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Economics: Which Way for Obama?

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Nudge: Improving Decisions About Health, Wealth, and Happiness
by Richard H. Thaler and Cass R. Sunstein
Yale University Press, 293 pp., $26.00

The bursting of the housing bubble and the associated credit crunch has so far wiped out about $3 trillion of wealth—nobody knows the exact amount—caused havoc in the financial markets, and prompted hundreds of thousands of homeowners to default on their monthly mortgage payments. Some experts predict that by the end of 2009, the number of homes entering foreclosure could reach two million. Not surprisingly, the question of what to do about the housing crisis has emerged as a divisive policy issue in the 2008 presidential election, with each of the three leading candidates representing a distinct economic ideology.

John McCain, for all his protestations that economics is not his strong point, has put forward a coherent, if somewhat heartless, case for doing nothing, or very little, anyway. Echoing the arguments that Andrew Mellon, Friedrich Hayek, and other enthusiasts of the free market espoused in the early years of the Great Depression, McCain has said it is no business of the government to bail out people who took out loans they couldn't afford. Evidently such socialistic interventions would only reward reckless behavior, and, in any case, they wouldn't work. The laissez-faire argument says it is better to let the market "correct"—i.e., let the foreclosures mount up—until people learn to live within their means and prices become more affordable, at which point sustainable economic growth will resume.

Hillary Clinton, after initially equivocating, has emerged as the would-be heir to FDR and John Maynard Keynes. In addition to imposing a ninety-day moratorium on foreclosures and a five-year freeze on certain adjustable mortgage rates, she would have the federal government buy up an

undetermined number of troubled home loans, enabling lenders to convert them to more affordable deals and putting a floor under the housing market.

Clinton would also allow bankruptcy judges to reduce the value of mortgages, a proposal the banking industry vigorously opposes, and she has criticized McCain as the reincarnation of Herbert Hoover—a comparison that is a bit unfair to the thirty-first president, whose intellectual commitment to voluntarism didn't prevent him from expanding public works programs, raising taxes on the wealthy, and creating two institutions that funneled federal money into the housing market: the Federal Home Loan Bank and the Reconstruction Finance Corporation.

Barack Obama has also criticized McCain for sitting back and watching while so many American families face eviction. Yet his own proposals are more nuanced than Hillary's. They include setting up a $10 billion fund to help prevent foreclosures, cracking down on mortgage fraud, providing tax credits to low- and middle-income homeowners who don't currently itemize their interest payments, and standardizing the terms of mortgages so that potential borrowers can more easily figure out when they are being hoodwinked. Obama has also expressed support for Democratic Senator Chris Dodd's plan to expand the Federal Housing Administration's ability to refinance troubled loans. So far, though, he has been noticeably less enthusiastic than Clinton about a large-scale injection of public funds into the market for mortgages and mortgage securities.

Should Obama win the nomination, political considerations may well force upon him a more interventionist position, but his first inclination is to seek a path between big government and laissez-faire, a trait that reflects his age—he was born in 1961—and the intellectual milieu he emerged from. Before entering the Illinois state Senate, he spent ten years teaching constitutional law at the University of Chicago, where respect for the free market is a cherished tradition. His senior economic adviser, Austan Goolsbee, is a former colleague of his at Chicago and an expert on the economics of high-tech industries. Goolsbee is not a member of the "Chicago School" of Milton Friedman and Gary Becker, but he is not well known as a critic of American capitalism either. As recently as March 2007, he published an article in *The New York Times* pointing out the virtues of subprime mortgages. "The three decades from 1970 to 2000 witnessed an incredible flowering of new types of home loans," Goolsbee wrote. "These innovations mainly served to give people power to make their own decisions about housing, and they ended up being quite sensible with their newfound access to capital."

