

Whither Behavioural Economic Policy?

Dr Adam Oliver, LSE Health, asks what is behavioural economics and explores the application of the findings of behavioural economics to policy concerns.

The use of behavioural economic findings to inform policy design is currently in vogue, probably for two main reasons. The first is in response to the 2008 economic crisis, the cause of which can be attributed to bankers holding too much faith in neoclassical economics, by believing that individuals can rationally decide on the amount of money that they can optimally borrow. The second is arguably due to the influence of Thaler and Sunstein's (2008) book, *Nudge*, much admired by David Cameron, prompting him on being elected to establish a Behavioural Insights Team (the so-called 'Nudge Unit') in the Cabinet Office at 10 Downing Street, with Thaler serving as an official advisor (Sunstein is currently serving as Barack Obama's regulation 'tsar'). The essence of the nudge approach is that behavioural economic insights can be used to change the 'choice architecture' (i.e. the environment) so that people are more likely to make voluntary decisions that, on reflection, they would like to make, and yet ordinarily fail to do so.

In policy circles, there appears to be the perception that behavioural economics, due to its potential to guide people towards making 'better' decisions, can be used as an alternative to stricter forms of regulation, such as taxes and bans. This no doubt in part explains the popularity of the approach with the current right-of-centre UK Government and its apparent preference for a smaller central state. It is, however, a misconception to believe that behavioural economists oppose stricter forms of regulation – few, if any behavioural economists would argue that voluntary behavioural interventions and nudges should replace, for example, compulsory seatbelt legislation, drink-drive laws, food safety legislation and taxation on certain harmful products. Behavioural economic-informed policy interventions can be 'softer' than stricter forms of policy, but they should be perceived as tools to complement regulation by moving society incrementally in a direction that might benefit all of us, and only as a substitute for regulation when additional enforced measures are perceived by the public as an expression of a government overstepping the mark. In some circumstances, however, behavioural economics would arguably imply that harder forms of regulation are warranted. For instance, referring back to the financial crisis, any behavioural economist would contend that most individuals are not the best judges of the optimal amount that they ought to borrow, and thus that the American mortgage market ought to have been more tightly regulated (Ariely 2009).

So, what is behavioural economics? Well, behavioural economics recognises the limits of human rationality, with 'rationality' being defined by the mainstream economic sense of the word, and comprises of a number of observations appertaining to human decision making that do not sit well with the neoclassical orthodoxy (Dolan *et al.* 2010). These include: the observation that losses loom substantially larger than gains, a phenomenon known as loss aversion; (ii) that reference points matter, such that people often care more about what they gain or lose around what they already have, rather than what they end up with; (iii) that people tend to overweight small probabilities; (iv) that people allocate their money to discrete bundles, so that the value that they attach to a particular amount of money will be contextual; (v) the observation of motivational crowding, such that offering money to people to do something has been shown often to 'crowd-out' their intrinsic, altruistic motivation to do that very thing; and (vi) 'hyperbolic discounting', which is the observation that people tend to place an enormous weight on the 'immediate' compared to the future, living for today at the expense of tomorrow.

In addition to the above stated observations, individuals often seemingly adopt a number of rules of thumb (or 'heuristics') when reaching their decisions, and apparently 'satisfice' rather than 'optimise', which goes against the grain of mainstream economics. A far from exhaustive list of these rules of thumb include: (a) the availability heuristic, in which people tend to assess the

probability of an event by the ease with which similar instances can be brought to mind (e.g. many people erroneously think that the annual death rate from shark attacks is greater than that caused by falling coconuts); (b) the anchoring heuristic, in which individuals often unconsciously focus upon, and can be manipulated by, entirely irrelevant cues when making decisions, and (c) the overconfidence bias (e.g. most people think their driving ability is better than average), which has obvious implications for choices in financial markets, and elsewhere. Behavioural economists have thus uncovered a library of systematic preference patterns and heuristics that cannot be explained by standard economic theory. Interestingly, although perhaps for many, on reflection, unsurprisingly, several of the observations and rules of thumb (e.g. the importance of reference points, availability, anchoring) appear to suggest that humans are influenced very much by prominent, or 'salient', attributes in choice options – once their attention is focussed upon a particular feature of a task, they tend to overlook somewhat other potentially important information (for an entertaining example of this phenomenon, see [selective attention test](#)).

