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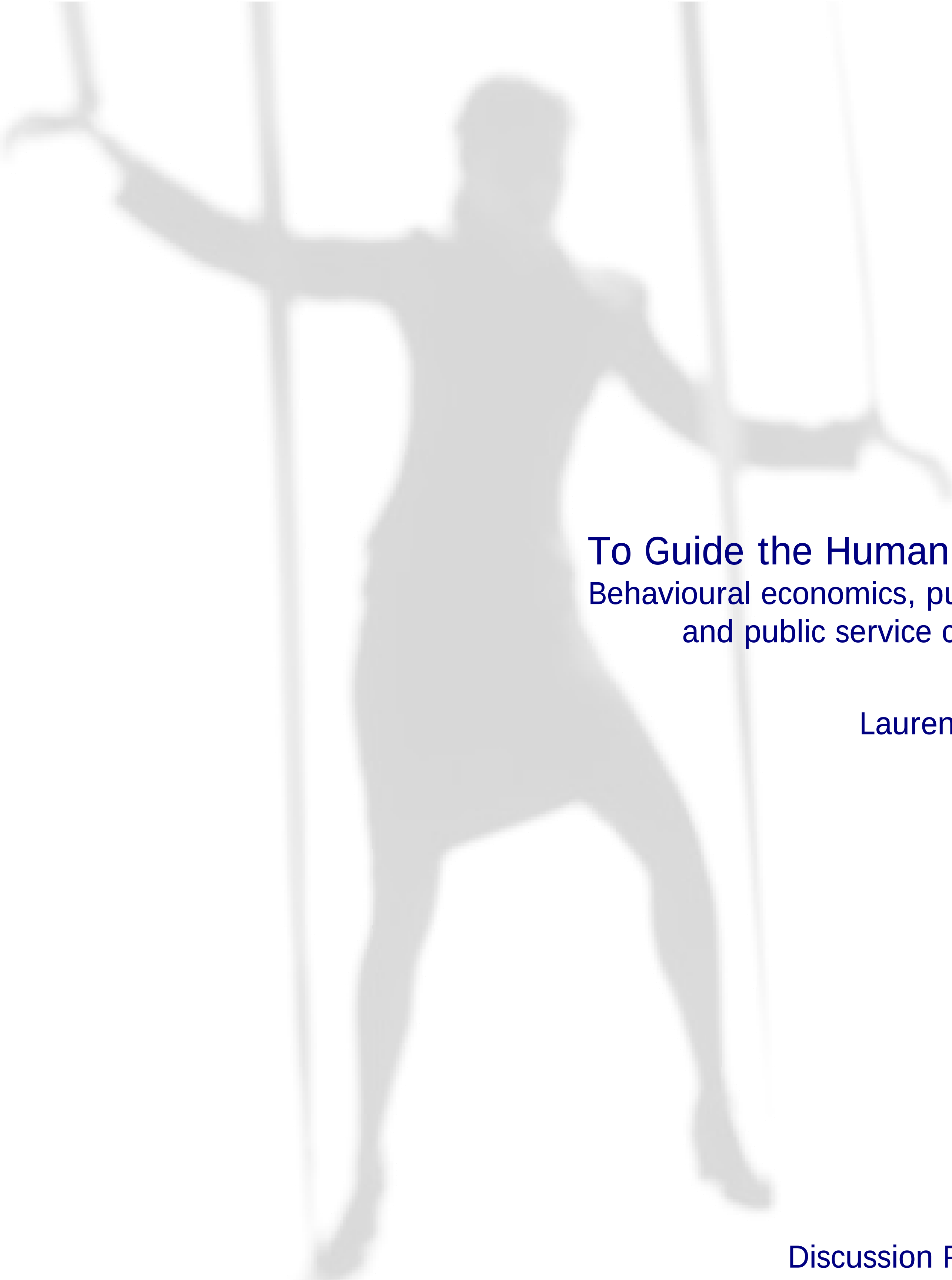

To Guide the Human Puppet:
Behavioural economics, public policy and public service contracting

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Discussion Paper No.3

Behavioural economics is the latest fashion in Westminster and Washington. The Serco Institute explores this new trend and asks what it means for public service contracting.

"To guide the motions of the human puppet, it is necessary to know the wires by which he is moved." ~ Helvetius

The exciting new tool in the policymaker's toolkit is a hybrid created by economists drawing on behavioural psychology, known as 'behavioural economics'. Among those who have shown interest are American Democratic presidential candidate Barack Obama and British Conservative leader David Cameron.