When I spoke to Goolsbee earlier this year, he said that one of the things that

distinguished Obama from Clinton was his skepticism about standard Keynesian prescriptions, such as relying on tax policy to stimulate investment and saving. In a recent posting on HuffingtonPost.com, Cass Sunstein, who for ten years was a colleague of Obama's at the University of Chicago Law School —and has said he is "an informal, occasional adviser to him"—made a similar point regarding government oversight of the financial markets: "With respect to the mortgage crisis, credit cards and the broader debate over credit markets," Sunstein wrote, "Obama rejects heavy-handed regulation and insists above all on disclosure, so that consumers will know exactly what they are getting."

If Obama isn't an old-school Keynesian, what is he? One answer is that he is a behavioralist—the term economists use to describe those who subscribe to the tenets of behavioral economics, an increasingly popular discipline that seeks to marry the insights of psychology to the rigor of economics. Although its intellectual roots go back more than thirty years, to the pioneering work of two Israeli psychologists, Amos Tversky and Daniel Kahneman, behavioral economics took off only about ten years ago, and many of its leading lights, among them David Laibson and Andrei Shleifer, of Harvard; Matt Rabin, of Berkeley; and Colin Camerer, of Caltech, are still in their thirties or forties. One of the reasons this approach has proved so popular is that it appears to provide a center ground between the Friedmanites and the Keynesians, whose intellectual jousting dominated economics for most of the twentieth century.

The central tenet of the Chicago School is that markets, once established and left alone, will resolve most of society's economic problems, including, presumably, the mortgage crisis. Keynesians—old-school Keynesians, anyway —take the view that markets, financial markets especially, often fail to work as advertised, and that this failure can be self-reinforcing rather than self-correcting. In some ways, the behavioralists stand with the Keynesians. Markets sometimes go badly awry, they agree, especially when people have to make complicated choices, such as what type of mortgage to take out. But whereas the Keynesians argue that vigorous regulation and the prohibition of certain activities such as excessive borrowing are often necessary, behavioralists tend to be more hopeful about redeeming free enterprise. With a gentle nudge, they argue, even some very poorly performing markets—and the people who inhabit them—can be made to work pretty well.

In a fortuitous accident of timing, Sunstein and his friend Richard Thaler have just published a book that makes the behavioralist case in nontechnical language: *Nudge: Improving Decisions About Health, Wealth, and Happiness*. On the face of it, finding two more suitable coauthors would be difficult. Sunstein is a one-man think tank and a prolific writer—by my count, this is his

eighth book in as many years. Thaler, who, like Goolsbee, teaches at Chicago's Graduate School of Business, is one of the founders of behavioral economics. During the 1980s, he began publishing a series of columns in the *Journal of Economic Perspectives* about economic phenomena that defied the accepted wisdom of the subject, which depended heavily on the twin assumptions of individual rationality and market efficiency.

Thaler's columns, some of which he coauthored with Kahneman and Tversky, ran under the rubric "Anomalies." Among the things they highlighted were the failure of participants in economic experiments to pursue their own self-interest; the buyer's remorse suffered by many auction winners when they contemplate what they have bought; and the popularity of lotteries. (If people were fully rational, they would realize they had virtually no chance of winning.) The articles, which in 1992 were published as a book, *The Winner's Curse: Paradoxes and Anomalies of Economic Life*, inspired many bright young economists to take a closer look at human psychology.

For decades hitherto, young economists wanting their elders to take their work seriously had followed a three-step research program that could roughly and uncharitably be described as follows: (1) write down a set of equations to describe how people or firms behaved; (2) fiddle around with the math until it yielded some refutable hypotheses; and (3) using the most highfalutin statistical technique you could master, subject the theory to the data. Thaler and his followers were savvy enough to couch their theories in mathematics. To test them out, though, they borrowed some tricks from experimental psychology, monitoring actual people—groups of students, usually—doing everyday things, such as drinking beer, playing computer games, bidding for cheap objects, and, in one case that has recently attracted some attention, masturbating while viewing online pornography. (MIT's Dan Ariely was one of the organizers of the latter experiment, which he covers at length in his best-selling book, *Predictably Irrational*.[*])