Knowing the key findings of behavioural economics may help academics and policy makers to design interventions that influence people in ways that are beneficial for those people, and for society as a whole. These interventions can range from those that have enormous import, potentially on a global scale (e.g. both lenders and borrowers in mortgage markets, if left unregulated, may, due to the overconfidence bias, bring the world to the brink of financial meltdown), to the more 'targeted' and specific. Thaler and Sunstein (2008) detail many such specific interventions, with one of the most memorable involving the image of flies being etched on the inside of urinals in Schiphol Airport. The fly provided a target, and the tendency for humans (well, men at least) to focus upon this salient feature led to a significant fall in 'spillage'. Although perhaps not of huge global significance, the flies, if 'universalised', would presumably improve the wellbeing of toilet cleaners (and toilet users) everywhere.

The UK Government, as aforementioned, through the offices of its Behavioural Insights Team, is internationally at the forefront of applying the findings of behavioural economics to practical policy concerns. So far, the Nudge Unit has released two policy reports, which have principally and sensibly taken the form of proposed pilot projects, one focussed on the area of health policy and the other on personal energy consumption. In the health report (Behavioural Insights Team 2010), an intervention is proposed that appeals to loss aversion in relation to smoking cessation. The intervention offers the opportunity to those who wish to quit smoking to sign a voluntary contract where they lose rewards if they fail a regular urine or blood-based smoking test. With rare exceptions, offering people rewards if they quit smoking has been shown ineffective in any sustained sense; it remains to be seen whether 'commitment contracts', due to the loss aversion phenomenon, demonstrate more success.

In addition to loss aversion, the health report takes heed of the influence of reference points by promoting a since enacted initiative of 'prompted choice' to be an organ donor. In the UK, people have traditionally had to opt-in to be a donor, which led to a donor rate of roughly twenty percent. In several other countries, such as France, Spain, Portugal and Austria, people have to actively choose not to be a donor. That is to say, they are required to opt-out. As a consequence, in those countries at least eighty percent of the adult population are listed as potential donors. Prompted choice is not quite as strong as an opt-out policy, but it does require people to indicate whether or not they wish to be a donor when applying for or renewing their driving licence, for example. This type of scheme has been introduced to good effect in several US states.

The health report also pays quite a lot of implicit attention to hyperbolic discounting, in that it offers forth a number of proposals that are intended to make unpleasant activities (e.g. exercising, eating vegetables) more enjoyable to do. For instance, the Nudge Unit has formed a partnership with LazyTown, a public-private initiative that has been operating nationally in Iceland since 1996. The initiative requires young children to sign an 'energy contract' with their parents that rewards them for eating healthily (fruit is labelled 'sports candy'), going to bed early and being active. Following the introduction of LazyTown, and probably uniquely in the western world, the Icelandic childhood obesity level fell. The notion of making tasks more enjoyable is extended in the report to novel

ways of getting people to use stairs and avoid escalators, a demonstration of which can be viewed [here](#)).

Similar appeals to behavioural economics can be found in the Nudge Unit's personal energy saving report (Behavioural Insights Team 2011). For instance, with respect to hyperbolic discounting, the energy saving report proposes the provision of a subsidised service to help people to clear their lofts prior to installing insulation, presumably so as to minimise the anticipated and immediate 'pain' associated with a loft clearing effort. Moreover, the report implicitly uses reference points, anchoring and loss aversion to inform some of its proposed interventions. For example, the report promotes the use of 'smart meters', so that people can compare their own energy consumption levels with households of similar type, and also specifies that the information on the costs of heating a home and how much can be saved from energy efficiency measures should be made much clearer on Energy Performance Certificates (that are meant to be presented when buying or renting a home). From using smart meters, it might be expected that people will choose the average energy consumption level of similar households as their reference point, and if they were to exceed this level in their own household they may perceive their 'excess' consumption as a 'loss'. This may in turn motivate them to be more careful about their use of energy in the future. Strengthening the salience of reference points, as proposed with respect to the information on Energy Performance Certificates, is a tool that is similarly used in the health report, where in relation to food intake and standards, there are proposals to provide people and organisations with visual prompts (on calorie counts, food hygiene standard etc.) to encourage behaviour change.

Behavioural economic insights are therefore clearly being used to inform government policy in the UK, and similar more localised experiments are being applied in many contexts all over the world (refer to Thaler and Sunstein (2008) for some examples of these). A few behavioural economists are currently attempting to build a grand theory of the approach, which whilst laudable for its intellectual ambition (and may even garner a Nobel Prize or two), is probably a mistake in that it is likely that such a theory would inevitably be at least as leaky as the neoclassical approach. Instead, behavioural economics can perhaps best be thought of as offering a library of tools, not all of which can be used at any specific time, but each of which may be of use in some particular contexts. Behavioural economics is not a panacea, but by using the insights from human psychology that are embedded in the approach, academics and policy makers may be able to design interventions that – in some circumstances – are relatively well equipped to motivate people to behave in ways that are better for themselves, and for society at large.

References

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