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The Dangerous Allure of Libertarian Paternalism

Richard A. Epstein*

The Laurence A. Tisch Professor of Law, New York University School of Law; The Peter and Kirsten Bedford Senior Fellow, The Hoover Institution; The James Parker Hall Distinguished Service Professor of Law Emeritus, The University of Chicago, USA

ABSTRACT

This paper offers a sustained critique of behavioral law and economics (BLE) on both a theoretical and practical level. The theoretical discussion fastens on the unwillingness of BLE take into account how the standard biological account of inclusive fitness helps explain key elements of human behavior in family and other nonmarket settings—an omission that it shares with much of traditional rational choice theory. The practical level disputes the central claims of libertarian paternalism. First, the theory is not libertarian—for at no point does it indicate areas where deregulation is appropriate, including the antidiscrimination laws in competitive labor markets. Second, its broad definition of paternalism is useless in all real world analysis. These omissions cause BLE to underestimate the extent to which market institutions can correct for various cognitive biases, leading it to systematically overstate the individual and social benefits deriving from either mandatory disclosures or mandatory contributions to both private and public pension plans and social security. The programs perform far worse than private pension plans regulated under classical principles of freedom of contract.

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1 Preliminaries: Methodological Caveats

There is little doubt that within the halls of academe, behavioral economics and its more pragmatic offshoot, behavioral law and economics, are growth industries; novelty has its excitement, influence and rewards. Richard Thaler won the 2017 Nobel Prize for his work on behavioral economics. His frequent coauthor Cass Sunstein won the Holberg Prize for his contributions to a theory of regulation. The common element that links these two authors is their effort to develop an agenda that aims to either supplement or dethrone neoclassical economics. Yet a very large caveat is in order. In this area, as in so many others, there is often a dangerous leap from interesting findings at the crossroads of psychology and economics to the policy prescriptions that are said to follow from the new findings. The former is to be welcomed to the extent that it increases human understanding. But the transaction from description to normative or policy implications is enormous. There is a huge intellectual and institutional gap between the findings that individuals as decision makers are not omni-competent, or even fully rational, to policy recommendations as to what should be done to respond to that rationality gap.

At root, there is a larger question of whether the new behavioral findings of both psychology and economics are consistent with traditional rational choice theory, or whether they require a whole new way of looking at the world. In my view, the key insight is simple: individuals who seek to make better choices on the basis of available information should be regarded as rational agents even though they commonly make mistakes. The reason for this conclusion is that such flawed individuals—among whose number I count myself—do not respond inertly to their ignorance once they have learned from their mistakes. Instead, they take steps to alter their own behavior, and most critically, to get advice from family, friends and professionals alike, to correct those errors. The theory of rationality does not require that they reach perfection the second or the third time through. All that is required is that they learn from their past mistakes, which means that they must take steps that are likely to correct some prior errors, even if they do not in one quick movement reach the ideal solution. In previous work, I have called this a form of second-tier rationality.[1] So long as people know, or can learn, what they do not know, they are able to better their own position, as measured against their own preferences.

The great attraction of some strands of behavioral law and economics (BLE) is that it claims to demonstrate that traditional rational choice theory—and the classical liberal rules and institutions that it supports—has to yield to the richer behavioral analysis. That analysis ultimately reveals a powerful set of cognitive biases that prevent people from making sound decisions on such issues critical to their welfare: choosing the optimal savings rate for

[1] Epstein (2006).

their retirement accounts, purchasing the correct basket of human goods, or making the correct decisions about the choices between risk and safety.[2] Many strands of behavioral studies are content to point out these difficulties, while leaving it to others to use the data in question to improve decision making in a variety of public and private contexts. But one strand of BLE, commonly called "libertarian paternalism," contends that some public decision maker (who apparently transcends these limitations) should be put in a position to make and implement substantive rules (sometimes by strict prohibitions and more often via default prescriptions or "nudges") that go a long way to protect individuals against their own worst instincts, without subjecting them to any form of government coercion.[3]

There are, of course, many statutes on the books that interfere with the freedom of contract that is prized (albeit for somewhat different reasons) by libertarians and classical liberals like myself. These include, for example, the antitrust laws and the application of rate of return regulation for public utilities and common carriers. There are also many systems of government regulation that, in competitive industries, are highly suspect on this view, including rent control, price controls, and minimum wage and overtime restrictions. There are many areas, like the many facets of environmental regulation, that do not yield a clear answer under a rational choice approach, and on which arguments, especially dealing with the question of decision making under conditions of uncertainty, can be made on both sides.[4]

What is so puzzling about the situation is that there are remarkably few cases or controversies in the public sphere in which the case for or against some form of regulation of voluntary exchange or negative externalities turns explicitly on the claims of behavioral economics. I say this not as a result of any systematic study, but from having worked over the years on many of the major disputes that involve such key regulatory issues as banking, financial, consumer health, labor, environmental, energy, pensions, tax, and product safety regulation, and so on. Of all these areas, the one in which libertarian paternalism has had the largest effect is with retirement plans, where as I shall argue its influence has often been for the worse. But in most other areas, arguments are made in favor of rules that alter or suspend market behavior, invoking such traditional standbys as unequal bargaining power or consumer ignorance, or social and racial injustice, or a flat out rejection to using statistics and probability theory to guide decision making. But there are few of these regulations, either before or after the maturation of behavioral economics in the mid-1990s, that seem to be animated by the insights of that field.

[2]For discussion, see Bubb and Pildes (2014).

[3]Thaler and Sunstein. (2008). Note the subtitle ("Improving Decisions About Health, Wealth and Happiness") stresses how these insights can help people better run their own lives, not how regulators can help them do this.

[4]For my own take, see Epstein (2016) and Epstein (2018).

My initial view is to be skeptical of this trend. I think that it is possible to form a strong normative view of the world by paying constant attention to certain key rules that help explain how legal systems are organized, while offering a sensible critique as to how they should be reformed.[5] Thus in the world of business arrangements, basic rules of property and contract allow for the combination and recombination of human and property resources into ever more complex structures. Using more complicated initial premises could in effect make the process of system regulation much more daunting. Think of how difficult it would be even to play a modified game of chess if the board were larger and the additional pieces had all sorts of novel moves. To be sure, there are good reasons to worry about elements of complexity, but these are typically best evaluated after the basic clear cases are evaluated. And it is part of the lawyer's advantage that truth is in many cases stranger than fiction, so that the most compelling problems often come not from abstract economic models but from the statutory schemes, regulations and cases that arise constantly in the legal system. Deduction has not only its uses, but also its limitations, so that some mix of high theory and trial and error should together guide legal inquiry.

I do not deny the existence of a full range of cognitive biases and mistakes, but any biases or errors whose very existence becomes apparent only after extensive (and disputed) experimentation are far less important than the more elemental forces of human nature that have guided and perplexed human societies from the beginning: greed, lust, envy, deceit, coercion, abuse, ignorance, indifference, and the like, which we might call, compendiously, the Hobbesian ills. The proof of these many ills does not require sophisticated theories and clever experimentation. Daily observation is sufficient to establish their existence, even if it cannot tell us all we need to know about their distribution and extent. Consider the following thought experiment: Would we regard it as a fair exchange if we could develop rules to cover the traditional wrongs, even if we could not find a way to counteract some forms of hindsight bias? Yes, is the only sensible answer. It is for that reason that I think that it is best to start with the standard models of human behavior that are sensitive to these well-known human frailties and only then to ask where they do not provide some adequate response. Once that is done, it is then possible to ask how much energy should be spent on dealing with the various behavioral tendencies, when and if these more pressing matters are taken care of. Libertarian paternalism tends to take the opposite approach. It tends to ignore the successes in ordinary behavior, and then develops a theory to deal with what it, often too hastily, finds as some innate bias.

