

TOO MUCH CHOICE?

Behavioural economics does not justify depriving individuals of choice, argues **James Paterson**

The ideas behind free markets have never been universally popular or without critics. Even those within the broad capitalist tradition have frequently questioned whether individuals were truly best placed to make decisions in their own interests. Influential economists such as John Maynard Keynes advocated a substantial role for the government to guide the market towards the outcomes deemed most 'optimal' by political leaders.

But in the wake of stagflation that gripped the world in the 1970s, a steady consensus has emerged—at least in policymaking in most of the Western world—that governments should intervene less in the marketplace and leave more decisions to rational, utility maximising, self-interested individuals. Successive governments, most notably in the Anglosphere beginning with Margaret Thatcher, Ronald Reagan and others, responded to the economic malaise of the 1970s with a comprehensive program of privatisation, deregulation, and moves towards free trade.

These policy developments—sometimes labelled the Washington Consensus or 'neoliberalism'—were well supported by neoclassical economics, the dominant field of economic study for decades, so much so that 'neoclassical' is often used interchangeably with 'mainstream.' It is also the discipline of economics that is most often taught at universities. At its core, neoclassical economics makes key assumptions about human motivation, in particular, about a creature labelled *homo economicus*—the economic man—a rational, self-interested, utility maximiser.¹ Steven Levitt, economist and author of the

bestselling *Freakonomics*, goes as far to say that the 'discipline of economics is built on the shoulders ... of *homo economicus*.'²

Free-market economics is today under assault from a new quarter. Behavioural economics is a relatively new field of study in economics that uses insights from psychology and experimentation to argue that humans often behave in irrational ways and not according to the assumptions made by neoclassical theorists. While the crucial insight offered by Herbert Simon—that human rationality is bounded—occurred in 1957, it wasn't until 1994 that the first PhD was awarded in the field and 2002 before a behavioural economist was recognised with a Nobel Prize in economics.³

Behavioural economics catalogues a whole range of ways that humans are observed to not act rationally: from discounting the future to overconfidence, loss aversion, and lack of self-control.⁴ Some commentators have gone as far to claim that the idea of 'hyper-rational Economic Man' has been 'eclipse[d]' because of the findings from this new field.⁵

The usual suspects of free-market sceptics have seized on these findings: 'When you accept that individuals are far from rational you open up the possibility that governments may well be better judges of what is best

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for the individual,' says economic journalist Ross Gittins.⁶ Louis Uchitelle argues in the *New York Times* that 'If the behaviorists prevail, the mainstream view of a rational, self-regulating economy may well be amended and policies adopted to control irrational, sometimes destructive behavior. Twenty-five years of deregulation might lose its appeal.'⁷ Nouriel Roubini states that 'laissez-faire capitalism has failed' due to the weaknesses exposed in the financial system by the recent economic crisis, and findings from behavioural economics explain why.⁸ Justin Fox used the latest financial crisis in conjunction with a behavioural understanding of financial markets to unveil what he calls the 'Myth of the Rational Market.'⁹

In a similar vein, Peter Ubel writes in his book *Free Market Madness* that the findings from behavioural economics undermine the

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core justification for free markets.¹⁰ Ubel states that referencing, choice overload, and other instances of bounded rationality are responsible for problems such as indebtedness, diseases associated with smoking and alcoholism, and, of course, obesity in the United States.¹¹

In 2008, Richard Thaler, one of the most significant thinkers in behavioural economics, and Cass Sunstein, a law professor at the University of Chicago, published *Nudge*, which explored the potential policy responses to the findings of behavioural economics. Their 'libertarian paternalism' seeks to incorporate the insights from behavioural economics to 'improve' people's choices through the actions of a benevolent authority, usually, though not always, government.¹² US President Barack Obama obviously thinks that their work and behavioural economics have implications for public policy—in 2009, he appointed Sunstein as his Administrator for the Office of Information and Regulatory Affairs.

