It's often argued that behavioral economics demonstrates the need for more government intervention – but CHRISTOPHER J. COYNE and RACHEL L. COYNE beg to differ...

THOUGHT Control

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Behaviourial economics informs a lot of economic policy discussions. But whilst its insights may be interesting and important, do they really tell us anything about the appropriate role of government in economic life?

In 2010, the UK government established the Behavioural Insights Team (BIT) or 'Nudge Unit'.

It was to use 'behavioural science to encourage people to make better choices for themselves and society'. The US government has recently launched a similar body. A central part of the work of these units is grounded in behavioural economics.

Behavioural economics focuses on differences between observed human behaviour and the models used in mainstream economic analysis.



economists have tended to use. These deviations are seen as 'failures'.

For example, it is suggested that people systematically

WHEN HUMAN BEHAVIOUR DEVIATES FROM THE PREDICTIONS OF ECONOMIC MODELS, IT IS INCORRECT TO ASSUME IT IS A HUMAN FAILURE THAT NEEDS CORRECTING THROUGH REGULATION

Many conclude that the deviations between predicted and actual behaviour provide a justification for expansions in government regulation. However, there is reason to be sceptical of this conclusion.

Ideal models versus reality

Behavioural economics identifies situations where people do not act according to the rational decision-making model that save too little, make diet decisions at odds with their long term health and misjudge risks. These failures, it is commonly argued, require correction by policymakers.

However, the models that economists use are tools designed to help us understand the world. They should not be mistaken for accurate representations of all aspects of reality. Consider a paper map of the world spread out on the floor. Standing on the map, one could easily step from the United States to the United Kingdom and back again in a matter of seconds. But this does not mean that, in reality, one can physically travel between the US and UK at that speed. No one would view this as a 'failure' on my part, or of the map.

Instead, people understand maps as incomplete representations of the world. They accurately portray geography, but not the scale of the actual world.

This same insight should be applied to economic models and their relevance for understanding economic behaviour.

When actual human behaviour deviates from the predictions of economic models, it is incorrect to simply assume that it is a human failure that

² Drew Fudenberg. (2006) "Advancing Beyond 'Advances in Behavioral Economics'" Journal of Economic Literature 44: 694-711.



¹ Colin Camerer, Linda Babcock, George Loewenstein, and Richard Thaler. (1997). "Labor Supply of New York City Cabdrivers: One Day at a Time" *The Quarterly Journal of Economics* 112(2): 407-441

needs correcting through regulation.

For example, a wellknown paper in behavioural economics found that New York City taxi drivers worked fewer hours on rainy days.¹

The authors concluded that the cab drivers have a daily income target, and once they meet that target, they stop driving. Since more people demand cabs on rainy days, drivers tend to meet their targets faster and, hence, drive fewer hours.

Many consider this behaviour 'irrational' because taxi drivers could, in principle, earn more income by driving more hours during rainy days, earn more overall income in a shorter amount of time (and have some more time off on sunny days).

However, this reasoning, and the model on which it is based, assumes that maximising overall income is the main goal of taxi drivers. In doing so it neglects a range of other possibilities.

For example, perhaps taxi drivers are more fearful of getting into an accident in bad weather and, thus, seek to limit their time on the road during inclement weather conditions. Or perhaps they value spending time with family or friends on a daily basis and are willing to trade off additional income to do so.

There are numerous other possibilities to explain this seemingly irrational behaviour such as the possibility that people are more likely to want to use taxis for shorter trips when it is raining and taxi drivers find these less lucrative.

The more general point is that it is too simplistic to assume that people are irrational because they fail to satisfy the predictions of an idealised, simplistic model.

Models are never able to fully explain the behaviour of economic actors. What appears irrational to outsiders may, in fact, be perfectly rational to the person taking the decisions.

MODELS ARE NEVER ABLE TO FULLY EXPLAIN THE BEHAVIOUR OF ECONOMIC ACTORS

For instance, some individuals may live happier lives eating doughnuts and smoking cigarettes rather than running marathons and consuming kale – having a long life expectation might not be a major part of their utility function.

Behavioural economics does not account for these differences in the subjective values of individuals, which are specific to their lifestyles and personal preferences. It purports to have better models of behaviour but, in reality, the discipline often misses the subtleties of real life.

Regulators are people with behavioural biases too

Despite the need for scepticism about the assumptions underlying behavioural economics, it cannot be denied that some of the observations it makes about human behaviour have some merit.

And it might therefore be possible to improve our understanding of people's behaviour by including some of the traits that are highlighted in behavioural economics in our models.

Such a model may produce

a better economic 'map'. However, the assumption underlying the work of the various government bodies that have been set up seems to be that, because we do not always make rational choices, those choices can be improved by regulation. But, can they be improved in practice?

Arguments for increased government regulation to address behavioural anomalies assume that policymakers are immune from those same behavioural traits.

But, policymakers are also error-prone human beings. If ordinary citizens suffer from the inability to self-regulate or to accurately judge risks, so do regulators. For example, regulators may systematically over-estimate their ability to improve on market outcomes.

Embracing this symmetry of behavioural assumptions has important implications. Just because economic actors are imperfect human beings does not, by default, suggest that government should be empowered to make appropriate corrections.

It is possible that if behaviour is directed by policymakers informed by behaviourial economics, it might generate worse outcomes. As economist Drew Fudenberg writes:

"Even if we believe people do make systematic errors in evaluating how various choices will influence the appropriately defined measure of their welfare, we might not trust that the government or policy analysts would make better evaluations. For this reason. it is consistent to believe both that people make mistakes and that government policy should (with a few exceptions) be based on the assumption that



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BEHAVIOURAL ECONOMICS... OFTEN MISSES THE SUBTLETIES OF REAL LIFE

people's actions and ex-ante predictions are the best guide to what is in their own interests."²

Appreciating that people acting in the market and regulators come from the same human stock and are prone to errors should lead us to consider what is the best institutional framework in which people should take decisions.

Should markets be broadly free? Or should governments nudge and cajole us to prevent us succumbing to behavioural biases?

Comparative institutional analysis

Comparative institutional analysis begins by recognising that human imperfections are pervasive and affect all people.

Rather than emphasising these limitations as failures, as is common in many discussions of behavioural economics, focus is instead placed on how different institutional arrangements allow people to best deal with their fallibilities.

For example, markets have several features that allow people to correct their mistakes and deal with their cognitive limitations – prices, profits and losses guide people's behaviours leading them to correct their mistakes over time.

The institutions of the market tend to filter out inefficient behaviours, including those that are inefficient due to behavioural biases. They provide feedback regarding our errors and an incentive to act on that feedback.

Political institutions lack these desirable properties and tend to be fragile in the face of human imperfection.

For instance, there is no clear feedback mechanism, analogous to the profit and loss mechanism in markets, which reveals the errors of regulators and provides incentives to correct them. When errors occur they will often persist due to political inertia resulting from the inefficiencies of bureaucracy and vested interests.

Error is a part of being human. One can appreciate this point and, at the same time, reject calls by 'experts' who seek to regulate private life in the name of removing human fallibility.

After all, policymakers are also imperfect human persons who act in an institutional environment which does not provide incentives for people to correct their errors•

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Further reading on behavioural economics

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