By way of a preliminary remark, both words in the phrase "libertarian paternalism" are used in somewhat idiosyncratic ways. Start with the term

[5]For my general position, see Epstein (1995).

libertarian, which carries with it the strong notion that interference is not justified in the absence of force, fraud and monopoly. The reason why this libertarian—or more accurately, classical liberal conception—is so powerful is that it offers a strong case for deregulation in many markets, including land use and labor markets. So the strong libertarian/classical liberal *never* favors any legal intervention that props up monopolies or cartels. A libertarian paternalist therefore should honor the first part of that description by indicating clearly and firmly his or her support for this agenda. But, as the material with sex discrimination will show, they do not take that position about labor markets. Instead they stress those cases in which currently unregulated areas might be better run by the manipulation of default rules or other strategies (like placing healthy food on eye-level shelves)—often piquing resentment by people who don't like to think that others are covertly manipulating their behavior. The commitment to libertarianism is erratic and incomplete.

By the same token, the account of paternalism is unduly broad. Thus Richard Thaler writes: "By paternalism, we mean trying to help people achieve their own goals. If someone asks how to get to the nearest subway station and you give her accurate directions, you are acting as a paternalist in our usage."[6] But as Daniel Houseman points out, this excessive form of nominalism carries with it a very high price.[7] By his definition we are all paternalists now because we believe in gains from cooperation. Thayer's difficulty is that no ordinary speaker of the English language uses that evocative term in that fashion. The reference to paternal means that parents have a special place that allows them to constrain the behavior of those who are too young to know better. They may choose to nudge (or noodge), but they can use more powerful forms of instruction and discipline including the use of force, subject to limitation on its excessive application, which is governed by the complex law involving parental use and neglect. Giving directions to someone on how to get to the subway has none of those overtones, because no one need request that advice or give that answer. More generally, the giving and receiving of advice is the quintessential market way in which people who do not know something about an area get family, managers, agents, coaches, teachers and countless other individuals to help them through voluntary transactions. Calling these arrangements paternalism just introduces needless confusion, but it allows the theory to gain some surface appeal by the stark juxtaposition of two terms that in ordinary language have at best a peaceful coexistence, and never a tight logical or theoretical connection.

I proceed therefore in this order. In part I, I examine the standard rational choice model of human behavior, which is often the foil for behavioral economic concerns. I do not think that this model captures all that is relevant, but the

[6]Thaler (2015, p. 325).
[7]Hausman (2018).

gaps in its analysis are, ironically, also overlooked in behavioral economics. In particular, two points bear some special mention. The first is the role of evolution in shaping preferences, most critically in connection with the doctrine of inclusive fitness, which explains why people do not have utility functions and preference sets of independent, unconnected, and autonomous people. The second involves the natural variation in all populations on matters of tastes and competence. The third key element is that neoclassical economics also recognizes the cost of acquiring and processing information, even if it does not limit that judgment to the specific biases on, for example, risk aversion and probabilistic errors that receive pride of place in behavioral economics.

Part II then examines the institutional settings in which ordinary individuals make choices in order to guard against the many biases and errors of ordinary individuals. Libertarian paternalism short changes these devices on the one hand while offering a series of counterproductive remedies on the other. A short conclusion follows.

2 The Becker Model of Rational Behavior—Critiqued

Historically, formal economics made certain (relatively) strong assumptions about behavioral determinants of all types of actors, covering the full range from private parties to government agents. Gary S. Becker captured this view in a single sentence: "[A]ll human behavior can be viewed as involving participants who [1] maximize their utility [2] from a stable set of preferences and [3] accumulate an optimal amount of information and other inputs in a variety of markets."[8] Each of the three conditions mentioned by Becker contains its own fair share of ambiguity.

2.1 Individual Utility and Inclusive Fitness

The first of these conditions is that individuals seek to maximize their utility. It is, however, clearly wrong as a general matter, if taken in the sense that all individuals care about themselves and only about themselves. There are, in practice, many transactions between strangers where that proposition holds true, but in the frequent interpersonal interactions between family and friends that assumption is surely false. One of the great insights of modern biological theory is the principle of "inclusive fitness" articulated by W. D. Hamilton in 1964.[9] Quite simply, individuals do not maximize their own (separate) utility. From an evolutionary perspective, the unending challenge is to make sure that the next generation survives to the same point in the life-cycle as the

[8] Becker (1976, p. 14). For my earlier evaluation of these issues that overlaps with the present, see Epstein (2006, pp. 356–60).

[9] Hamilton (1964).

previous generation: from birth to birth, for example. Do it even once, and there is a template to do it many times thereafter. Fail once, and it is all over. The forces, therefore, to ensure these generational transfers have to be powerful indeed, which means that they are also easily observable. If parents only thought of children as playthings to be used for their private amusement, and otherwise ignored or discarded when times get rough (as they always do), humanity (indeed any other living creature) could not have survived or evolved. The clear implication therefore is that individual utility functions have to be much more complex, as virtually all individuals have to weigh the consequences of their actions on others, especially those closely related to them.

As a first approximation, the precise interdependence between related individuals depends on the closeness of the genetic connection, and the possibility of extending or receiving help to offspring and/or parents. Each parent has one-half of his or her genes in common with his or her child, and therefore should be expected to expend one unit of effort on a child's welfare, so long as it produces two or more units of benefit to that child. On the other side, the child will be prepared to take from the parent so long as it gains one unit of benefit for each two units of costs imposed on the parent. It follows, therefore, that conflicts will arise when the child gets between one and two units of benefit for each unit of parental cost.[10] The child will want to go on, but the parent will not. Tussles over weaning are classic illustrations. Yet once the child gets less than one unit of benefit for each two units the parent spends, the conflict is over, and neither party wishes to continue the activity. Note that these conflicts of interest do not arise because the parties are strictly averse to each other, which happens when one party gains when the other loses. Rather, the conflict is solely in the magnitude of the benefits for each party. Analytically, this conflict is identical to principal-agent conflicts that arise when the agent bears all the costs from which he derives only a fraction of the benefit.[11]

The payoff functions for mothers (who nurse in the early years) and fathers are likely to be different, so that the level of direct investment will vary by sex and over time. That change in turn will influence the level of interaction with the outside world, which will on this model tend to be dominated by fathers, given that (especially in primitive conditions) the opportunity cost of engaging in outside activities is routinely lower for the father than for the mother. Yet in their dealings with strangers, the individual self-interest model of neoclassical economics should work tolerably well because there is no (or more precisely, far, far less) genetic overlap between the parent and the stranger. But once the gains from trade are acquired from the outsider, they are not distributed within the family in accordance with any market measure; subjective notions

[10] Trivers (1974).
[11] Jensen and Meckling (1976).

like perceived relative needs of parent versus those of the child play a far more important role, especially for offspring too young and helpless to fend for themselves. On this model, there is little or no place for reciprocity in the sense that the offspring has in time to provide for the parent to offset the early gains. The transaction at the earlier age is perfectly self-contained, and there is no need to suppose that a contingent service, perhaps rendered by children years later, counts as implicit compensation for the earlier care. That transaction too is intelligible as a stand-alone arrangement. Over time, moreover, these relationships will not be static because with maturation of the offspring come constant fluctuations in the relevant cost/benefit ratios between parents and children. The situation is made still more complex by the presence of siblings who themselves share a common genetic background. The allocations of care in question thus move in all directions simultaneously.