Choice overload

Perhaps the trait that behavioural economics claims to have uncovered and which could most undermine confidence in neoclassical economics is the concept of 'choice overload.' Other than the obvious implications for a perspective that relies on free, rational individuals making decisions in their own best interests, the consequences of this alleged finding are heightened by the reliance of many free-market advocates on choice as a way to improve welfare in modern policy debates. For example, the Howard government's deregulation of the industrial relations system in Australia in 2005 was called *WorkChoices*. Another example is the provision of 'parental choice' via education vouchers in the United States. But some behavioural economists argue that too much choice can be counterproductive, and the more choices we have the more likely we are to make a bad decision or even fail to make a decision at all.

A landmark study in 2000 by Mark Lepper and Sheena Iyengar raised serious questions about the benefits of choice.¹³ Using luxury jams, Lepper and Iyengar demonstrated that experiment participants were less likely to make a decision when faced with more choices and expressed higher levels of satisfaction with their decision when they were forced to choose from fewer alternatives. In a similar study, Richard Thaler found that offering Swedes 456 different companies to manage their retirement savings resulted in sub-optimal allocation of investments and lower returns.¹⁴ He argues that if the United States were to privatise its social security system, it should restrict Americans to choose between just two or three providers to avoid this problem.¹⁵ Indeed, an entire book, *The Paradox of Choice*, was published by Barry Schwartz in 2004, arguing that humans are overwhelmed by the number of choices they are offered and that, contrary to a neoclassical understanding of economics, more choice is not always a good thing.¹⁶

However, there are reasons to doubt that the phenomenon of choice overload, first identified by Iyengar and Lepper, actually exists in the

real world. In 2009, Benjamin Scheibehenne, Rainer Greifeneder, and Peter Todd attempted to recreate the effects of choice overload in three distinct experiments.¹⁷ They offered participants the chance to choose between restaurants, charities and CDs, and found that the only instance where the availability of too many choices appears to affect decision-making is when participants are required to justify their decision to an observer. This suggests the act of being observed may affect results in behavioural experiments.

Further, as Tim Harford argues, evidence from the real world also contradicts this idea—why else do companies offer ever-increasing variety of products, including the option to make additional modifications to those products?¹⁸ The corporate turnaround of McDonalds in 2003 was in large part due to offering more products to its customers (in this case, healthier varieties) rather than fewer.¹⁹ Indeed, one of the fastest growing fast-food franchises in North America, Subway, bases its business on variety, choices and the opportunity to tailor your meal. The menu includes five types of bread, two types of cheese, nine different salads, nine different sauces as well as pepper and salt, plus sides including drinks, cookies, chips and fruit.²⁰ If choice were so overwhelming and debilitating, we'd expect these businesses to fail after offering expanded choice offerings, but the opposite has clearly been the case.

Harford also points out that even if we accept choices can overwhelm individuals, it is not necessarily a good idea to restrict choice in order to overcome that. Part of the reason we have such an array of high quality products to choose from is because of the competition to sell them. If we restricted choice, we may find that less competition will result in poorer quality offerings.

There are also serious questions about the reliance of behavioural economics on experimentation to arrive at its findings. For example, Levitt and List review a range of studies in behavioural economics and note that results obtained from lab experiments cannot be replicated in the real world.²¹ They argue that a range of factors, including the

effect of being observed, induce lab experiment participants to behave in ways that they do not in the real world. They argue that for behavioural economics to have major implications, economists will need to show that the irrational behaviours they observe in the labs exist to the same extent in the real world.

Yet even defenders of neoclassical economics such as Gary Banks, Chairman of the Productivity Commission in Australia, admit that while a traditional understanding of economics already accounts for the possibility that markets will not always function efficiently—because of market failure, information asymmetry, externalities, and imperfect competition—it is also possible other failures can occur because agents are not 'perfectly rational, calculating, utility maximisers.'²²

Policy implications

Even if we accept that behavioural economics demonstrates that humans are not always rational, we still must evaluate whether implications can be drawn from this for policymaking. There are persuasive reasons to believe that it should not.

