the median portfolio as significantly more attractive than their own. (Only 20% of subjects preferred their own portfolio to the median portfolio)**

**-> By people's own revelation, they do not gain much from being allowed to choose their own investments and are choosing sub-optimally**

# Examples

**Status Quo Bias – Automatic enrollment in 401(k) plans. Most use an “opt-in” design – once employees are eligible, they receive plan information and an enrollment form**

**Under an opt-out design, employees are automatically enrolled (under some default contribution rate and asset allocation) unless they un-enroll**

**For companies that offer 401(k) matches, most employees do join the plan, but enrollments occur much sooner under automatic enrollment. For example, initial enrollments of 49% for the opt in plan versus 86% for the opt out plan**

**Similar status quo effects were found for both the default contribution rate and the asset allocation**

# Misconceptions

**1<sup>st</sup> Misconception – There is an alternative to paternalism.**

**Sometimes, an organization or agent must make a choice that will affect the behavior of at least some other people.**

**Example – The director of a cafeteria notices that customers have a higher tendency to choose items that are earlier in the line**

**What order should the director place items?**

- 1) At random**
- 2) In the order she thinks will make customers best off**
- 3) In the order that she thinks customers would choose on their own**

**(2) Is the paternalistic choice and (3) is the libertarian choice. However, 3) is much harder to implement than appears. How can we truly judge what they prefer given this order effect?**

# Misconceptions

**Some skeptics or die-hard libertarians argue there is a way out of this dilemma – employers can avoid choosing a default if they require employees to make a choice, either in or out. This is known as coerced choosing**

**Response:**

- 1) You call that libertarian? - The very requirement that employees make a choice is pretty paternalistic**
- 2) Many employees may not want to make a choice or WANT a better informed or experienced person to make the decision for them (health decisions) Likewise, when they do make a choice they may make a second-order choice (investment decisions)**

# Misconceptions

**2<sup>nd</sup> Misconception: Market pressure or learning will take care of it**  
**For example, the cafeterias that gave people what they wanted would be more profitable and prolific.**

**Generally, the thickness of the market or the institutional veil will determine just how much pressure there is.**

**However, we saw anomalies such as endowment and disposition effects even in the stock market, and partitioned price framing effects in very thick markets.**

**Likewise, not every market has many buyers or many sellers, so there is no reason to always rely on market arbitrage.**

# Misconceptions

**Further, in some cases, the profit motive may work in favor of perpetuating the bias**

**For example, if unhealthy desserts are also the most profitable item for the cafeteria**

**Gabaix and Laibson (2006) – “Shrouded Attributes” – Why do we see so many hidden fees? (Hotel room surcharges, cell phone fees, expensive printer ink)**

**Consider 2 firms: Honest Abe and Sneaky Sam. Honest Abe is upfront about all costs. Sneaky Sam tacks on lots of hidden costs. As such, Sneaky Sam can charge a lower price to get more customers in the door.**

**Suppose there are both “rational” and “irrational” consumers. Who goes where?**

# Misconceptions

**Irrational types will be attracted by Sneaky Sam's lower price, but end up paying more due to the higher fees.**

**Rational types will also be attracted to Sneaky Sam's. Knowing that they can avoid the high surcharges, they can profit from the lower base price.**

**Dual exploitation will always occur – Sneaky Sam's exploits irrational people, and rational people exploit Sneaky Sam's  
(This occurs even in competitive markets, markets with costless advertising, and when the shrouding creates inefficiencies)**

**Note that Honest Abe gets no business – there is zero profit motive for either unshrouding fees or for correcting biases**

**The other standard solution is learning. Repeated decisions should help align choice utility and decision utility. As such, time will eliminate any biases.**

**It is certainly reasonable that people will make better choices in realms in which they have experience and good information (choosing the optimal ice cream flavor) than in contexts in which they are inexperienced and ignorant (choosing medical treatments or investment options)**

**However, several important economic decisions are NOT repeated multiple times, such as choosing a spouse, buying a house, deciding when to retire**

**Likewise, although in some contexts people will learn, the learning is extremely context specific – biases are only corrected in that one specific case. People do not appear to generalize the rules to other cases**