As is true of almost all research programs, some of the results the behavioral economists obtained weren't exactly shocking. (Ariely "discovered" that sexually aroused young men develop a taste for unprotected sexual intercourse and other, more deviant, sexual practices.) Taken together, however, the experiments confirmed something most people outside of economics hadn't doubted for a moment: rational economic man, the all-seeing, all-knowing figure on whose shoulders much of contemporary economics had been constructed, was a purely fictional character. Faced with even simple sets of options to pick from, human beings make decisions that are inconsistent, suboptimal, and, sometimes, plain stupid. Rather than thinking things through

logically, they rely on misleading rules of thumb and they leap to inappropriate conclusions. Moreover, they are heavily influenced by how the choices are presented to them and, sometimes, by completely irrelevant information.

If you think you are too smart for this description to apply to you, try this simple mental exercise. Take the last three digits of your cell phone number, obtaining a number between zero and 999, and add two hundred to it. Write down the resulting figure and put the letters AD after it. Now, consider this question: When did Attila the Hun invade Europe?

Unless you are an expert on the Dark Ages, or your brain is unusually wired, the chances are that your answer will be pretty close to the date you write down. Say the last three digits of your cell number are 787 and the number you write down is 987 AD. Then, most likely, 900 AD will sound like a reasonable answer to you, and so will 1050 AD, but 400 AD will sound wrong. That was certainly how it worked when I tried the exercise.

The last three digits of my cell number are 314, so I wrote down 514 AD. Then, I volunteered 450 AD as the answer to the history question. (As chance would have it, I almost got the correct answer, which is during the 440s.) My experience was fairly typical. When Thaler and Sunstein asked some of their students to play this game, those who started out with high numbers gave dates that were, on average, three hundred years later than those proffered by students with low numbers.

What is going on here? As a matter of logic, we know perfectly well that there is no connection between our cell phone numbers and the date of Attila's campaigns, but the figure we write down gets stuck in our heads, where it acts as an "anchor" when we come to answer the subsequent question. "In the language of this book, anchors serve as nudges," Thaler and Sunstein write. "We can influence the figure you will choose in a particular situation by ever-so-subtly suggesting a starting point for your thought process." Of course, others can do the same thing. Thaler and Sunstein cite charitable organizations that ask, in their circulars, for a donation of "$100, and $150, $1,000, $5,000." The fundraisers know that few people will give $5,000, but by presenting this set of options rather than, say, "$50, $75, $100, and $150," they manipulate people into giving relatively large amounts. "In many domains," Thaler and Sunstein write, "the evidence shows that, within reason, the more you ask for, the more you tend to get. Lawyers who sue cigarette companies often win astronomical amounts, in part because they have successfully induced juries to anchor on multimillion-dollar figures."

Anchoring is one of several mental shortcuts that Tversky, who died in 1996,

and Kahneman, who is an emeritus professor at Princeton, wrote about in a 1974 paper that marked the beginning of what became behavioral economics. (For this and other contributions, Kahneman received the 2002 Nobel Prize in economics.) Another way of saving mental energy, which Kahneman and Tversky termed the "availability heuristic," involves assessing risks on the basis of particularly salient examples rather than a calm assessment of mathematical probabilities. Fear of a terrorist attack is a good example. Following September 11, 2001, many people, myself included, greatly overestimated the chances of their being killed in another al-Qaeda attack, relative to, say, their perishing in a car crash. A third shortcut, known as the "representativeness heuristic," involves seeing patterns where none exist. If I flip a coin and get six heads in a row, I may well conclude that there is something wrong with the coin. Much more likely, the coin is perfectly fair and the run of heads was simply a random event.

Once Tversky and Kahneman got people thinking critically about the rational actor model, they and others quickly identified many more mental quirks, or biases, that are pretty much ubiquitous. From the perspective of behavioral economics, the key ones are inertia, overconfidence, and loss aversion. In their everyday existences, people tend to stick with what they are doing, even if trying something different wouldn't be very taxing. One reason Oprah Winfrey's television show is so commercially valuable is that so many of its viewers stay with the same channel for the evening news and for prime-time programming. Students sit in the same chair for lecture after lecture. Families go on vacation to the same spot every year. In the vernacular of behavioral economics, they have a "status quo bias."

