

Behavioral Economics and Public Policy: The Libertarian Paternalism Approach

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Some Recent Papers

- “How much is Investor Autonomy Worth?” *Journal of Finance* 2002 (with Shlomo Benartzi)
- “Save More Tomorrow” *Journal of Political Economy* 2004 (with Benartzi)
- “Social Security Privatization: Learning from the Swedish Experience” *American Economic Review* 2004 (with Henrik Conqvist)
- “Libertarian Paternalism” *American Economics Review* 2003 (with Cass Sunstein)

One Approach to Policy: Libertarian Paternalism

- Both terms are currently unpopular (at least in the US), and seemingly contradictory.
- But, neither concept should be controversial:
 - Libertarian: protect the individual's right to choose
 - Paternalism: do what you can to improve the welfare of people
- And it is possible to achieve both goals.
- Libertarian Paternalism policies are designed to improve and guide choices without coercion or the elimination of freedoms.

What is the alternative?

- Program planners must choose *some* set of institutional arrangements. What design should planners pick?
- Example: cafeteria menu planning—in what manner (order, salience..) should the food be presented?
 - The plan that make participants better off?
 - The options that make the participants worse off? (e.g., fattest?)
 - Random?
 - The options that make the planner best off?
- Note that **some** choice has to be made.

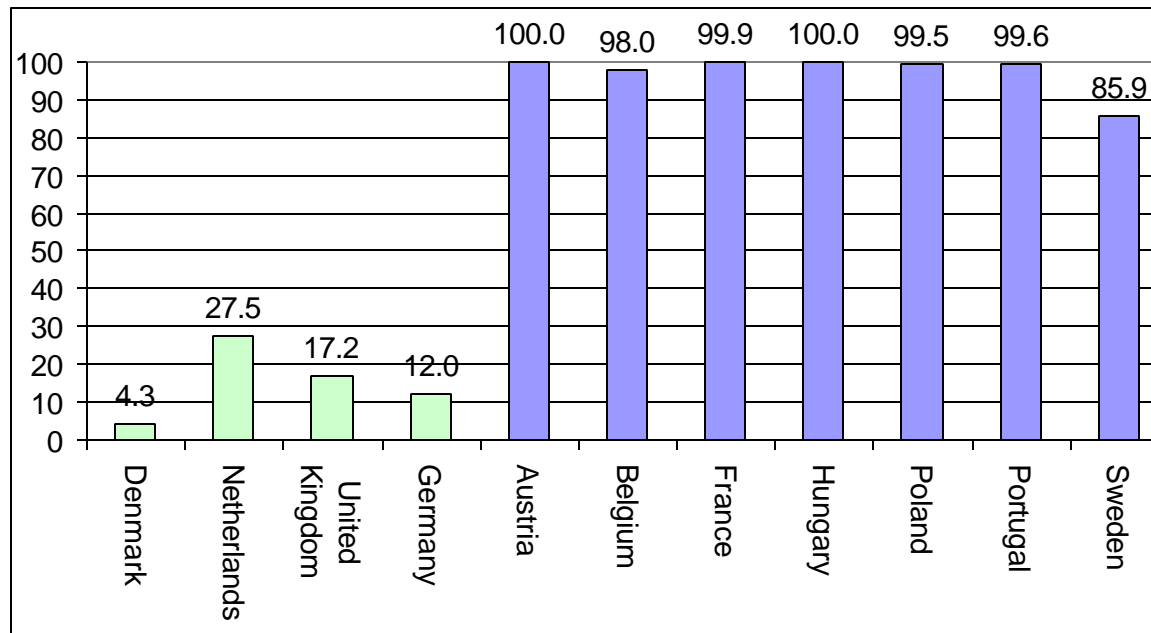
One Example: Organ Donation

- Countries adopt two approaches to organ donation:
- Opt in. (as in US). To make your organs available you must take action.
- Opt out or “presumed consent”. To opt out you must take action.

Does the rule matter? (Data from Johnson and Goldstein)

Organ Donation Consent Rates

Figure 1: Effective Consent Rates, by country, the four leftmost green bars are explicit consent (opt-in) the seven blue rightmost are presumed consent (opt-out)



Why do economists hate paternalism?

- The maintained hypothesis is that individuals choose what is in their best interest.
- Or, at least that they choose better for themselves than someone else would do.
- Especially if that someone else works for the government.
- Note that this is an empirical claim. What is the evidence?
- Experiments show that subjects often fail to choose the option that will make them best off.

Plan for Talk

- Evidence from lab and field experiments about savings and investing behavior.
- Lessons to be learned for policy designs based on the libertarian paternalism approach.

Do consumers know how to maximized utility?

- How Much is Investor Autonomy Worth?
(J. of Finance, 2002)
- Do Investors gain much from choosing
their own portfolios?
- How much choice should they get?

Experiment

- Main question: do investors prefer the portfolios they have constructed themselves when compared with the average or median portfolio of their co-workers?
- Setting: UCLA employees investing for retirement.

Sample Stimuli

	Investment Program A	Investment Program B	Investment Program C
Upside Income	\$60,300	\$81,000	\$95,900
Median Income	\$23,800	\$26,800	\$25,600
Downside Income	\$9,590	\$9,270	\$7,740

Results: Mean Ratings

N	Participants' own portfolios	The average portfolio	The median portfolio
157	3.07	3.05	3.86

- Only 21% of the participants prefer their own portfolios to the median.

Conclusion so far

- In many situations planners are forced to make some choice.
- Plan designs strongly influence the choices participants make.
- So, it should be possible to go further and design programs to actively improve choices without restricting freedom.