# Misconceptions

**3<sup>rd</sup> Misconception: Paternalism necessarily implies coercion or restriction of choice**

**As the cafeteria example illustrates, the choice over which order to place the food in does not coerce anyone to do anything.**

**Likewise, the order choice does not restrict or eliminate any choices.**

**This will be a characteristic of all plans involving status quo or default choices – steering behavior in one direction while still preserving the original choice set**

# Paternalism

**Is it possible to get the best of both worlds? Is it possible to neither dictate nor restrict choices, yet still aid consumer choice?**

**Libertarian Paternalism – Steering people’s choices in a welfare-promoting direction without eliminating freedom of choice**

**Asymmetric Paternalism – Enacting policies that create large benefits for those who make errors, while creating little or no harm to those who are fully rational**

**Suppose a fraction  $p$  of consumers are “behavioral”, either due to bounded rationality or bounded willpower, and thus  $(1-p)$  are fully rational**

# Paternalism

Let  $B$  denote the benefits to the behavioral consumers of some paternalistic intervention, and  $C$  denote the costs.

Enacting any policy also involves some implementation costs  $I$ .  
Finally the policy might alter firms' profits  $\Pi$ .

A potential paternalistic policy is on net beneficial if:

$$p*B - (1-p)*C - I + \Delta\Pi > 0$$

A policy is asymmetrically paternalistic if the first term is greater than the 2<sup>nd</sup>, either because  $B > C$  or because  $p > 1-p$

**2 Caveats:**

Implementation Costs matter

# Paternalism

**The effect on firm profits is ambiguous. Firms may either be benefiting (either intentionally or unintentionally) from consumer errors, or they may be harmed. In the latter case, everyone gains from the paternalistic policy.**

**However, the net social benefits must always be positive. Why? Exactly akin to the case of externalities. With either positive or negative externalities, the market outcome welfare is sub-optimal.**

**When consumers make errors, it is as if they are imposing externalities, but oftentimes, the other party harmed is merely themselves.**

**As such, correcting biases brings true costs and benefits in line with private/market costs and benefits.**

# Paternalism

**Option 1) - manipulating status quos, defaults, or anchors**

**Examples: Putting the fruit before the desserts – This is as mild as it gets. Choice isn't harmed at all.**

**As a real example, setting the status quo so that the default is 401(k) enrollment in order to encourage retirement savings**

**This obviously passes the libertarian paternalism test.**

**This also strongly passes the asymmetric paternalism test, as long as the transaction costs of switching options are small. Rational types are unharmed, but behavioral types have the potential to benefit greatly.**

# Paternalism

**Option 2 – “Putting distance between options”**

**For example, putting the desserts in another room altogether – so that diners have to get up afterwards.**

**Or creating two lines, the tempting line and the non-tempting line – people may give in to chocolate cake when it’s in front of them but able to resist getting into the tempting line in the first place**

**According to the standard model, this simply raises the transaction costs of eating dessert, and thus makes dessert eaters worse off and everyone else no better off.**

**The 2<sup>nd</sup> example makes simply raises the cafeteria’s costs.**

# Paternalism

**In the real world, this includes “cooling off” periods. For example, employees might be automatically enrolled in a 401(k) plan with a right to opt out, but also might require a waiting period, or consultation with a financial advisor**

**Likewise, freezing credit cards in a block of ice so that they can only be used in emergencies**

**This is libertarian paternalistic because it still preserves complete freedom of choice (eventually).**

**It's asymmetrically paternalistic because these actions minorly raise the transaction costs of “legitimate” users. However, it may help those with self-control issues.**

# Paternalism

**Cooling off periods take 2 different forms:**

- 1) They can force people to delay an action until after a certain period.**
- 2) Alternatively, they could enable immediate decisions but render them reversible for a certain period.**

**Obviously (2) is less costly than mandatory time delays.**

**However, in many situations decision-reversals are either not feasible – it's impossible to undo unsafe sex or suicide – or too costly – as when using a purchased good during the cooling off period would cause significant depreciation**