At the start of one of his classes, Thaler makes his students fill out an anonymous survey in which he asks them how they expect to perform relative to their classmates. Typically, fewer than one in twenty say they expect to achieve a grade below the median. That is overconfidence. Loss aversion refers to the fact that once people own something they hate giving it up, be it a house, a car, or even a humble coffee mug. Many years ago, Kahneman and two collaborators divided a class of students in two, giving the members of one group a mug each that they could keep. After waiting awhile, the researchers asked the mug owners how much they would be willing to sell their mugs for, and they asked the students without mugs how much they would pay for one. "The results show that those with mugs demand roughly twice as much to give up their mugs as others are willing to pay to get one," Thaler and Sunstein write. "Thousands of mugs have been used in dozens of replications of this experiment, but the results are nearly always the same. Once I have a mug, I don't want to give it up."

Exploring the limits of human reason is interesting in its own right—witness the popularity of Ariely's book—but what has it got to do with Obama? Thaler and Sunstein lay out a number of principles that can be used to encourage better choice-making, and they apply them to various topical issues, including retirement saving, health care, and the environment. In a number of cases, the measures that Thaler and Sunstein recommend are mirrored by proposals in Obama's voluminous policy papers, which can be downloaded from his Web site.

In a chapter entitled "Save More Tomorrow," Thaler and Sunstein endorse the idea of automatically enrolling people in corporate savings plans, such as 401(k)s, rather than making them fill out a form if they wish to opt in. In the idealized world of neoclassical economics, this shouldn't make much difference—rational people will decide what works best for them and do it. In reality, because of the status quo bias, or, perhaps, because of sheer laziness, the fallback option matters plenty. Studies show that when employees have to sign up, participation rates are often as low as 50 or 60 percent. When people are enrolled as a matter of course, with an option to opt out, the participation rises to more than 90 percent.

For decades now, economists have been bemoaning the fact that so many Americans save hardly at all. Simply offering tax breaks for saving has been tried many times, and it doesn't have much impact on overall savings rates. Here is a simple, noncontroversial measure that seems to work. An Obama administration would build upon it by requiring firms that don't offer 401(k) plans to open a direct deposit retirement account for their workers, with an opt-out clause rather than an opt-in clause. For the first $1,000 in savings that an employee contributed, the government would provide a $500 tax credit.

Elsewhere, Thaler and Sunstein endorse Justice Louis Brandeis's injunction that "sunlight is…the best of disinfectants." In financial markets, especially, prices are often opaque, which gives unscrupulous businesses ample scope for ripping off customers by imposing on them hefty hidden charges, late fees, and the like. Thaler and Sunstein propose that credit card companies, mortgage issuers, and other financial services firms should be forced to disclose all of their charges clearly, in plain language, so that potential customers can comparison shop. Applying the same argument to cell phone plans, the authors write: "The government would not regulate how *much* issuers charge for services, but it would regulate their disclosure practices." Adopting similar language, Obama has proposed a Credit Card Bill of Rights, which would require issuers to provide lenders with full and clear information about the terms of their loans, including all charges.

Disclosure not only helps consumers make better choices: it can also shame businesses into curbing their egregious behavior. Thaler and Sunstein cite the Toxic Release Inventory, a piece of legislation from the 1980s that forced companies to disclose to the government what potentially harmful chemicals they had stored or released into the environment. As James Hamilton pointed out in his 2005 book, *Regulation Through Revelation*, the measure was originally intended simply to provide the Environmental Protection Agency with more information, but once enacted it allowed activists and the press to target the worst offenders. Fearful of attracting bad publicity, many companies changed their policies, and overall emissions fell sharply. In light of this experience, Thaler and Sunstein propose setting up a Greenhouse Gas Inventory, which would require companies and other organizations to publish the total amount of carbon they are releasing into the atmosphere:

> In all likelihood, interested groups, including members of the media, would draw attention to the largest emitters. Because the climate change problem is salient, a Greenhouse Gas Inventory might well be expected to have the same beneficial effect as the Toxic Release Inventory. To be sure, an inventory of this kind might not produce massive changes on its own. But such a nudge would not be costly, and it would almost certainly help.