The clear implication of these notions is that this behavior involves an implicit form of sociability within family that is neither tracked nor discussed by *either* the standard economic model *or* by its behavioralist alternative (at least within libertarian paternalism), both of which stress autonomous individual choice. The point holds true even if these individuals differ as to the anticipated patterns in which that choice is exercised, given the standard difference between expected utility theory and its behavioral alternative, "prospect theory."[12] This restricted assumption about individual choice under both models can generate serious mistakes, of which perhaps the most famous is Gary Becker's well known "rotten kid" theorem, developed in his article "A Theory of Social Interactions."[13] The simplest set-up assumes one parent and two siblings. There are interdependent utilities between the parent and each child, but no interdependent utilities between the two children, who treat each other as if they were strangers. The parent deals with threats that each child may make against the other by making offsetting payments to the child who is victimized by his sibling, and withholding expected payments to the aggressor.

At a workshop in 1977 at the Center for Advanced Studies in the Behavioral Sciences, (where Kahneman was a fellow, and Tversky was nearby in the Stanford Psychology Department) Oliver Williamson, himself a future Nobel prize winner in economics—asked Becker what the parent would do if the one child killed the other, to which Becker had no reply at all. The game is at an end, and the parent would only hurt himself if he withheld aid from the surviving sibling. To be sure, in real world settings, instances of fratricide will occur, but at a far lower rate than would be predicted because the interdependent utilities between the two children suggests that the death of a sibling is in most cases a loss and not a benefit to the child that survives. The standard prediction is that each sibling will spend one unit of wealth

[12]Kahneman and Tversky (1979).

[13]Becker (1974, pp. 1076–1083). For a critique, see Epstein and Loyola (2016, pp. 92–94).

to obtain two for the sibling. It is for this reason that partnerships among siblings are easier to maintain than among strangers, because the familial bond reduces the likelihood of defection from the ideal norm of good faith, which is that each partner in making decisions treats the welfare of the other partner as carrying the same weight as his own.[14] It is not the case, however, that all siblings will form partnerships. On this, as on other questions, there is always a natural variation in traits within any large group—yet another key feature of human behavior that is ignored by both neoclassical and behavioral economics.

2.2 Stability of Preferences

The second assumption of the Becker model is stable preferences over time—a nice philosophical question of whether each day we are the persons that we once were.[15] But whatever the philosophical doubts on the issue, the evolutionary perspective again settles the question in favor of Becker's insistence on the stability of preference over time: no species could survive across multiple generations if each set of parents were not steadfast in their loyalties to their offspring, which can only happen if this preference above all others is stable. In addition, that one preference tends to drive the stability of others preferences about the need for the long-term health and fitness as well. As with cooperation, there are of course variations in taste and temperament among individuals, so that some individuals will fail in their efforts to become parents while others excel. So a more accurate statement about stability of preferences is that there is a distribution of tastes and temperaments, but a large enough fraction has this stable preference set, and it will be selected for.

The real difficulty in many cases is deciding at what level of description to define these preferences. It is no argument against the stability of preferences to observe that most individuals will update their choices of particular items of anything from food to software when they discover new information about their value. The food may turn out to cause hives or the software to contain bugs. But the changes occur only at the level of instrumental preferences, not an abandonment of the large objective of inclusive fitness, and all the collateral familial supports that it requires. It therefore follows that personalities, as dispositions and traits, tend to be constant, which means that they tend to vary in specific ways with age or changes in financial circumstances. It is not possible to think of what insights behavioral economics would substitute for these points, so again it turns out that there is virtually complete congruence between the two models.

[14]For one application of this measurable standard in the context of the duty to defend an insured party in good faith, see Merritt v. Reserve Insurance Co., 110 Cal. Rptr. 511, 519–520 (Ct. App. 1973).

[15]See Parfit (1984, pp. 53–110) for a discussion on the need to protect the "Future Self" against aggressions from the present self.

2.3 Optimal Choices Under Conditions of Uncertainty

Becker's third condition has to do with the use of information as an instrumental good to achieve some particular end, so the term "optimal" carries with it a lot of baggage in the individual case. First, the term "optimal" does not mean "complete" information, which is in fact never obtainable in a timely fashion, especially by people who have limited intelligence and computing capacity. The notion of bounded rationality is opposed to the notion of "omniscient rationality." Recognizing as did Herbert Simon,[16] the force of that distinction does much to blur any purported difference between the neoclassical and the behavioral approach; one look at the distribution of scores on the SAT should be enough to dispel the inference of perfect rationality of ordinary individuals. Bounded rationality therefore is necessarily a feature of *all* economic approaches, once it is understood that rationality does not mean getting the right answer every time, but only the more modest proposition that people try on average to do what is best for them in any given setting given that they labor under obvious constraints of time, knowledge and intelligence.

The task is fraught with difficulties. Unfortunately, the passage of time necessarily leads to its deterioration. Delay is often costly. Indeed, in some life-or-death situations the need for a rapid response is so imperative, that only evolutionary theory explains how reflexive behaviors take over from conscious deliberation. In practice, the autonomic nervous system overrides conscious activity so that tasks like breathing and moving away from physical danger are done routinely done in, as it were, the background, without a millisecond reflection, as hard-wired responses that cannot be overridden by conscious thought. That distribution of function is something that both neoclassical and behavioral economics has to address. Perhaps this is one reason why Herbert Simon suggested—if only fleetingly—that "[i]f we wish to be guided by a natural science metaphor, I suggest one drawn from biology rather than physics. Obvious lessons are to be learned from evolutionary biology, and rather less obvious ones from molecular biology."[17] I think that the right answer is that both physics (with the central role of force) *and* biology should be the independent disciplines from which economics as the science of human behavior draws. Behavioral economics tends not to draw any theoretical insights from either physics or biology. Indeed in one famous quip, Tversky said after a testy interchange with an evolutionary biologist: "Listen to evolutionary psychologists long enough, and you'll stop believing in evolution."[18] But that

[16] Simon (1979, p. 496).

[17] Simon (1979, pp. 510–511).

[18] Sunstein and Thaler (2016). On a personal note, Kahneman and I were fellows at the Center for the Advanced Studies in the Behavioral Sciences, during which there was a yearlong seminar led by Professor David Barasch that talked about sociobiology (which morphed into evolutionary psychology). I attended just about every session. I don't recall that Kahneman or Tversky ever attended a single session of the sociobiology working group.

evolutionary approach offers a cautionary note against easy extrapolation from experiments done typically with university students, which resist easy generalizations.

