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Editorial Note

The Behavioural Case For Regulation

"Look at this lead pencil. There's not a single person in this world, who can make this pencil. Remarkable statement? Not at all!", exclaims Milton Friedman in a 1980 book and TV series called Free to Choose. Nobel Laureate Friedman borrows the idea from Leonard Read's timeless classic, I, Pencil, in which he traces the genealogy of the humble pencil. Read demonstrates that millions of individuals, as disparate as mill workers in California, coffee pickers in Brazil and graphite miners in Ceylon, contributed to the making of single pencil. Materials involved in the making of the pencil originated from numerous sites, like Mississippi (clay), Mexico (candelilla wax) and Indonesia (rapeseed oil). What is stunning is that there is no single person who contributes more than a tiny bit of know-how; and no single mastermind coordinating the making of a pencil.

This story illustrates the case for free markets: markets, left to its own with no external intervention, with free trade among self-interested and rational individuals, will lead to the best societal outcome (and efficient resource allocation), as if under the direction of an 'invisible hand'. Fundamental to this system of economic organization is the freedom of choice, competition and market equilibrium. Economists have identified several instances of 'market failure', warranting state intervention. Some examples are the presence of externalities and information asymmetries. In this essay, a fresh case for state intervention will be made: that of behavioural market failures.

The foundation of free market economics ('conventional economics'), rests on a set of simplifying assumptions about human behavior. Human actors in a market, known as 'homo economicus', are assumed to be self-interested, rational utility maximisers with stable preferences and unlimited computational or information processing abilities. The project of behavioural economists has been partly to show that these assumptions are unrealistic - in other words, to show that 'homo economicus' is simply a myth. Behavioural economists, as I will elucidate in subsequent paragraphs, have shown that humans have bounded rationality and bounded self-interest, and that they do not have stable preferences. But this is not the complete project of behavioural economists. As Friedman explained in his famous essay, Methodology of Positive Economics, whether economists make unrealistic assumptions is irrelevant, as long as the predictions or hypotheses arrived at it is correct. If one is to predict the shots of an expert golfer, one would reach fairly accurate predictions by assuming that the golfer plays as if he/she knew and calculates all the mathematics pertaining to the travel direction of the ball. Of course, the golfer is not actually calculating all of this before the shot (argument from realism), but we nonetheless get an accurate prediction. The behavioural economics project then, also has to prove that the incorrect assumptions also affect the predictions and hypotheses made in the conventional model.

According to behavioural scientists, our thinking is divided into two cognitive systems: System 1 and System 2. System 1 thinking involves automatic, fast, 'gut' thinking, whereas System 2 thinking involves conscious, deliberative and 'slow' thinking. According to the Homo Economicus presumptions, all decisions (where time is available) are taken after consulting System 2. That is, however, not the case with humans. Due to our limited cognitive abilities (or in case of external reasons such as non-computability, uncertain future and ambiguous goals), we often consult and use System 1. More specifically, we tend to use rules of thumb or mental shortcuts, also called 'heuristics'. Heuristics are mostly useful, but behavioural economists have experimentally demonstrated that they can also lead to systematic and predictable 'biases'.

One example is the 'availability' heuristic – where humans answer (probability-related) questions going by ease of recall. Although people are likely to state that murder is more common and frequent than suicide, National Crime Records Bureau's all India statistics show that suicide is four times more common. This is because instances of murder are cognitively more easily available, being given greater media attention and generally forming the locus of many conversations. Another instance is the 'overoptimism' bias, which is centred on cognitive egocentricism. Illustratively, one study showed that 93% of the drivers in the United States think they are above-average drivers (which is mathematically impossible). Another clear indicator of the biases of the human mind is the status quo bias (cognitive inertia) - organ donation rates in several

countries increased by nearly 100% or more when the default option was changed to presumed consent (with the choice to opt-out) in contrast to the earlier system of opt-in. Conventional economics here would predict no change in organ donation rates.

These studies, which clearly suggest that the unrealistic assumptions affect predictions about behaviour, are only a small set of those available in the field of behavioural economics. Crucially, they establish that unrealistic assumptions considerably affect economic analyses and forecasts. They also establish that heuristics and biases lead to an inefficient outcome, putting forth a case of behavioural market failure. Consider the following example. According to the Coase Theorem, absent transaction costs, bargaining between the parties will ensure that initial allocation of property rights will not finally affect the efficient allocation of resources. An important assumption here is that one's valuation of goods remain constant irrespective of whether one has possession or legal entitlement over the goods. However, there is strong evidence to suggest an "endowment effect", i.e., one's valuation of a good changes according to whether one has legal entitlement/physical possession over the good or not. For example, one study showed that people who give 5$ to ensure air pollution is kept below a certain level (Willingness to Pay – WTP), whereas the asking price to give up the right to clean air was about 24$ (Willingness to Accept – WTA). Depending on the underlying psychological reasons for this offer-ask gap, the valuation of the good can be 'irrational'. Thus, the initial allocation of rights can affect the efficient allocation of resources. Due to 'irrational' valuation, transactions will be inefficiently low.