Application: Increasing Retirement Savings

- In many countries, retirement savings decisions are made by workers, not firms.
- Many workers save too little. How to help?
- Key fact to remember: most savings (at least in the US) is “automatic”:
 - Payroll deductions
 - Mortgage Payments

Psychological Principles to Keep in Mind

- Many people want to save more, but lack the self-control.
- Self-control restrictions are easier to accept if they take effect in the future.
- Inertia: Once an automatic savings plan starts participation is persistent, and money tends to “stick” in retirement

One Prescription: Automatic Enrollment

- The default option is changed. Participants are enrolled into the plan unless they explicitly opt out.
- Good news: enrollments jump. In one company studied by Madrian and Shea, enrollments of new employees go from 49% to 86%.
- Bad news: whatever default options are selected by the plan administrators are taken as “suggestions” by employees and stick.

The Save More Tomorrow Plan (SMarT)

- People pre-commit to saving more in the future.
- Saving increases are synchronized with salary increases.
- People remain in the plan unless they drop out.

The First SMarT Program

- Manufacturing firm hired a financial consultant to advise employees on how much to save
- Financial consultant typically advised 5% increases
- If participants did not accept the advice, they were offered the SMarT program

The First SMarT Program (cont.)

- Participants precommit to increase their saving rate by 3% per year
- Saving increases are synchronized with pay raises
- The increases continue unless the participant opts out or hits the plan max

Participation Data

Plan participants	315
Received advice	286
Accepted the advice	79
Offered the SMarT plan as an alternative	207
Accepted the SMarT plan	162
Bailed out of the SMarT plan before 2 nd pay raise	4
Bailed out of the SMarT plan before 3 rd pay raise	33
Pre-SMarT participation rate	64%
Post-SMarT participation rate	81%

New Data on Saving Rates (1st Case)

	ALL	No Advice	Took Advice	Took SMarT	Declined Advice
N	315	29	79	162	45
Pre-advice	4.4%	6.6%	4.4%	3.5%	6.1%
1 st Pay Raise	7.1%	6.5%	9.1%	6.5%	6.3%
2 nd Pay Raise	8.6%	6.8%	8.9%	9.4%	6.2%
3 rd Pay Raise	9.8%	6.6%	8.7%	11.6%	6.1%
4 th Pay Raise	10.6%	6.2%	8.8%	13.6%	5.9%

Social Security Privatization

- Most economic analyses of social security privatization concentrate on funding issues.
- Little attention is given to design features.

Swedish Social Security Privatization (AER, 2004)

- In 2000, Sweden launched a partial privatization of their social security system, similar to the proposal of President Bush.
- 2.5% payroll tax contributed to individual accounts that are self-directed

Important Design Details

- Participants were allowed to form their own portfolios by selecting up to 5 funds from an approved list.
- One fund was chosen (with some care) to be a “default” fund for anyone who, for whatever reason, did not make an active choice.
- Participants were encouraged (via a massive advertising campaign) to choose their own portfolio.
- Both balances and future contributions can be changed at any time, but unless some action is taken, the initial allocation determines future contribution flows.

Plan Details, Cont.

5. Any fund meeting certain fiduciary standards was allowed to enter the system. Thus, market entry determined the mix of funds participants could choose from. As a result of this process, there were **456 funds** to choose from.
6. Information about the funds, including fees, past performance, risk, etc., was provided in book form to all participants.
7. Funds set their own fees (except for managers included in the default fund, whose fees were negotiated).
8. Funds (except for the default fund) were permitted to advertise to attract money.

Analysis of Plan Details

- Every design choice is consistent with standard neoclassical economic principles—
 - Free entry
 - “Pro choice”
 - Market generated information transfer via advertising.
- How well did it work?

Lobbying for active choices

- The advertising campaign to encourage active choice worked. 66.9% formed their own portfolio.
- As new participants enroll (mostly younger workers) they go through the same process, but without the ad campaign to encourage active choice.
- In the original sign-up period, 56.7% of those under 22 made an active choice, but only 8.4% of those joining in 2003 did so

Asset Allocations in the Default Fund and Mean Selected Portfolios

	Default Fund	Mean Chosen Fund
Asset Alloc.		
Equities	90%	96.2%
Sweden	17%	48.2%
Americas	35%	23.1%
Europe	20%	18.2%
Asia	10%	6.7%
Hedge Funds	4%	0%
Private Equity	4%	0%

Other Portfolio Characteristics

	Default Fund	Mean Chosen Fund
Fixed Income	10%	3.8%
Indexed	60%	4.1%
Average Fee	0.16%	0.77%
Beta	0.98	1.01
Ex Post (3 year) Performance	-29.9%	-39.6%

Return Chasing

- The largest market share (aside from the default fund) went to *Robur Aktiefond Contura* which received 4.2 percent of the investment pool.
- This fund invested primarily in technology and health care stocks in Sweden and elsewhere.
- Its performance over the five year period leading up to the choice was 534.2 percent, the highest of the 456 funds in the pool.
- In the first three years since the launch it lost 69.5 percent of its value.

A More General Lesson from This Experience

- Economists often think that the biases observed in psychologist and economist laboratories will be eradicated in open market settings.
- The Swedish experience reveals how just the opposite can happen. Markets and advertising reinforced individual biases:
 - Invest at home (familiarity)
 - Chase returns (extrapolation)
 - Active management (overconfidence)

Objections

- Planners are boundedly rational too, and if they are government employees, may be captured by the political process.
- But there are economies of scale in acquiring information. Planners (both human resource managers and bureaucrats) know more (or should) than the average participant.
- We do not propose a larger role for government: just a better role.

Conclusions

- Behavioral Economics offers additional tools to achieve policy goals.
- Libertarian paternalism is an attractive approach to solving policy problems.
- Libertarian paternalism may offer a political compromise. Often no government intervention is necessary (e.g., SMarT.)
- What else? Inept neglect?