Becker's use of the word "optimal" reflects all of these cognitive and biological limitations of ordinary human beings. To the extent therefore that people labor under disabilities, they have to (when reflex gives way) rely on rules of thumb that guide in the absence of formal theorems. The human condition often relies on trial and error. But it is trial and error not for the individual, but for the family unit in which a high level of informal instruction—lions teach their young how to hunt—reduces the error in transmission across the generations. Behavioral economics may differ from neoclassical economics in its estimation of the rate of error and source of error in the execution of certain tasks. But from the evolutionary perspective, it seems clear that any such errors in perception or judgment should be greatest with respect to those tasks that are not critical for survival, often in cases when particular responses to novel circumstances are not hard-wired into individuals.

2.4 The Role of Variation in Family and Firms

The situation becomes more complex still for both theories when the notion of variation across traits and individuals, alluded to above, is introduced into the mix. There is no trait, physical or mental, that does not exhibit some variation among individuals in any population.[19] Tastes for given foods or activities will thus differ in intensity even if they are all positive or negative for all group members. The same is true with respect to competence, intelligence, or any other variable that deals with the ability of people to respond to the physical or mental challenges that they face. The presence of these differences in all situations necessarily allows for gains from trade between individuals on both matters of taste and competence in the organization of production within both the family and the firm. Within the family, the hunters tended to be the men and the gatherers tended to be the women—a specialization that was critical to survival when the level of family output could, and often did, fall below the level needed to sustain the lives of family members. The use of team production for both activities, especially hunting, also required a hierarchical organization in which age, experience, temperament and other traits had key roles to play. The evolutionary pressures could easily intensify the level of specialization by sex, because modern distributional concerns will always take a back seat to the more elemental pressures for survival that mark any earlier age.

The same basic argument on distributions of competence and tastes applies to the formation of a firm. Coase saw the formation of the firm as an alternative

[19] For my longer discussion, see Epstein (2011).

to spot contracts as a common means to control transaction costs that had to be incurred in working out a price system: one wage for a worker is less transaction intensive than payments for each of the countless tasks that workers engage in every day. But the incompleteness of that basic approach should be evident: it gives no clue as to what forces explain the many permutations in the internal organization of firms in general or any firm in particular. Nor does it explain how firm structure evolves over time because of changes in scale or the external environment. One element in this mix is the affinity that people have with respect to the chosen ends and the style of work that they wish to engage in. Academics spend little time talking about mission statements, but these short and pithy documents are central to most businesses because they provide the reference point for making major substantive choices down the road. In business, these divergences are like schisms in religion. Few firms can survive them, and they have nothing whatsoever to do with any of the theoretical or experimental agenda of either neoclassical or behavioral economics, neither of which is particularly attentive to the internal dynamics within the firm.

Matters of differential competence are every bit as important in the formation of the firm. In general, individuals with greater skills should have greater control and thus become the firm's residual claimants. Nothing is more common than for abler people to command higher salaries for taking on greater responsibility, often with greater risk. In the simplest model they become the owner of a firm with residual claims on assets, while others take in the role of subordinates. The design of basic business models often requires the firm organizers to set out protocols that will allow less able employees perform jobs for lower wages. The permutations and intermediate positions here are infinite, but it blinks at reality to ignore these fundamental choices in human relationships. These differential abilities are also pervasive outside the firm in every walk of life. One common response is for people to hire agents to represent them, on the assumption that the risks of imperfect monitoring are lower than those of trying to do the job yourself. It is for this reason that there are huge professions of brokers and agents and other intermediaries who take on fiduciary duties to represent people who are not in a position to represent themselves.

3 Why Behavioral Mistakes Don't Matter That Much—Institutionally

At this point, it is critical to note that behavioral economists, especially libertarian paternalists, focus more on mistake—indeed on mistakes of all kinds, sorts and variations—and less on fraud. Behavioral economics is sensitive to the matters of incompetence, but tends to tie them to particular biases on such topics as representativeness (where people systematically underrate

the importance of such key matters as sample size, underlying probability distributions and randomization) and adjustment and anchoring (dealing with such issues as the probability of conjunctive and disjunctive events).[20]

3.1 Self-correction—by Individuals and Groups

The good news about cognitive biases is that they should be relatively easy to correct without any form of government regulation at all. As Tversky and Kahneman point out, "These biases are not attributable to motivational effects such as wishful thinking or the distortion of judgment by payoffs and penalties."[21] By definition these mistakes do not stem from weakness of human character, such as pride of authorship, or from bureaucratic manipulation. They are just mistakes. One implicit bias in the experimental literature on cognitive biases on mistakes simply asks whether, and how often, a particular mistake is detected and corrected by isolated individuals under laboratory conditions. But team production is a key fact of life in ordinary business activities, and the corrective effects of cooperation are ignored by generalizing from experimental results tied to the operations of lone, uncontextualized individuals who have no experience in a particular area. Firms have every incentive to help their workers correct for these errors, because sound management increases both worker productivity and firm profits. This explains why firms often pay workers to learn how to better manage their own personal finances.[22] Empirically, these simple strategies work.[23] What matters is not whether firms are familiar with the field of cognitive bias, but whether they follow the simple adage that two heads are better than one when it comes to avoiding routine errors—the same reason why good writers still need good editors.

Here are a couple of examples as to how simple precautions can control cognitive biases. In 1977, Tversky and Kahneman presented some of their results at Stanford University workshop. Their stylized example posed this problem. There are two types of jackets that pilots can wear in combat: jackets that are good against flak and jackets that are good against fire. Neither jacket will protect against the other hazard. Two-thirds of the time, the hazard comes from flak and one-third of the time it comes from fire. What percentage of the time should pilots wear each type of jacket? Impulsively, I blurted out that the answer was two-thirds of the time wear the flak jacket and one-third the time the fire jacket. Wrong. They both smiled and explained that the correct answer was always to wear the flak jacket, which will save you two-thirds of the time. Putting on the fire jacket one third of the time reduces the success rate to five-ninths. (Two-thirds × two-thirds + one-third × one-third = five-ninths).

[20] For example, see Tversky and Kahneman (1974).
[21] Tversky and Kahneman (1974, p. 1131).
[22] For an example of this trend, see Tergesen (2018).
[23] For discussion, see Rizzo and Whitman (forthcoming 2019).

But the larger lesson cuts in the opposite direction: once the error is pointed out, it is not made a second time. And in group contexts the correct response will come even more quickly because only one member of the group needs to detect the error for all to take the correct approach. This probabilistic error is at most a temporary glitch of no long-term institutional significance, especially if new programs and protocols are subject to any testing before being put into use. I have made many other elementary blunders over the last forty years, but have not repeated that one a second time.[24]

Here is a second example of greater import. It is a common teaching of behavioral economics that the "endowment effect" implies the willingness to pay (WTP) differs from the willingness to accept (WTA), so that people demand more to keep what they have than they will pay to acquire it, in violation of the standard rational choice axiom that sets these two figures equal.[25] The result is often attributed to the greater loss aversion predicted by prospect theory. No biological or social explanation is offered as to why this quirk, as opposed to many others, has any survival or welfare value. Instead, the finding is said to be confirmed by repeated experiments often done with coffee mugs in casual sales between two ordinary people. In business, these transactions are of little importance, and are in general subject to legal rules that differ from those applicable merchant-to-customer transactions.[26] Merchants generally have superior knowledge and thus are said to offer implied warranties of merchantability and title that are not found in casual transactions.