All of this makes for interesting reading, and much of it is sensible. Having written many times about the shortcomings of neoclassical economics, and the political ends to which it has been exploited, I am sympathetic to Thaler and Sunstein's effort to construct a more realistic economic philosophy, and one partly based on insights borrowed from other disciplines. However, the more I read of *Nudge* the less convinced I was that its authors, for all the useful and interesting material they present, have succeeded in their larger aim.

Some of my misgivings were editorial. After starting out strongly, the book gradually degenerates into a laundry list of proposals, some of which seem out of place. Reforming the medical laws so that patients can get cheaper insurance coverage in return for forgoing the right to sue their doctors might be a good idea, as might removing the state from the marriage industry and confining it to the legal endorsement of civil unions; but neither suggestion has much of a connection to behavioral economics. Rather than spending an entire chapter on each of these issues, plus another shaky one on school choice, the authors could have spent more time on issues like myopia and procrastination, both of which have stimulated interesting research. The failure to include any discussion of the difficulties people have in making decisions over time is particularly striking. Readers wishing to know more about this issue, or about the evidence

showing that people are surprisingly altruistic and cooperative, at least according to the findings of economic experiments, would be better off picking up an old copy of Thaler's *The Winner's Curse*, of 1992. (One consistent finding: in so-called "ultimatum games," where subjects bargain over a small sum of money, say $10, they tend to reach egalitarian solutions.)

In defense of Thaler and Sunstein, their emphasis is on public policy. Yet the program they outline seems unduly restrictive. Not content to be behavioralists, they are also libertarians, and they endorse something they call "libertarian paternalism." They write:

> Libertarian paternalism is a relatively weak, soft, and nonintrusive type of paternalism because choices are not blocked, fenced off, or significantly burdened. If people want to smoke cigarettes, to eat a lot of candy, to choose an unsuitable health care plan, or to fail to save for retirement, libertarian paternalists will not force them to do otherwise—or even make things hard for them. Still, the approach we recommend does count as paternalistic, because private and public choice architects are not merely trying to track or to implement people's anticipated choices. Rather, they are self-consciously attempting to move people in directions that will make their lives better. They nudge.
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> A nudge, as we will use the term, is any aspect of the choice architecture that alters people's behavior in a predictable way without forbidding any options or significantly changing their economic incentives. To count as a mere nudge, the intervention must be easy and cheap to avoid. Nudges are not mandates. Putting the fruit at eye level counts as a nudge. Banning junk food does not.
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> Many of the policies we recommend can and have been implemented by the private sector (with or without a nudge from the government)…. In areas involving health care and retirement plans, we think that employers can give employees some helpful nudges. Private companies that want to make money, and to do good, can even benefit from environmental nudges, helping to reduce air pollution (and the emission of greenhouse gases). But as we shall show, the same points that justify libertarian paternalism on the part of private institutions apply to government as well.

On the penultimate page of the book, they write:

> The twentieth century was pervaded by a great deal of artificial talk about the possibility of a "Third Way." We are hopeful that libertarian paternalism offers a real Third Way—one that can break through some of the least tractable debates in contemporary democracies.

The addition of the word "real" was presumably meant to distinguish Thaler and Sunstein's ideas from the "Third Way" approach that Bill Clinton, Hillary Clinton, and Tony Blair endorsed back in the 1990s. But just as that well-meaning intellectual construction project, in which the London School of Economics sociologist Anthony Giddens had a prominent part, suffered from soggy intellectual foundations, libertarian paternalism has some fundamental problems, beginning with the fact that it sounds suspiciously like an oxymoron.

