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Session 1: Introduction to the issues

An Introduction to the Roundtable*

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Welcome to today’s roundtable on the policy implications of behavioural economics. The profile of behavioural economics has been increasing in recent years, and the high calibre of the participants sitting around this table demonstrates the level of interest in the topic among the policy community. The Productivity Commission shares this interest, and through this roundtable hopes to get a better understanding of a number of issues that are raised by this developing area of research.

The Commission has long recognised that the assumptions that we make regarding the behaviour of individuals, firms and regulators have important implications for our policy analysis. Likewise, the Commission is aware that the assumptions about people’s behaviour that are found in introductory economics textbooks do not always accurately describe how people actually behave. Just as mainstream economics has taken on board the implications of market failures that arise from externalities, imperfect competition and information asymmetry, so our analyses should include the potential for market and government failures that arise from the fact that agents are not perfectly rational, calculating, utility maximisers.

The Commission has a long history of applying emerging developments in economic theory to its work. Examples include the work of the Commission’s predecessor bodies in the use of effective rates of assistance, and general equilibrium modelling to measure the impacts of government policies in Australia. More recently, the Commission has taken on board the findings of strategic trade theory and New Growth Theory, and examined the ramifications of ‘social capital’ for community well-being. Behavioural economics presents a new set of challenges and opportunities to policy practitioners that the Commission welcomes.

This roundtable is the Commission’s first event focussing specifically on the policy implications of behavioural economics. But it has considered these issues in its research and inquiries over the years. For example, in a 1994 report on the tobacco industry, the Commission recognised that individuals may be unable to correctly incorporate information about the risks of smoking into their decisions. It also examined the effects of peer group pressure and persuasive advertising on individuals’ preference formation. It found that some of these factors may support the case for governments to influence individual decisions in relation to smoking. Likewise, in its 1999 report on Australia’s gambling industries, the Commission recognised that some gamblers do not act rationally, and that the damage done by gambling addiction to addicts themselves is a policy-relevant cost. In this case, the Commission found that intervention could help gamblers to help themselves.

The Commission is currently conducting an inquiry into consumer policy and a number of submissions to the inquiry and participants in public hearings have drawn on the findings of behavioural economics. For example, some participants have questioned the assumption that providing information to consumers necessarily leads them to make better choices, and have argued that consumers can be confused rather than informed by lengthy disclosure statements. Other participants have suggested that the findings of behavioural economics could be used to assess the likely effectiveness of proposed regulations. We are expecting that this roundtable will contribute to our understanding of behavioural economics for that inquiry and for our other work in the future.

Elsewhere in the Commission, the Office of Best Practice Regulation, which is the Australian Government's watchdog on regulatory practice, is increasingly being presented with regulation impact statements that make a case for policy intervention on behavioural grounds. It is clearly important that we can make a well-informed assessment of such rationales.

A relaxation of the assumption that agents are rational, calculating, utility maximisers opens up a raft of challenges for policy analysis. It has been observed that there is only one way for people to reach the optimal outcome identified by the classical economic models, but a thousand ways to miss that outcome. Harvard Professor Edward Glaeser has described this as 'Tolstoy's Corollary on Suboptimal Behaviour'. Tolstoy's famous introductory line in *Anna Karenina* noted that: 'Happy families are all alike. Every unhappy family is unhappy in its own way.' Glaeser says the same holds for economic theory: every rational, well-informed, utility-maximising agent reaches the optimal outcome in the same way. Every real person, firm or policy maker that misses that point has missed it through their own unique behaviour.

In many cases where people make bad choices, the consequences may not be very serious. We each make hundreds of choices every day, and are continuously learning from our actions and from the actions of other people. We can respond to the consequences of bad decisions by changing our behaviour to prevent further damage and possibly undo past damage. We can set goals, routines, or personal rules. We can even cut up our credit cards, swear off fast food and join a gym, or unplug the television and read a book. Provided we can recognise the consequences of our choices and respond in time, there would seem to be little argument to support government intervention on the grounds of behavioural biases. However, in some cases it is difficult for people to recognise that they *are* making bad choices, and to respond in time to recover from their losses.

The behavioural economics literature describes circumstances where people's behaviour is systematically biased in one way or another. For example, behavioural economists have demonstrated that people have inconsistent attitudes to risk, uncertainty, and discounting that lead them to make decisions that they may regret later in life. Experiments in the laboratory and results in the real world have shown that people's sensitivity to losses relative to gains is greater than implied by the expected utility approach. Behavioural economics has highlighted the importance of contextual or 'framing' effects in decision making. And experiments and everyday observations have confirmed that some decisions are influenced by altruism and fairness — not just by narrow self interest.