But does this endowment effect matter anyhow? One response is that these errors do not stem from any deep-seated quirk of valuation, but from the prosaic difficulty that it is harder to learn to solve these rather arcane brain-teasers than most experimenters assume.[27] But, for the sake of argument, assume that this WTP-WTA gap does arise in isolated individual transactions. How important are these findings when these casual sales of mugs and used furniture constitute a miniscule fraction—probably well under 0.001 percent—of the total economy, once we take into account the trillions of dollars of goods and services sold by firms both large and small in the ordinary course of their business? If in these business contexts the WTP-WTA ratios were below one, the commercial market would shut down as competitive sellers in every market from fine art to diapers would be reluctant to part with their goods which they value so highly. But merchants vault over these supposed biases, because the whole object in business is to move inventory as quickly as possible. Why then

[24] A similar argument applies to the simple mathematical problems used to introduce Thaler and Sunstein. (2008, pp. 1–5).

[25] See Plott and Zeiler (2005) citing articles that defend the WTP-WTA gap. For a later reiteration of the theme, see Klass and Zeiler (2013).

[26] See Uniform Commercial Code, Article II. And casual sales are exempt from the rules of strict products liability. See Section 402A, comment f. of the Restatement (Second) of Torts. American Law Institute (1965).

[27] Klass and Zeiler (2013, p. 34).

feature a finding about idiosyncratic individual behavior of no importance to the economy as a whole?

The same arguments apply to the supposed finding of loss aversion, where the rule of thumb is that a person feels a loss of $X twice as keenly as they benefit from a gain of $X. Again suppose for the sake of argument that this is true about casual trades by individuals and ask how it carries over to traders in high-volume markets. To take the simplest of examples, suppose that a trade has two payoffs of 50 percent each at loss of $1 and a gain of $1.50. A trader would leap at this opportunity which has an expected value of $0.25 cents, and deal with individual losses by relying on volume. The larger the volume, the smaller the variance. The person who labors under cognitive bias will treat each trade as though it had a value of minus $\$0.25(\frac{1}{2} \times -\$2.00 + \frac{1}{2} \times \$1.50)$. Aggregating the trades only increases the losses by $-\$0.25$, which leads to exiting the market. The moment that this biased subject starts to net out, he behaves like the rational trader. Why then think that the behavioral economic approach makes any more sense with traders than with institutional sellers? The supposed behavioral insight only applies to a tiny corner of the universe.

3.2 Institutional and Legal Responses to Mistakes—Ex Post or Ex Ante

These anomalies or mistakes, then, lose their punch when put into context. Yet there is still a further reason why behavioral economics has such a little place in basic legal disputes. The law is rightly suspicious of any effort to set aside transactions in litigation because they are tainted by mistake, regardless of its source, unless there is some additional reason to intervene like an estoppel, when one party either misleads or allows the other person to fall into error.[28] The role of mistake is further diminished whenever there is an occurrence of fraud, when the level judicial scrutiny goes up, and occasionally some fleeting reference to behavioral economics is made, but in ways that do not alter the outcome of the litigation.[29] The commercial reason to be reluctant to intervene in simple mistake cases is *not* that omniscient actors never make mistakes: nothing is more common than observing individual employees or consumers making mind-blowing errors of judgment and execution, which should not happen if all people took optimal precautions. But workers and consumers alike make mistakes in addition and subtraction, just as they make more subtle errors in choosing the applicable discount rate for investing in retirement plans.[30]

[28]Courts may allow an estoppel in principle, but deny it on facts of case when defendant had equal opportunity to locating the boundary line between them. For an example, see Maye v. Tappan, 23 Cal. 306 (1863).

[29]For an example of a class action suit that contains references to behavioral economics, citing works by Sunstein and Thaler for the field and Posner suspicious of it, see Honorable v. Easy Life Real Estate System, 100 F. Supp. 2d 855, 889 (N.D. Ill. 2000). However, the suit was for commercial fraud, a staple of the legal environment.

[30]For an exhaustive discussion of these errors, see Bubb and Pildes (2014).

3.2.1 Truth-in-Lending

The challenge, then, is to decide what should be done institutionally in response to these errors. This proposition does not depend on whether some misguided heuristic or common blunder generated the mistake. It rests instead on the conviction that the overall level of mistakes will be lowered and the security of transactions increased by following a simple rule that presumptively assigns the costs of a mistake to the party who makes it.[31] By rewarding parties who correct their mistakes, that one rule takes huge chunks of cognitive biases out of the day-to-day operation of the legal system.

There is of course the question of whether *ex ante* protection should be imposed in cases where the choice is between the use of disclosure methods or a more coercive set of mandatory requirements. The difficulty in these cases is that *ex ante* disclosures work best when parties are told what information they must supply in order to avoid liability *ex post*—like the so-called Schumer box, which features a standardized definition of the annual percentage rate (APR), a consistent number that facilitates loan comparisons across different lenders.[32] The Schumer box removes some uncertainty in an important context, no matter the source of consumer errors. But whether one embraces neoclassical or behavioral economics, it should never be thought that disclosures alone are routinely sufficient to overcome the competence gap that plagues ordinary people in many transactions. It is in general difficult to tailor disclosures to different subpopulations, so what then should be done? Here it is possible to take two routes. One is to give information and advice—decidedly nonpaternal—on an individual basis. The other is to impose some mandatory norm on the ground that the disclosures in question are insufficient to lead people to make optimal borrowing decisions.

3.2.2 Retirement Plans

The principles of libertarian paternalism seem to have exerted the greatest influence over the design of retirement plans—itself a topic on which Richard Thaler has devoted an enormous attention—by advocating shifting the default rules so that ordinary employees are encouraged to set aside a substantial portion of their income for retirement. These shifts have in general increased

[31] For an example of a case where the cost of the mistake was placed on the person who made it, see Smith v. Hughes, 6 QB 597, 607 (1871): "If, whatever a man's real intention may be, he so conducts himself that a reasonable man would believe that he was assenting to the terms proposed by the other party, and that other party upon that belief enters into the contract with him, the man thus conducting himself would be equally bound as if he had intended to agree to the other party's terms." Blackburn, J.

[32] The Schumer Box comes from the Fair Credit and Charge Card Disclosure Act of 1988, Pub. L. No. 100–583, 102 Stat. 2960. For a discussion on how this information is in fact presented to ordinary consumers, see DiGangi (2012).

the amount of money that individuals put into retirement plans. These plans raise not just descriptive questions, but also normative ones: are these changes desirable? If not, what alternative regime should be instituted? It is also important to ask whether it is possible to raise criticism of current policies toward retirement plans that have little or nothing to do with libertarian paternalism—that is, to show the continued importance of neoclassical economics in this area.

Let us start with the behavioral side of the picture. It seems fair to assume that many individuals know very little about how to manage their retirement accounts. For the most part they have learned how to balance their check books and acquire a mortgage on their home. But they have little or no direct experience with present value calculations or portfolio theory in their daily lives. The stakes are high, and the knowledge base is weak, which makes this field a fertile ground for potential errors. But no matter how pronounced the errors, a firm or regulator has just these four familiar options—disclosure, advice, manipulation of default rules, or state mandates. These may be used in combination with each other. Behavioral economists tend to favor either of the last two alternatives. Classical liberals tend to favor some combination of the first two.

