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Behavioral economics and austrian economics: Lessons for policy and the prospects of nudges

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Abstract
This paper draws on Austrian Economics contributions and its criticism of interventionist policies and programs to assess the prospects of Behavioral economics nudges and libertarian paternalism in a world where fallible knowledge is pervasive. We go on to argue that one of the main problems underlying behaviorally informed regulations and nudging in the real world is epistemic. This is largely so because policy makers tend to underestimate "the importance of the knowledge of the particular circumstances of time and place" and their own cognitive limitations. It concludes with two advices to policy makers and regulators. One is that decisions over nudging are to be made on a case-to-case basis. Another is that it is worthwhile to dig deeper into specificities of institutional environments suggesting under which conditions nudges can(not) deliver what they promise.

JEL Classification: B40; B41; D11; D91

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austrian economics — behavioral economics — policy — biases — nudges

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Introduction

It is a commonplace to suggest that there have been many changes in contemporary agent-based policy literature (Shafir 2013, World Bank 2015). One recent trend is to appeal to behavioral economics insights to identify, formulate, test and implement new policy tools, development programs and consumer services that help individuals to approximate their intentions and actions.

In his lecture for the American Economic Association, Harvard economist Raj Chetty (2015) stressed that one important implication of behavioral economics for public policy is that it provides tools (for instance, changing default options and framing choice architectures) to shape and change people's behavior. To him, these tools for designing policies are subtle (public or private sector) behavioral interventions that might improve policy outcomes and help individuals to pursue what it is in their best interest.

The departure point of this paper is the conjecture that the behaviorally informed policies carry the risk of being pushed too far by some policy makers and regulators who underestimate one of the most important challenges posed to design and implementation of nudges in the real world: the epistemic (knowledge) problem (Abdukadirov 2016, Rizzo 2016)[1].

More specifically, this essay focuses on contributions of Austrian economics and its criticism of interventionist policies and programs to assess the prospects of nudges. The latter refer to designed choice architectures that promote certain behavioral patterns among consumers and the targets of public policy in general. We go on to argue for the idea that popular regulatory nudges (e.g. weight-loss nudges) might not accomplish what it promises because public officials and policy makers tend to underestimate "the importance of the knowledge of the particular circumstances of time and place" and their own bounded rationality and cognitive biases (Hayek 1945).

The remainder of this article is structured as follows. Section discusses the behavioral approach to policy and its intimate connection with nudge interventions and libertarian paternalism. Section analyzes how Austrian Economics deals with policy issues. Section examines what behavioral economists can learn from Austrian economics about the challenges posed to policy and regulation in the real world. Section wraps all the overall argument, briefly tackles some implications and concludes.

Behavioral economics applications to policy: nudges and designed regulation of individual behavior

It is a commonplace to suggest that the debate over nudge is an implication of behavioral economics and its applications to policy. Contemporary literature on behavioral economics that has been lately invoked to inspire development programs, regulatory policies and welfare debates is largely inspired

[1] There are many other troubling issues of nudges, such as ethical and practical issues of nudges. For a good review of the main problems, (White 2016).

by Daniel Kahneman's systems 1 and 2 map of bounded rationality (Kahneman 2003).

Kahneman's dual portrait of human thinking implies that automatic judgment and decision-making underlying system 1 depends largely on mental shortcuts called heuristics. Their role is to simplify matters and help individuals respond fast to cognitively demanding decision problems. However, heuristics can be conducive to suboptimal behaviors since they promote a narrow frame of mind.

Inspired by Amos Tversky and Daniel Kahneman's experimental research program to understand the major roles heuristics play in probability judgments and human decisions, behavioral economists claim that one implication of automatic thinking among boundedly rational agents is that behavior is context dependent (Tversky and Kahneman 1974, Kahneman 2003). Their view sheds extra light on the fact that behavior is sensitive to the ways individuals perceive tasks, i.e., how options are framed to them in terms of relative losses and gains (Kahneman and Tversky 1979).

Decision-making in the real world is also sensitive to self-control problems people have and their tendency towards procrastination. Behavioral economics literature explains conflicting time preferences and inconsistent choices over time by appealing to hyperbolic discounting (Frederick, Loewenstein, and O'Donoghue 2002). Hyperbolic discounting implies that people have difficulty waiting for a higher delayed gratification when they have the chance to have an immediate (lower) gain, while they can commit to the future more easily when both choice options yield gains in the future.

In their best-selling 2008 book Nudge, Richard Thaler and Cass Sunstein provide arguments for subtle interventions informed by behavioral and experimental economics. (Kahneman 2003) claims that the book is a "manifesto of the behavioral approach to policy".