# Paternalism

**Some real-world examples:**

**Some states impose mandatory waiting periods before people may receive a divorce decree**

**(One could also imagine similar restrictions on obtaining a marriage license)**

**Mandatory waiting periods when purchasing a gun**

**Door to door salesmen must have written statements telling buyers they have the right to rescind purchases within 3 days**

**Cooling off periods make the most sense in cases where:**

- 1) People are making decisions that they make infrequently**
- 2) Emotions are likely to be running high: hot-cold empathy gap**

# Paternalism

**Option 3) – Paternalism – either complete restriction of choice, or make costs and penalties prohibitively high so as to restrict choice**

**-Requiring helmets on motorcyclists**

**-Minimum wage laws**

**Some problems with libertarian paternalism:**

**Problem #1) What is the appropriate default rule to establish?**

**If what people choose depends on the starting point, one cannot determine the starting point by asking what people choose.**

**In some cases the costs and benefits make it naturally clear which direction to err- for example, the costs of saving too little for retirement are greater than having saved too much**

# Paternalism

**Another alternative is to set the default rule that minimizes the number of opt-outs.**

**For example, when organ donation is the status quo and drivers must opt out, only 10% opt out.**

**When drivers must enroll, 30% “opt out” of no enrollment and sign up to donate.**

**This is an ex-post evaluation, and hence presumably better than simply picking what the majority would have picked, but is obviously still susceptible to status quo biases.**

# Paternalism

**Problem #2) How much choice to offer? How much information to offer?**

**The standard model dictates that utility is weakly increasing in the number of choices.**

**Do participants gain from an increase in their choice set? One recent study found that when 401(k) plans offered more choice, “paralysis of choice” set in and participants were slower to join.**

**Likewise, subjects using heuristics such as “invest equally in all funds offered” may exhibit very different portfolio compositions depending on what choices are offered.**

# Paternalism

**In some instances, either additional information or re-framing current information may be beneficial.**

**For example, lottery tickets are popular despite being wildly –EV, presumably because people overweight small probabilities.**

**As such, alternative presentations of what 1/100 Million really means, such as graphical devices, might help.**

**Federal Truth in Lending Act – “Promote the Informed use of credit through an awareness of costs” – 1) enables consumers to compare credit terms 2) Protect the consumer against inaccurate and unfair credit billing and credit practices**

**Similar: Food content labels, anti-tobacco advertising, FDA grading**

# Paternalism

**Because the shops are exempt from the above legislation, the implicit interest rate on “rent-to-own” items and payday loan shops are astronomical – typically in excess of 100% per year or more.**

**These places typically present in terms of “only xx per day.” Presenting consumers with the true yearly interest rate might aid in decisions.**

**However, presentation of additional information may be counter-productive. In the face of health risks, additional info may incite fear, and people may respond by refusing to think about the risk at all.**

**Likewise, retailer requirements to display detailed facts about food content may have the unintended consequence of increasing eating disorders.**

# Application

Recall that people will under-save for a variety of reasons:  
hyperbolic discounting, status quo, procrastination

Choi et al – 2/3 of participants said their savings rate was too low

However, when one approaches people and ask them if they'd like  
join a plan and start saving more, they'll generally say no

Thaler and Benartzi – Save More Tomorrow plan (SMarT)

4 Key Ingredients:

1) Employees are asked if they would like to allocate a portion of  
their *future* earnings for retirement

Due to hyperbolic discounting, this is more attractive than saving  
current income

# Application

- 2) Specifically, their retirement contributions are enacted at the first paycheck after a raise.**
  - This mitigates against loss aversion of take-home pay.**
  
- 3) The contribution rate continues to increase with each scheduled raise until the savings rate reaches a preset maximum**
  - This way, inertia and status quo work towards keeping people in the plan**
  
- 4) The employee can opt out of the plan at any time.**
  - Keep those libertarians happy.**

# Application

**1998 – Midsize manufacturing company was concerned its employees weren't saving enough**

**Hired an investment consultant to offer services to employees. 90.7% chose to meet with the consultant, who simulated the effects of various saving rates. If employees seemed hesitant, the consultant constrained the recommendation to a maximum increase in the savings rate of 5 percentage points.**