Representative of the dispute within behavioral economics, Professors Ryan Bubb and Richard Pildes are skeptical of libertarian paternalism, thinking that nudges are often a bad way to improve behavior. Initially, they point out some of the difficulties that arise in the disclosure side of the line. They rely heavily on research from Brigitte Madrian and Dennis Shea, which shows how switching default rules to encourage retirement contribution can often backfire. The source of the risk is that many employees will think that setting the default amount of contributions at, say 3.0 percent means that it is unwise to contribute any larger sum. This could nudge employees who had previously contributed more to their plans to reduce their contribution to the 3% default rates.[33] Total retirement contributions thus go down rather than up, because too many people, quite reasonably, take that unexplained number as a recommendation for an *optimal* contribution instead of a minimally acceptable one. To make matters worse, these individuals often invest most of their savings in money-market funds, which Bubb and Pildes note no responsible financial advisor would recommend, especially for younger employees.[34]

The first response to this problem should be to improve the disclosures so that they offer information about the range of variation in these plans. That approach is consistent with the classical liberal approach to the matter, at least if it is done voluntarily by firms, which uses it to increase the value of the employment contract for both sides. But there are limits, for no general

[33]Bubb and Pildes (2014, p. 1618).
[34]Id.

disclosure form can be tailored to individual circumstances, dependent on such factors, as age of spouse, size of equity in a home, health condition of self, spouse and children, and continued earnings prospects. Financial and life planners can give this advice, so long as their services are affordable. Yet it is far from clear what this ideal advice to be. Todd Zywicki has explained at great length why it is difficult to be confident that any increase in retirement savings works to the advantage of workers.[35] The first difficulty is that it is not clear whether it is rational to save for old age when people can receive payments from a wide range of public support benefits that come outside the savings network—assuming that individuals in question live to receive these benefits—which for some portion of the population is unclear. Nor is deferment necessarily a sensible strategy when the costs of running a household with children are far greater than running one without, so that deferring savings until they are older makes good economic sense, especially if the amount of income needed in retirement is less than that in earlier years. But even if savings are required, it is often difficult to know exactly how much saving is done outside the retirement plan. Individuals who acquire durable assets are not engaged in immediate consumption, but have implicitly saved for the future. The same is true of people who prefer paying down debt to saving. And finally, there are real dangers if mandated savings requirements make it necessary for individuals to borrow more on homes or cars to meet their current consumption needs, as those liabilities are an offset for the retirement program. The behavioral case is tricky, even taken on its own terms. It is, therefore, as Zywicki notes, hopelessly overbroad to claim with Thaler and Sunstein that "the costs of saving too little are greater than those of saving too much."[36] If so, then changing the behavior will in some, perhaps many cases, be a move in the wrong direction.

In light of these complications a strategy that seeks to provide more information, not less, seems to be preferable to the alternative of imposing mandates that increase the minimum contributions. These could come from two sources: employers or government. As Bubb and Pildes note, many institutions like New York University use mandatory defined contribution plans for faculty. It is possible, but deeply unwise, to call these private programs paternalistic, for the employers who impose these contractual conditions are more likely to understand something about the composition of their workforce that might not carry over to the population at large. Accordingly, as noted earlier, the term should be reserved for government mandates on anyone but its own employees, thereby excluding ordinary contractual arrangements. Employers often impose these restrictions because they do not want employees begging for assistance after retirement when they have not saved enough. The restrictions, moreover,

[35] Zywicki (2018, p. 35–44).
[36] Thaler and Sunstein. (2008, p. 106).

are accepted easily. Indeed, parties can purchase supplemental retirement benefits, and often do. Bubb and Pildes do not dwell on this difference between the private and the public. Instead they report that two scholars, Professor Madrian and the noted behavioral economist Professor David Laibson "told us in personal communications that, despite the view they expressed [earlier], they *do* in fact support mandatory savings programs like Social Security on paternalistic grounds."[37]

Bad choice all around, if the phrase "like social security" is taken seriously. The differences between Social Security and the private plans are so astounding on so many levels that no one should ever prefer Social Security to private plans, for reasons that come straight from a combination of public choice and financial economics, both of which rest exclusively on neoclassical foundations. The first point is that private employers impose their conditions as part of a contract. The offset is that the employees who do not like those terms are free to push back or to go elsewhere. Given those options, employers do not, like the NYU plan, resort to nudges and hints to achieve their ends. They flat out declare what the rule is going to be, when all the while they are constrained by the exit option. The most salient feature of these plans is that they will only be adopted if they produce net gains to the firms and the workers together. They may well contain many insurance features, but, unlike Social Security, they will not contain redistribution features. And what is done with retirement benefits carries over everywhere else. Employers don't nudge workers about key restrictions on health, as Thaler and Sunstein suggest. They tell them what they have to do to remain employees. They monitor health and use carrots and sticks to achieve their desired ends, constrained again by the exit option.

Social Security operates on wholly different principles, for it is not operated *solely* to provide savings for each plan participant. Instead it engages in a massive form of redistribution from younger to older plan participants when the previous and future contributions of the older individuals are not sufficient to cover future payouts to them. To make sure that these transfers are not politically salient, the Social Security system never supplies its plan participants a direct accounting of the fair market value of their contributions at any time or their time adjusted return on their original investment. The recipient only gets a set of potential payout options that are difficult to evaluate. The NYU private employment plan has none of these difficulties, and offers a menu of payout options of equal cost to itself, from which the recipient can choose. In addition, defined contribution plans are generally portable for recipients, which allows for greater job mobility, and these defined contributions plans are not subject to the massive political manipulation that can be applied to defined benefit plans set up for government employees.

[37] Id. (2014, n. 101).

To give but one illustration of the constant crisis in public pensions, in 1999 then-Governor Gray Davis of California signed SB 400, which substantially upped the pension payout formula to all existing California public workers on the dubious grounds that the stock market improvements would cover the increases, which of course they did not.[38] Getting private wealth out of the hands of public trustees is the first step to pension rationality. Even if an employer or state mandates contributions, it should follow the employer model of having individuals set aside some portion of their funds into some approved private investment vehicle, which keeps all accounts separate. That will never happen in the public sector because the Social Security shortfalls will then have to come out of general revenues, which would provoke a huge political outcry. State paternalism has many hidden costs that behavioral economics does not explore. Any concern with behavioral economics should not ignore the many institutions that are best understood by traditional means.

The difficulties with government intervention in the operation of pension plans is not confined to government run plans like Social Security. It also extends to private pension plans to the extent that they are subject to the general antidiscrimination mandates of Title VII of the 1964 Civil Rights Act. The point is shown by the position that the United States Supreme Court took on sex-based actuarial tables for the calculation of pension benefits. In the private sector these tables take sex into account in order to avoid the implicit cross-subsidy that arises when equal sums are paid in order to achieve unequal benefits. The great concern of these private systems is that any pooling will allow someone to impose that cross-subsidy below the radar, which in the case of pensions stems from the differential life expectancies of men and women. It turns out that private plans systematically guard against these issues, while government laws that cover employment discrimination actively require just that cross subsidy.