Nudges are mild and choice preserving interventions that purport to steer people's behavior in direction of their own long-term goals. Examples abound. They range from reminders in cigarette packages to inform people about consequences of smoking and stamps on energy efficiency products to designed default rules about organ donation, retirement savings and health insurance options that establish what happens when people choose not to choose.

Thaler and Sunstein regard nudge as designed behavior changes that are libertarian paternalistic. This is because they influence people's choices in a non-coercive way and do not pose any harm to individual freedom of choice or autonomy. Nudges purport to de-bias people's behaviors.

Putting the issue somewhat differently, nudges are justified in terms of behavioral experimental evidence that suggests that people fail to make choices to promote their welfare or long-term preferences because of informational constraints, heuristic dependencies, perceived relative loss-gain asymmetry, self-control problems and social preferences[2]. In his latest book Nudge Theory in Action, Sherzod Abdukadirov put the issue very succinctly: "what elevates some behavioral failures to the level of public policy is the harms caused by behavioral biases" (Abdukadirov 2016, p. 2-3).

Nudges resemble a GPS (navigational system) that guide people's behavior in certain directions but let them free to select what alternative course of action or route they want to (Sunstein 2015). Based on field experiments with randomized control trials, Thaler suggest that changing choice architectures through automatic enrollment in a 401(k) savings account enable people to commit to the future without hurting their freedom of choice. Individuals can opt out of their retirement savings plans whenever they want to (Thaler and Benartzi 2007).

Bounded willpower has a great deal to do with self-control problems that enable contemporary development economists to provide a new explanation of why parents cannot keep their children at school and why fertilizer use is small in some African countries. Empirical development studies even suggest that some of the poor are aware of the consequences of their time inconsistent preferences and even demand commitment strategies.

We are not yet convinced that government nudges can deliver all that they promise. Our hunch is that Austrian economic insights can help us examine more critically the epistemic and practical difficulties with nudging in the real world.

Austrian economics for public policy: necessary critical lenses

It comes as no surprise that the Austrian perspective on market process, does not seem to fit well together with the overly optimistic behavioral economics view that under many circumstances it is necessary to manage individual behavior to meet a welfarist criterion and promote economic development. The optimism over social engineering has a great deal to do with the belief that it is possible to redesign and regulate society (Ebeling 2016).

For instance, Ludwig von Mises regarded minimal policy as the best public policy (Cobin 2009, p. 135). In his magnum opus, (Mises 1949) developed a conception of market competition firmly built on methodological individualism, which gives a major role to entrepreneurial action in promoting market coordination. To him, public policy that arises to manage market forces and regulate economic action brings severe distortions that prevent the emergence of coordination and learning among entrepreneurs.

Based on Mises' framework, Hayek wrote various papers that revealed his sources of objections to public policies

[2] It is important to stress that Experimental Economics and Behavioral Economics are two independent research programs, though both make use of the experimental methodology. We are grateful to the referee for his appropriate remark about the importance of distinguishing the two agendas, their methodological commitments and purposes. We agree that the methods of experimental economics are more articulate than those in behavioral economics. Due to space constraints and the aim of this paper, we cannot tackle this interesting issue. For details, see (Guala 2005, Santos 2007).

committed to central planning and government interventions to design markets and control human behavior. He played an important role in the economic debate over central planning and went on to elaborate on the concepts of equilibrium and competition that later inspired his institutional approach to examine the emergence of spontaneous orders from rule-following behavior among individuals with limited knowledge (Hayek 1982).

Throughout his intellectual life Hayek focused his attention on the study of coordination problem. Given that coordination is a complex task and agents' cognitive ability is limited, knowledge is fallible. In his framework, perfect knowledge assumption is replaced by the hypothesis that agents formulate entrepreneurial conjectures. Then, the task of economics is to explain why and how action based on these conjectures is coordinated with the plans of the others agents and with the fundamentals of the economy. In the Hayekian perspective, the price system plays a major role, since a) entrepreneurial plans take prices as (subject to interpretation) signals of scarcity and b) realization of gains and losses functions as a selection mechanism for entrepreneurial conjectures.

The foregoing explanatory scheme progressively assumes an evolutionary guise. Competition is taken as a discovery process, by trial and error, of new ways to meet human needs (Hayek 1978). Later, this explanation is extended to the actions of individuals guided by rules, leading to spontaneous social orders formation, whose rules agents cannot fully understand (Hayek 1982, Hayek 1988).

Hayek emphasizes two central elements: complexity and subjectivism. How is it possible to deal with the high degree of complexity of structures if knowledge about their inner working is limited? The answer to this question sheds light on the evolutionary process of trial-and-error learning.