Once you concentrate on the reality that people often make poor choices, and that their actions can harm others as well as themselves, the obvious thing to do is restrict their set of choices and prohibit destructive behavior. Thaler and Sunstein, showing off their roots in the Chicago School, rule out this option a priori: "We libertarian paternalists do not favor bans," they state blankly. During a discussion of environmental regulations, they criticize the Clean Air Acts that banned some sources of air pollution and helped to make the air more breathable in many cities. "The air is much cleaner than it was in 1970," they concede, "Philosophically, however, such limitations look uncomfortably similar to Soviet-style five-year plans, in which bureaucrats in Washington announce that millions of people have to change their conduct in the next five years."

If you start out with the preconceptions about free choice of John Stuart Mill or Friedrich Hayek, it is difficult to get very far in the direction of endorsing active government. (This is precisely the problem that the New Liberals of the late nineteenth century, men like L.T. Hobhouse and T.H. Green, faced.) Once again, consider the subprime crisis. At this stage, it is hard to find anybody willing to defend some of the mortgage industry's practices, such as offering gullible borrowers artificially low teaser rates that shot up after a couple of years. Hard, but not impossible. "Variable rate mortgages, even with teaser rates, are not inherently bad," Thaler and Sunstein write. "For those who are planning to sell their house or refinance within a few years, these mortgages can be highly attractive."

Strictly speaking, Thaler and Sunstein are correct. But many of the borrowers who took out loans planning to sell, or refinance at lower rates, within a few years were speculators, and unwittingly they helped to generate the biggest property bubble in American history. Others were simply taken for a ride. Dealing with this bursting of that bubble is going to involve spending a lot of taxpayers' money, which surely justifies the placing of some limits on future borrowers and lenders. A refusal to accept that individual freedoms sometimes have to be curtailed for the general good is an extreme position even for a neoclassical economist to take, and it is alien to the traditions of the

Democratic Party.

As it happens, there is a coherent and well-developed economic philosophy that was explicitly designed to deal with the law of unintended consequences, and it is regulatory Keynesianism of the sort practiced in the United States and Britain from the end of World War II until the 1980s, a period, not coincidentally, in which working people saw their living standard improve at an unprecedented clip. With respect to the national economy, Keynesians worry that unfettered capitalism is subject to ruinous boom-bust cycles, so they advocate management of demand through interest rates or government programs that create jobs. On the micro-level, they believe that some economic activities have harmful effects that the price mechanism fails to capture, so they support taxation and regulation. Behavioral economics, by demonstrating how people often fall victim to confusion, myopia, and trend following, provides another convincing rationale for Keynesian policies, but you wouldn't realize that from reading Thaler and Sunstein.

Obama, as far as I know, doesn't refer to himself as a libertarian, but on occasion he appears to be unduly influenced by the need to preserve choice. Rather than mandating universal health coverage, for example, he has promised to set up a new, subsidized, government-operated insurance plan for people who aren't covered by their employers and who don't qualify for Medicare. But if a young and healthy person, for whatever reason, didn't want to buy health coverage, an Obama administration wouldn't compel that person to do so, despite the strong financial and moral arguments for expanding the risk pool. Just how to compel healthy young people to buy health insurance remains a large question; but it is one that should be addressed.

On other issues, such as trade policy and regulation of the financial industry, Obama has recently adopted a more dirigiste tone than Thaler and Sunstein would care for. More generally, he has talked about confronting entrenched interests and giving a voice to the excluded. Doubtless, he means what he says, and his ability to attract new voters, especially young ones, suggests he could have more success in overcoming the forces of inertia and reaction than the Clintons did in 1993–1994.

But for what policy purposes are the masses to be mobilized? According to Obama's program, the answers include another middle-class tax cut; more tax credits for education and fuel-efficient cars; a bigger budget for the National Science Foundation; and the establishment of a National Infrastructure Reinvestment Bank, with an annual budget of $6 billion. At best, these proposals would represent a useful start in redressing the inequities and

shortcomings produced by twenty-five years of Republican domination. If the next Democratic president wants to leave a truly lasting legacy, he or she will have to do more than nudge the country in a different direction.

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* HarperCollins, 2008.↩

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