The litmus case in this instance is *City of Los Angeles Department of Water and Power v. Manhart*,[39] which came before the United States Supreme Court in 1978. Under Title VII of the Civil Rights Act of 1964, it is unlawful for employers on matters of compensation, terms, conditions, or privileges of employment to discriminate against any individual employee because of sex.[40] Before the Act was extended to cover state employees, the practice of the Los Angeles Department of Water and Power ("LADWP") was to make

[38] For discussion, see Dolan (2016).

[39] City of Los Angeles Department of Water and Power v. Manhart, 435 U.S. 702 (1978).

[40] Section 703 (a) (1) of Title VII of the Civil Rights Act of 1964 reads:

> "It shall be an unlawful employment practice for an employer—"
>
> (1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin. . . . " 78 Stat. 255, 42 U. S. C. §2000e-2 (a) (1).

sex adjustments for its male and female employees. Both received the same amount of compensation on a monthly basis, but the female employees had to contribute close to 15% more to the plan to offset the statistical certainty that women as a group lived longer than men. The figures in question were derived both from general actuarial tables and company specific information about both men and women. If the money had been put into two separate plans, one for women and one for men, each of the plans would be solvent.

Nonetheless, Justice Stevens held that the larger deductions from the women's paychecks violated Title VII. He first noted that it was unacceptable to use "stereotyped" impressions of the differences between men and women, but the point has no traction here, for in the next breath he notes that the statistical data here is "unquestionably true." But he then observes:

> It is equally true, however, that all individuals in the respective classes do not share the characteristic that differentiates the average class representatives. Many women do not live as long as the average man and many men outlive the average woman. The question, therefore, is whether the existence or nonexistence of "discrimination" is to be determined by comparison of class characteristics or individual characteristics. A "stereotyped" answer to that question may not be the same as the answer that the language and purpose of the statute command.[41]

Justice Stevens then further adds that the focus of the statute is on the *individual* (his italics) without explaining how that justifies the total disregard of all statistical norms in order to further the ends of the antidiscrimination law. It is a commonplace that markets work better when parties act with full information, and yet here the legal requirement is to disregard information known to be valid, and indispensable from the *ex ante* perspective, where no one knows which women will outlive which men, or the reverse, which is why statistics are used in the first place. The disregard of statistical information where necessary cannot be justified by observing that "If height is required for a job, a tall woman may not be refused employment merely because, on the average, women are too short." But what he utterly fails to see is that in his hypothetical there is no ex ante uncertainty. Nor does it matter that there are other issues like smoking or obesity that influence life expectancy.[42] Justice Stevens acts on the assumption that these are never taken into account, to which there are two replies. First, there is nothing which says that they cannot be taken into account, and it is common for all sorts of health and insurance plans to rate in accordance with these variables, precisely to combat the cross-subsidy problem. Second, the addition of these other variables results

[41] Manhart, 435 U.S. at 708.
[42] Id. at 711.

in shifts from some men to other men, and the same for women. But so long as the initial sex classifications are correct, the cross subsidy between men and a group to women as a group will continue just as it did before.

It is clear, moreover, that these sex-linked statistics will have to be used in order to calculate the total amount to demand from men and from women, for if the ratio of employees stood at 5 females to 1 one male, the only way that the common retirement pool could remain solvent with the same level of monthly payouts would be to increase the total amounts taken out. The prohibition against discrimination is not idle whenever the statistical calculations are consciously skewed. Indeed, given standard actuarial tables, if the women were charged 20 percent more than men, there would be discrimination against women, just as if they were charged only 10 percent more than men, there would be discrimination in their favor. And there is nothing about the language or purpose of the statute that requires the opposite result. The statute calls for equalization of compensation, which includes both wages and benefits. Indeed, it is critical to note that the sex differences continue to have predictive value whether or not these other variables like smoking or family history are, or are not, taken into account. Either way the refusal to take sex differences into account is itself a form of illicit discrimination because it gives women larger total compensation packages than men for the same work. Justice Stevens also misses this point because he looks solely at the wage component of the package to establish discrimination and then notes that, unlike the Robinson-Patman Act, Title VII contains no cost justification for discrimination.[43] But if in fact the net discrimination is in favor of women, the cost justification argument drops out, so that the very result he requires is in violation of Title VII.

Justice Stevens, ironically, then makes a similar point that shows the danger of refusing to use accurate information in statistical settings: "Nothing in our holding implies that it would be unlawful for an employer to set aside equal retirement contributions for each employee and let each retiree purchase the largest benefit which his or her accumulated contributions could command in the open market."[44] But he fails to see the economic absurdity in his argument. Let the employer take that option, and the female employees will have to pay the additional premiums given that Title VII does not require cross-subsidies by third parties. But if employers were to take this path both male and female workers would be left *worse off* than before—a Pareto pessimal move. The group purchase gives the insurer a defense against adverse selection, which is not available when individual employees of either sex file their individual applications. Hence the costs of those policies are higher per unit of coverage than those which were obtainable under the efficient practices that were in

[43]Manhart, 435 U.S. at 717.
[44]Id. at 717–718.

place before Title VII was extended to public officials. So the only way to avoid the cross-subsidy problem is to use a wasteful system of cash compensation.

This stunning reversal of libertarian principles should provoke Thaler and Sunstein to stress the serious errors that even justices of the Supreme court can make when they mangle probability theory. But it is perfectly evident that the theory is rarely used to attack limitations on freedom of contract when discrimination cases are at stake, even though its unambiguous command is to reject these rules. But *Nudge* has nothing whatsoever to say about these massive violations of the libertarian command, because it does not want to raise hackles by taking on the antidiscrimination issue. Hence its only limp response is to note:

> The laws that ban discrimination on the basis of race, sex, and religion are not waivable. An employee cannot be asked to trade the right to be free from sexual harassment in return for a higher wage. These various prohibitions are not in any sense libertarian, but perhaps some of them can be defended by reference to the kinds of Human errors that we have explored here. Nonlibertarian paternalists might like to build on such initiatives to do a great deal more, perhaps in the domains of health care and consumer protection. [45]

So the cat is out of the bag at last: nonlibertarian paternalism is quietly tolerated, but never justified. *Manhart* is passed by in silence. The overall program thus has a decided tilt toward larger role for government. It asks to manipulate default laws and other forms of behavior in areas that are unregulated, but does not push hard to deregulate in areas where paternalism is particularly inappropriate, where other forms of regulation have two undesirable consequences. They result in the suppression of relevant information and the creation of unstable cross-subsidies, neither of which should be consistent with libertarian paternalism.

The question then arises as to what should be done to deal with the obvious deficiencies in information markets when the traditional forms of intervention have all proved to be counterproductive. On this score, consistent with a sensible classical liberal agenda, there are a wide range of market mechanisms that can be used to deal with these issues. These market-supporting measures aim to increase the level of information that is available to employees, not only by disclosure but by tailored personal advice, preferably on an individualized basis.[46] Private firms are set up to supply these services at reasonable cost, at

[45] Thaler and Sunstein. (2008, p. 261). And for one expression of doubt, see Sunstein (1991).