It is important to stress that decentralized learning mechanisms are essential for the knowledge relevant to deal with the coordination problem. It is not the abstract scientific knowledge of experts, but the practical and dispersed knowledge among human agents.

To Hayek, the pretension of control of social process by central planners and regulators is due to confusion between the foregoing forms of knowledge. Consequently, policy makers, development experts, regulators had better be prudent to avoid the dangers of transferring strong simplifications underlying their models to the complex social systems in the real world to legitimate increasingly centralized designed solutions and strong regulations. This warning should be taken as a "friendly reminder" to those contemporary behavioral economists and policy makers pushing nudges and libertarian paternalism a bit far.

In his Nobel lecture held in 1974, (Hayek 1967) stressed his opposition to the view that government officials have the wisdom to plan and steer economic life and behavior. Rather, policy makers are more properly portrayed as those who systematically make mistakes and propose regulations that prevent coordination problems from being resolved in the market. This is largely so because of regulators' pretense of knowledge and their confusion between scientific knowledge (learned through education) and practical knowledge (dispersed, local regarding time and place, largely tacit and independent of formal education).

The lesson to be drawn is that it is impossible that policy makers can be familiar and even master all the various types of knowledge dispersed and decentralized in the minds of different individuals in society. If this is so, we should better focus on the evaluation of different sets of abstract rules (institutions) instead of supposing that we could have information about the magnitudes of all costs and benefits for individual as well as social welfare involved in a specific intervention. There might be always unintended consequences that can bring policy ineffectiveness, economic inefficiency, new constraints on agents' capacity to learn from mistakes and extra pressure for more behavioral regulation and control.

Finally, within the Austrian framework, it is worth citing Israel Kirzner's work that puts the Hayekian insight about the nature of human knowledge with the Misesian entrepreneurial theory to assess the problems of regulation. (Kirzner 1985) revealed his worries about the unintended consequences of government interventions and regulations. This is because some interventions and regulatory policies tend to block and distort people's incentives to discover and select some entrepreneurial courses of action. Consequently, interventionism and increasing paternalism might imply strangulation of wealth promoting mechanisms (Ebeling 2016). With that in mind, policy makers might be more careful when they propose a public policy based only in the Pareto optimality or other static welfarist criterion that neglects the complexity of market processes and impact on people's action in the real world. It might be wise to take into consideration the potential effects of specific regulatory policies (for instance, changing the rules of overdraft fees and services in the evolving banking market) on fostering or punishing market coordination process and the potential of human agency.

What can behavioral economics learn from Austrian economics?

Despite the important existing differences between Behavioral Economics (BE) and Austrian Economics (AE), the starting point of this article is the view that the relationship between them are very complex and multifaceted (Rizzo and Whitman 2009b, Rizzo and Whitman 2009a), so that some gains from trade are worth exploring. More precisely, our aim in this essay is to put forth the idea that, unlike folk wisdom, AE and BE teach complementary lessons for policy. This claim is based on the premise that BE as well as AE enrich the critical debate over the nature of human rationality. Together they provide some critical thinking about some worrisome paternalistic trends worldwide.

The essential characteristics of AE is its view of market competition in terms of processes and its ecological rationality,

not just end state optimal equilibrium. This is required because AE's main interest is in understanding the emergence of coordination from initially incompatible plans among agents with limited knowledge. In other words, market process theory is equivalent of a theory or individual learning in markets. This learning, in turn, is evaluated in terms the capacity of certain institutions to a) allow people to discover new solutions to market problems and b) to realize and correct individual mistakes.1

To the best of our knowledge, the standard welfare criterion dependent on Pareto optimality seems to leave a blind spot in assessing policy-making and its effectiveness. This is partly so because it neglects the fact that the relevant knowledge on which an effective policy depends is disperse among individuals, the targets of the policy as well as regulators.

Furthermore, some behavioral papers applied to policy seem to assume an asymmetric rationality between policy makers and the targets of the policy. In his analysis of behavioral economics articles, Niclas (Berggren 2012) found out that "95.5% of the articles that contain a policy recommendation (. . .), no behavioral analysis of policymakers is included." Just like the nudged ones, bureaucrats, policy makers and development professionals are also boundedly rational and not immune to cognitive errors. We briefly present some of them.

Policy makers and regulators also appeal to heuristics to deal with complex cognitive tasks, such as selecting a strategy to fight against a disease. The World Development Report team replicated the Influenza disease experiment to test the framing effect (and loss aversion) and found the same results. In the context of perceived gain 75 percent of World Bank staff preferred sure gain, whereas in a loss frame, 66% preferred a lottery and 34 percent opted for certainty (World Bank 2015).