A particularly strong case for state intervention in case of behavioural market failures is described by Nobel Laureates Robert Shiller and George Akerlof in their book Phishing for Phools: Economics of Manipulation and Deception. Introducing the idea of the 'phishing equilibrium', they argue that the manipulation and deception in the markets exist not necessarily because men are inherently evil, but because players are likely to lose out in the market in case they do not resort to such deception. If one entrepreneur Mx. X does not resort to an available opportunity for deception, there will always be a Mx. Y who will resort to it (since it is an opportunity for profit), reaching a phishing equilibrium. This tendency to manipulate and deceive due to competitive pressures stems from the existence of behavioural biases. Harvard Professor Oren Bar-Gill provides the example of credit card contracts, which look favourable in the short term but are less favourable in the long term (the strategy of cost deferral), exploiting the myopic and overoptimistic consumers. Players in the market who do not offer such contracts are likely to lose out. Similar is the case with the design of health club contract offers: a study by Stefano DellaVigna and Ulrike Malmendier found that customers, after considering various options, significantly overpaid for their contracts. When customers had three options - to pay by the visit, by credit card monthly contract

with automatic rollover or by annual contract - most paid with the second option. The study found that 80% of them would have paid less had they chosen to pay by the visit.

Before proposing coercive state intervention for addressing behavioural market failures, it is worth noting a few points. First, state officials themselves are not immune from behavioural biases, and state interventions can have substantial costs. Second, philosophical debate on behavioural intervention is inconclusive. For instance, some philosophers apply Derek Parfit's account of identity to argue that time inconsistent preferences are rational, since our present selves and future selves are essentially two different and separable identities. Third, as pointed out in a multi-author, defining paper on 'asymmetric paternalism' (i.e., a form of regulatory paternalism that "creates large benefits for those who make [behavioural] errors, while imposing little or no harm on those who are fully rational"), not all people make 'irrational' decisions in all cases. Hence, any intervention based on these behavioural findings must be designed in a cautious manner.

In such circumstances, a useful way forward would be to employ the policy prescription of 'nudges', prescribed by Richard Thaler and Cass Sunstein in their 2008 text Nudge: Improving Decisions About Health, Wealth and Happiness. A nudge alters or steers people's behaviour without closing off choices or significantly changing economic incentives. One example is that of Part VIII of the Model Code of Conduct for elections in India. In his book Predictably Irrational, Dan Ariely calls zero (or free) an 'emotional hot button'. Subjects of an experiments were offered a Lindt truffle at 15 cents (a steal) and a Hershey's Kisses at 1 cent. 73% of the subjects chose the truffle. Next, they were offered the truffle at 14 cents and the Hershey's Kisses for free. 69% chose the Kiss. This, and several other biases like present biases (myopia) is often exploited by political parties by offering freebies. In order to curb this practice, Part VIII of the Model Code of Conduct contains a clause that directs political parties to "reflect the rationale for the promises and broadly indicate the ways and means to meet the financial requirements for it" in their election manifestos. The nudge in this instance is mandating disclosure. Although no choice is imposed on the voters, the state intervention is designed to combat biases, allowing voters to carefully consider their choices and not fall prey to the immediate promises of freebies (which may cause greater long term harm).

Although libertarian in nature, leaving open the freedom of choices, nudges are not without controversy. The ethics of nudging is a much debated and much misunderstood subject. The paternalistic nature of some nudges has also been criticised. However, any criticism must be guided by an acknowledgement of the eclectic variety of nudges available. Nudges enlisting biases, such as changing the default in case of organ donations, have met with many

objections. On the other hand, many nudges, such as those mandating disclosure, are relatively uncontroversial. Although constraints of space hinder a more detailed discussion on the subject, it is worthwhile to point out that howsoever controversial, nudges by definition are easy to avoid by the nudgees, since they keep the freedom of choice unaltered. This safeguard alone leaves it superior to other forms of regulation to counteract behavioural market failures.

—Vasujith Ram
On behalf of the Editorial Board