[46] Harvey (2014). For a discussion on how APRs do not allow for an easy comparison of loans of different lengths or different types, such as fixed and variable rate mortgages, see Ben-Shahar and Schneider (2014, pp. 18–19).

least if they are not driven out by high regulation. The ability to provide that advice, however, is subject again to intense regulatory pressures on which, once again, behavioral economics sheds no light. One key issue on this topic was raised in *Chamber of Commerce v. United States Department of Labor*.[47] In that case, Judge Edith Jones, writing for the majority, examined the obligations of a person who occupies the role of "investment advice fiduciary," a status that had been subject to comprehensive regulation by the Department of Labor (DOL) in the Obama Administration. "The stated purpose of the new rules is to regulate in an entirely new way hundreds of thousands of financial service providers and insurance companies in the trillion dollar markets for ERISA plans and individual retirement accounts (IRAs)."[48] The justifications offered by DOL in no way refer to any element of behavioral economics, but repeated the same general proposition that is found in connection with all such regulatory statutes, namely that ordinary consumers are said to "lack the sophistication and understanding" of the financial marketplace possessed by investment professionals who manage ERISA employer-sponsored plans, or that there are "conflicts of interest" that will lead various individuals to persuade their customers to make improvident purchases.

At this point the debate turns to the traditional inquiry of whether the costs of the regulation are an efficient means to stop the potential abuse, which is an inquiry that requires no behavioral economics overlay. This issue is then coupled with the definitional inquiry of whether to accept the then thirty-five-year old distinction drawn between an "investment adviser," who is a fiduciary regulated under the Investment Advisers Act, and a "broker or dealer" whose advice is "solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."[49] The combined answer to the two question raised in *Chamber of Commerce* questions should be no, unless of course some undue deference is given to the administrative agency, which a majority of the Fifth Circuit refused to do, in light of the wholesale shift that the DOL rule worked with the traditional institutional arrangements.

The neoclassical view is that reputation and competition work to bridge the knowledge gap better than the 275 dense pages in the Federal Register.[50] The evidence from that review comes from the large and well-established firms that are prepared to withdraw from lines of business because the costs of compliance are simply too high. Thus, in striking down the regulation, Judge

[47] *Chamber of Commerce v. United States Department of Labor*, 885 F.3d 360 (5th Cir. 2018).

[48] *Chamber of Commerce*, 885 F.3d at 362, referencing ERISA, which refers to the Employee Retirement Income Security Act of 1974, Pub. L. No. 93–406, 88 Stat. 829 (ERISA), codified as amended at 29 U.S.C. §1001 et seq.

[49] Employee Retirement Income Security Act of 1974, Pub. L. No. 93–406, 88 Stat. 829 (ERISA), at section 80b–2(a)(11)(C) of 15 U.S.C.

[50] Id.

Edith Jones reports: "The Fiduciary Rule has already spawned significant market consequences, including the withdrawal of several major companies, including Metlife, AIG and Merrill Lynch from some segments of the brokerage and retirement investor market."[51] Judge Jones then continues her relentless dissection of the statute by noting that the new rules will force literally "thousands of brokers" to either change their fee structure (by forgoing commissions) or find other ways to charge for their services, including account management, which customers who make only a few transactions per year do not like at all.[52] In fact, the best way to understand this dispute is as a conflict between aloof government administrators and private firms in establishing sound industry practices. There is nothing useful that behavioral economics can contribute to either side of this debate.

The argument against this regulation does not imply that more limited responses to perceived failings should be dismissed out of hand. Indeed, the sensible way for agencies should proceed is on exactly that basis. First, wait for some sign of trouble; then check with key industry players and their critics to see if there is system-wide error that can be corrected through cooperative action. This approach is now being used more frequently in various environmental issues,[53] and it could work here. Behavioral economics adds nothing to what traditional neoclassical economics teaches about the uses and limits of regulation.

4 Conclusion

We are now in a position to sum up. One of the major claims of behavioral economics is that it offers a unified and richer form of analysis than the neoclassical system that it seeks to overthrow. But that claim is in large measure false because of the artificial environments in which the key experiments of behavioral economics operate. Behavioral economics tends to underrate the evolutionary forces that help shape human (and animal) psychology and thus misses out the key role of inclusive fitness in dealing with intergenerational loyalties, which leaves it with nothing to say about critical dynamics within nuclear families and larger kin groups. It tends, as does much of neoclassical economics, to ignore the importance of variation on matters of taste and competence, and fails to understand that information deficits are not confined to a list of calculation quirks, but extend far more broadly.

Indeed, the difficulties are still deeper. Because behavioral law and economics uses too weak a model of human behavior, it does not appreciate the key limitations that attach to behavioral economics in institutional settings. It

[51] *Chamber of Commerce*, 885 F.3d at 11.
[52] *Chamber of Commerce*, 885 F.3d at 11.
[53] For documentation, see Gilligan (forthcoming).

ignores the capacity for self-correction by individuals and especially by groups. It assumes that the quirks of individual behavior (even if true) carry over into complex markets that deal with such matters as commercial sales and trading on the one side, and consumer transactions and individual retirement plans on the other. And it underestimates the enormous political pressures that can distort political as opposed to economic markets, as with the antidiscrimination laws and the disclosure laws. Its ostensible paternalist prescriptions ignore the risks of massive redistribution to which public choice theory makes us sensitive. All of these errors are not random. Sadly, it is hard to find instances in which behavioral economics is used to strengthen private market behavior. The study of individual psychology may benefit from some behavioral insights. But the study of markets and regulations do not. The case for regulation on paternalist grounds has not been made out.

Institutionally, one of the fundamental choices faced by any modern regulatory system revolves around the choice between competition and monopoly as a means for providing goods and services. The neoclassical view of the subject matter has several major prescriptions, some of which should be embraced by libertarian paternalism, but which it passes by in silence. The first of these is that that the state should impose strict limitations on the creation of monopoly power by legislation or regulation. It should not therefore organize cartels in agriculture for the benefit of farmers; it should not impose rent control price limitations for the benefit of sitting tenants; it should never use zoning laws to drive out competitors of existing businesses; it never can justify the contortions in health care insurance markets where the adverse selection bias has indeed placed the individual insurance market under enormous stress; it should never sanction the massive forms of labor regulation that deal with such matters as minimum wages, mandatory collective bargaining, or even the application of antidiscrimination laws in competitive markets. And it should not prohibit various forms of labor contracting, most notably the contract at will, which allows, in the absence of a contrary agreement, either side to terminate an arrangement for good reason, bad reason or no reason at all.[54]

Most of these issues are not discussed in Nudge, which does not contain a single mention of the terms "monopoly" or "cartel." The traditional models all demonstrate large social losses from the legislation support of cartel and monopoly forms of industrial organization. The institutional challenge to behavioral economics in this area is therefore just this: is there any particular area in which the introduction of behavioral economics *reverses* the central conclusions that neoclassical economics reaches? I cannot think of how the full appreciation of any of the supposed biases in individual conduct alter the basic conclusions in these areas, any more than it does in those areas in which it is commonly understood that information and competence deficits

[54]See, for discussion, Epstein (1984).

render individual decisions suspect. Indeed, one of the reason why behavioral economics is so silent in dealing with these key structures is that huge institutional players know all too well what is at stake so that the set of biases that may loom large in the individual context have no salience in this case. There is every reason to understand how individuals behave. But there is also every reason to be cautious before extending that knowledge in ways that upset well-established principles of neoclassical economics.

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