Slavisa (Tasic 2009) examines some regulatory errors resulting from policy makers' limited cognitive powers. One is called action bias. The latter refers to the human difficulty in representing and reacting to perceived risks and uncertainties. To him, strong political pressure might prompt some impulsive reactions by bureaucrats that motivate their decision to regulate some activities to change individual behavior. For instance, in response to new data about the partial bankruptcy of some Pension Systems in many countries and estimated ageing of population, policy makers fast change the regulatory schemes to foster increase of private sector retirement savings. Statistics about population obesity can also prompt impulsive policy makers' proposals to pay vouchers to people willing to commit to a national weight loss program.

Action bias often implies that regulators go on to try to correct government failures originating from unintended consequences of previous regulations. They tend to react with more interventions instead of abandoning the original plan (Tasic 2009). This fits perfectly with Mises' critical account of the dynamics of interventionism (Ikeda 1997). Our suggestion is that behavioral economists engage in experimental studies of action bias among policy makers and nudgers, too. Following (Hayek 1989), we are inclined to suggest that it is worth investigating which institutional settings give rise to action biases that call for growing intervention cycles.

In addition, regulators' behaviors are also sensitive to confirmation bias. Just like all people consider only pieces of information that give support to the factors or issues regarded as the most relevant ones. For instance, airport security regulations in response to terrorist threats are presented as effective to make travelers' lives better. Nevertheless, there are unintended consequences like increase in the costs of flying and leading people to choose alternative means of transportation like driving accompanied with higher risks of accidents with fatal victims.

The above cognitive error can be also called the illusion of explanatory depth and has everything to do with Hayek's discussion of the "pretense of knowledge" and bureaucrats' tendency to mix theoretical with practical knowledge up (Tasic 2009, Tasic 2011). Theoretical knowledge of complex phenomena can only be abstract, in the sense that cannot yield detailed predictions, but only pattern predictions (Hayek 1967) of general characteristics of the object under study. Yet successful regulation requires detailed information about dispersed information. Quite similarly, (Rozenblit and Keil 2002) stress that people overestimate their understanding of complex phenomena and often appeal to superficial knowledge about patterns to draw conclusions about the nature and causal nexus of things in the world.

Regulators tend to believe that they know better the problems with which the targets of the policies face. This is because public officials have more access to information and can draw on behavioral experiments to detect specific cognitive errors that prevent people from behaving optimally. Bureaucrats and policy experts are not immune to the illusion that their knowledge is sufficient to identify some policy bottlenecks and to design regulations that help people behave as if they were fully rational. To complicate matters, some policy issues are emotionally charged and can distort policy makers' judgment and decision-making.

Concluding remarks

Based on insights from Austrian economics, this paper attempts to draw behavioral economists' attention to the fact that the epistemic problem is a non-negligible issue underlying the contemporary debate over nudges. It might be prudent to dig deeper into specificities of institutional environments suggesting under which conditions nudges can(not) deliver what they promise to help individuals make better choices.

Even if policymakers sincerely want to accomplish that, they would have to meet at least four very difficult requirements (Rizzo 2016). The first is to know exactly what constitutes a rational choice to individuals given their own circumstances (instead of imposing to people what bureaucrats decided what it is the best for them based on a welfare economic criterion). Second, regulators would have access to robust pieces of evidence that individuals systematically deviate

from their own standard of rational choice. Third, regulators would be able to design and implement effective policies to de-bias people's behavior in a way that boost their personal deliberative capabilities and do not harm their autonomy, dignity potential for individual learning from mistakes. Finally, policies cannot impose high costs on the nudged people. Yet behaviorally informed policymakers cannot underestimate the fact that it is not that simple to identify what individuals want and what their true preferences are all about. There is always the risk of designing public policies or regulations to change behavior that give rise to unintended consequences, which call for new stages of interventions.

In a nutshell, decisions over nudging are to be made on a case-to-case basis. It requires policy makers to have access to the estimated magnitudes of the costs and benefits involved. Unfortunately, such complex task does not only depend on the reliability of experimental and non-experimental data. It also brings a source of embarrassment since it assumes that a centralized analysis of costs and benefits (made by experts capable of intelligently designing choice architectures that de-bias individuals' behaviors) is better than to promote an institutional environment that expands people's freedoms and human agency. With that concern in mind, we end up with a wise Adam Smith French economist advice:

> There is no need to prove that each individual is the only competent judge of this most advantageous use of his lands and of his labor. He alone has the particular knowledge without which the most enlightened man could only argue blindly. He alone has an experience which is all the more reliable since it is limited to a single object. He learns by repeated trials, by his successes, by his losses, and he acquires a feeling for it which is much more ingenious than the theoretical knowledge of the indifferent observer because it is stimulated by want. (Turgot 2011, p. 109-110)

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