While few people would dispute these findings, the policy implications are still very much open to debate. One of our keynote speakers, Bruno Frey, has suggested that although people can exhibit systematic behavioural biases, it does not necessarily follow that governments should intervene. He and his colleague Alois Stutzer (2006) identified a number of situations where individuals tend to misjudge the 'utility' they will gain from certain activities, and are left worse off because of it. For example, people who watch a lot of television often find themselves regretting the time wasted (at least, after the event). And people who commute long distances to work in order to live in better houses further out of town tend to underestimate how burdensome they will find the commute. Stutzer and Frey (2006, p. 21) found that these results give 'no cause for immediate government intervention', but do raise questions about the appropriateness of government subsidies for activities that are subject to excessive consumption, which can be a widespread phenomenon.

While these results may provide some justification for relatively 'benign' policies such as information provision, other researchers support more activist interventions. University of Chicago academics Cass Sunstein and Richard Thaler use the term 'libertarian paternalism' to describe an approach to policy design that stems from the observation that the way in which decisions are framed can have significant effects on outcomes (Sunstein and Thaler 2003). Advocates of this approach have proposed policy interventions to influence the decision context, to help people make the 'right' choice. The Economist described advocates of 'libertarian paternalism' as being like generous uncles who try to give their younger relatives the benefit of their experience:

> Their aim is not the 'nanny state', a scold and killjoy forcing its charges to eat their vegetables and take their medicine. Instead they offer a vision of what you might call the 'avuncular state,' worldly-wise, offering a nudge in the right direction, perhaps pulling strings on your behalf without your even noticing. (The Economist 2006, p. 65)

One area where this approach has been proposed is in retirement savings plans where, for example, firms may be required to enrol new workers automatically in a savings plan, while allowing them to opt out at any time. Experiments have shown that the decision made as to the default setting can significantly increase levels of participation in such schemes (although the effect on overall savings may not be as great).

Other researchers have advocated policies that go further than 'libertarian paternalism'. It is often observed that the patterns of people's choices imply that much larger discount rates are applied to the distant future than to the near future. This can lead people to make decisions that hurt them later in life, such as saving too little for a comfortable retirement. A 'libertarian paternalist' may suggest changing the default option on savings plans. A 'harder' paternalist would legislate compulsory superannuation contributions. Or, to change the example, a 'libertarian paternalist' may suggest that cigarettes be sold in packets of three; a 'harder' paternalist, that governments should levy 'sin taxes' to reduce our consumption of products that we want to consume now, but that could do us harm in the long run. Thus, Gruber and Koszegi (2001, p. 1263) estimated that the so-called 'internalities' — costs imposed by 'present selves' on 'future selves' — arising from cigarette smoking are of the order of US$30 per pack. They proposed that even modest time-inconsistency in smokers' preferences would justify an additional tax of US$1 per pack.

While there have been relatively few policy interventions that have been explicitly attributed to the findings of behavioural economics, many long-standing policies have been based on a view of how people behave in the real world. This roundtable is an opportunity for further discussion of how policy makers' understanding of people's behaviour has influenced policy development, and specific examples of policies designed to address behavioural biases. Behavioural economics has the potential to formalise our understanding of some of the characteristics of people's behaviour that policy makers have been acting on intuitively for years. To explore this potential today, the Commission would like to address two broad groups of questions.

The first group is concerned with the extent to which the behavioural approach can help policy makers *achieve given policy goals more effectively*.

- In what circumstances are the usual economic assumptions regarding behaviour likely to diverge from reality to such an extent that their use would have adverse consequences for our analysis?
- What alternative (and workable) assumptions could we make that more accurately characterise people's behaviour?
- How do 'framing' and context influence decision making? When do policy makers need to explicitly take these effects into account?

The second group focuses on whether the findings of behavioural economics can be *used to support or justify particular policy goals*.

- If the choices that people make in markets do not represent their 'true' preferences, what benchmarks should policy makers use in assessing the costs and benefits of intervention? Can evidence from experimental economics determine what people’s ‘true’ preferences are, and what are the implications of using this kind of evidence?

- Policies that address behavioural biases can have distributional impacts. The benefits may flow to naïve consumers but more savvy consumers may bear some costs. What consideration should we give to the distribution of the costs and benefits of policies that address behavioural biases?
- What are the possible consequences of letting governments deliberately influence the choices that people make? Should we set limits on how and when governments can intervene to address behavioural biases?
- Can the findings of behavioural economics contribute to the way we design institutions to minimise the costs of mistakes made by policy makers and regulators?

Of course, we are not confronted with an either/or situation of having to choose between mainstream and behavioural economics. To pick up the earlier example, there may be a number of reasons for governments to encourage private saving. One is the conclusion from classical welfare economics that progressive income taxes have a negative effect on savings rates. Another is the finding from behavioural research that people are myopic and underestimate the costs of living in retirement. Both the classical and the behavioural approaches to the issue of saving show that there are distortions that may justify government intervention to improve on market outcomes.

I hope that this framework provides a useful springboard for today’s roundtable, and I look forward to our discussions.

References

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