For instance, some economists do not think it is possible to incorporate all of the ways that humans are recognised to act irrationally into meaningful policy advice. Paul Frijters argues that there is such a variety of anomalous behaviours exhibited by humans that no one has been able to, nor is likely to, model the consequences of this irrationality for the purposes of policy advice.²³

Mark Harrison advances the theory that while all humans may not be perfectly rational, some are prone to higher degrees of irrationality compared to others. In particular, he notes that welfare recipients are more likely to 'have more extreme judgemental biases and self-control problems than the general population.'²⁴ If individuals exhibit a variance of irrationality, it may be impossible to design policies that do not inadvertently also restrict the freedom of rational actors.

Perhaps the strongest argument against expanded government intervention due to

behavioural economics is the observation that policymakers are human too and may suffer from the same cognitive biases we observe in other individuals. In addition to being prone to cognitive bias on their own, as Harrison argues, policymakers are elected by 'the same people considered too irrational to run their own lives.'²⁵

There are many potential problems with relying on policymakers to arrive at the 'right' decisions. First, they are elected by people who are not always rational and who have little incentive to remain informed about elections. Bryan Caplan argues that the cost of acquiring information to arrive at a decision in an election outweighs the benefits for the voter in doing so. Noting that the vote of one person is highly

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unlikely to change the result of an election, Caplan reasons that there is no cost borne by the individual if he or she gets her vote 'wrong.'²⁶ If we agreed with the behavioural observation that humans are prone to irrationality, we could argue that policymakers are often elected by irrational people who have no private incentive to become more rational. This irrationality could skew the incentives of policymakers who will seek election and re-election from these voters.

Second, policymakers are subject to influence and pressure from lobbyists and other people who have an interest in securing a beneficial outcome for their group. Caplan notes that unlike ordinary voters, one group that has a significant incentive to be informed and politically active is the one that will benefit from government largess, for example, a domestic industry protected by a tariff barrier.²⁷ This group is likely to influence policymakers to protect its interests, further influencing the capacity of policymakers to act rationally and choose policies that maximise welfare.

Third, policymakers themselves are fallible and prone to mistakes. In an article contemplating the consequences of behavioural

economics for health care reform in the United States, Jerome Groopman notes multiple failures from government mandated 'best practice' standards, including instances where compliance with best practice leads to more fatalities and poorer standards of care.²⁸ Groopman argues behavioural economics shows why experts should not impose solutions on others. So-called 'experts' are subject to the same behavioural bias as everyone else, and instances of confirmation bias (ignoring contradictory evidence) and overconfidence bias have led to bad medical standards being imposed on health professionals. It requires a certain intellectual flexibility to on the one hand argue that all humans are prone to irrationality, and simultaneously believe that the answer is to entrust other humans to regulate this irrationality out of existence.

Free-market economics, and the idea that individuals are best placed to make decisions in their own interest, will always face attack from those who believe that society would be better if experts were running the show. Those who are sceptical of the virtue of individual liberty have become more sophisticated over time in their criticisms. Old-fashioned Marxists argued that people were being manipulated and taken advantage of by a ruling class of capitalists. Keynesians suggested that economies ran best when they were directed from the top, rather than allowed to grow organically. Modern behaviourists have adopted a scientific veil to argue that humans are fundamentally irrational and that society would be better off if these irrationalities were controlled. But it is not clear that people are as wildly irrational as they claim. Even if they are able to conclusively prove that individuals are so irrational they can't be trusted to run their own lives, surely the answer is not to hand power over their lives to equally irrational policymakers with potentially skewed priorities. The philosophy of individual liberty has faced substantial threats in the past, but no alternative world-view has ever demonstrated that it can generate wealth and prosperity on the same scale as granting individuals freedom over their own lives.

Endnotes

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