**Only 28% were willing to accept his advice, even with the 5 percentage point cap.**

**Alternative – could also join the SMART program**

# Application

**Were asked to increase their savings rate by 3 percentage points each year (after 4 years, this would put most employees at the maximum tax-deferred contribution), but starting with the *next* pay increase**

**This was fairly aggressive, since the average pay raise was 3.25% for hourly employees and 3.5% for salaried**

## **Result:**

**Those who talked to the advisor increased their savings rate from 4.4% to 8.8% after 4 years. Those in the SMarT plan went from 3.5% to 13.6%**

**The SMarT plan was very popular: 80% remained in the plan for all 4 pay raises.**

# Application

Another implementation: Midwestern steel company –  
Here there was no investment advisor

AVERAGE SAVING RATES FOR ISPAT INLAND (%)

	EMPLOYEES WHO WERE ALREADY SAVING ON MAY 31, 2001		EMPLOYEES WHO WERE NOT SAVING ON MAY 31, 2001		ALL ELIGIBLE EMPLOYEES (N= 5,817)
	Joined SMarT (N= 615)	Did Not Join SMarT (N= 3,197)	Joined SMarT (N= 165)	Did Not Join SMarT (N= 1,840)	
Pre-SMarT (May 2001)	7.62	8.62	.00	.00	5.54
First pay raise (October 2001)	9.38	8.54	2.28	.26	5.83

# Peak-End Rule Time

The great economist George Stigler joked that since criticisms of papers are always the same, presentations and conferences could be run much more efficiently if discussants standardized their comments and called them out by number:

1. You've got an endogeneity problem
2. The residuals are clearly non-normal
3. Why don't you use xyz as an instrument?
4. How could you possibly use xyz as an instrument??
6. Your results would change if you introduce heterogeneity
8. What about transaction costs?
29. You've only considered the partial equilibrium case; what about general equilibrium?

# Peak-End Rule Time

**Since the same criticisms of Behavioral Economics pop up over and over again, for the sake of efficiency, we should just refer to them by number from now on:**

- 1. If the stakes were larger, people would get it right**
- 2. In the real world, people will learn to get it right**
- 3. In the aggregate, the errors will cancel out**
- 4. In markets, arbitrage and competition will eliminate the effects of irrational agents**
- 5. Where is the theory?**

# Peak-End Rule Time

Here's the kicker: every one of these criticisms is wrong.

*1. If the stakes were larger, people would get it right*

Time and again, experiments with “large” stakes show at worst the same basic pattern as smaller stakes, and most of the time identical results

People still reject unfair offers in \$400 Ultimatum games

Same pattern with substantial Ultimatum games in developing countries

Experiments on risk and time discounting

# Peak-End Rule Time

*2. In the real world, people will learn to get it right*

**Really? Think back to all the examples of prospect theory – stock markets and housing markets**

**Time Discounting – Procrastination, under-saving, commitment devices**

**Real world biases:**

**Status quo bias – 401(k), Jersey/Pennsylvanian insurance**

**Self-serving bias – teacher contract negotiation**

**Mental Accounting examples**

# Peak-End Rule Time

***3. In the aggregate, the errors will cancel out***

**“Of course in the real world people won’t be perfect and will make errors, but over a large sample or a long time frame, they will cancel out”**

**Not if the errors are systematic. They’re always in the direction of overweighting small probabilities and underweighting large, or the Smaller Sooner becoming relatively more attractive as time gets closer, or being pulled in the same direction as the anchor, or sellers having higher WTA post-endowment**

# Peak-End Rule Time

**4. *In markets, arbitrage and competition will eliminate the effects of irrational agents***

**We just addressed this one in the Paternalism lecture**

**5. *Where is the theory?***

**This criticism had more bite a decade or two ago, when Behavioral Economics was more of a “laundry list” of cognitive errors. Now, virtually every finding we discussed in this class, from prospect theory to hyperbolic discounting to social preferences, has a testable and falsifiable theory behind it.**

# Peak-End Rule Time

**I close this lecture and this class with two wildly false statements:**

- 1. “Rational” models are useless**
- 2. All behavior is rational**