Nudge[1], the book that has popularised behavioural economics and translated it into policy-speak, proposes an attractive way for policymakers to influence decision-making without increasing spending or resorting to 'nannying'. The authors, Thaler and Sunstein, advocate a regulatory architecture that guides the citizen to select a predetermined 'best' option, while leaving alternatives open. Thaler and Sunstein call their approach *libertarian paternalism*, an example of the 'Third Way' language that makes behavioural economics particularly appealing to politicians.

Behavioural Economics

Two propositions unite the diverse strands of behavioural economics: 1) The classical economic assumption of *homo economicus* – a fully rational man capable of processing massive amounts of information to make optimal decisions in his own interest – is not an accurate depiction of human motivation and decision-making; and 2) Taking cognitive biases into account will allow economists to predict patterns of human behaviour more accurately.

Laboratory studies have found that people tend to use simple rules of thumb when making decisions, resulting in systematic judgment errors. Some examples include:

- *"Following the herd"*: we tend to copy those around us.
- *Framing*: the way choices are presented to us often affects the decision we make.
- *Status quo bias*: most of the time, most of us would prefer to stay with the current situation; this means we rarely change pre-selected default settings.
- *Poor computation*: we are poor at calculating probabilities, frequently overestimating the probability of events that are easy to imagine or have taken place recently, while underestimating the likelihood of events that have not transpired for a number of years but that recur at regular intervals.
- *Excessive discounting*: we tend to underestimate the significance of future events, exaggerating the importance of the present.
- *Loss-aversion*: most of us value a loss much more than the equivalent gain.
- *Fairness and reciprocity*: many of us are motivated to 'do the right thing', rather than simply maximising our immediate return when making decisions.

Behavioural economics is not new. David Hume wrote about the human tendency to favour the present over the future; Adam Smith wrote about our disproportionate aversion to loss. Contemporary behavioural economics, however, was born in the 1950s when Herbert A. Simon proposed that economists substitute the existing model of rational man with a more realistic theory of human behaviour that could take into account the level of "access to information and the computational capacities that are actually possessed by organisms".[2] This seminal article opened up an on-going theme of research. For more than fifty years scholars have studied and expanded the list of judgment errors that cause humans to make suboptimal decisions. Much of the research has been theoretical, analysing decision-making under different conditions, such as uncertainty and risk. Some academics have, however, attempted to apply these findings to such diverse areas as consumer behaviour, firm efficiency and investment banking.

Politicians and policymakers have long recognised that people do not always make decisions that are in their best interest over the long term and have tailored their interventions with this in mind. Mandatory cooling off periods for major purchases, baby bonuses and tobacco taxes are examples of policies based squarely on this assumption. Some have described this as reflecting an "implicit knowledge of behavioural economics"; others might refer to it as common sense.[3]

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What has changed recently is that a small group of academic economists have tried to make their theories relevant to decision-makers. There appear to have been two serious attempts to do this, both published for the first time in 2003. The first advocated a framework called *asymmetric paternalism*. The idea is that a majority of people are not fully rational and sometimes make poor decisions. The government should intervene on behalf of these people by restricting their actions so that they are guided toward the 'best' option. However, the government should weigh the benefit to these 'boundedly rational' people against the cost of restricting the freedom of those who are more rational. Only when there are net benefits to society from intervention should a policy be pursued.[4] The second article argued simply that "it is both possible and legitimate for private and public institutions to affect behavior while also respecting freedom of choice." The authors called this approach *libertarian paternalism*.[5]

One study of how libertarian paternalism might nudge people toward socially-desirable outcomes was carried out in San Marcos, California. Researchers found that when households were informed of how much energy they were consuming compared to the average household in their neighbourhood, those consuming more than average cut back while those consuming less used more. However, when a smiley face was put next to a lower than average figure, those households consuming less maintained their lower level of consumption.[6] This study used a small sample of less than three hundred households, but the Conservative Party in Britain has already pledged that it would make this kind of disclosure a requirement for energy suppliers should it win the next election.[7] Interestingly, this study was not done in isolation. The Design Council in Britain conducted research in 2005 which, while not directly referencing behavioural economics, drew on many of its concepts such as harnessing social norms by comparing the energy consumption of identical houses.[8]

Critique

Critics of behavioural economics and its application to policymaking raise several objections. For academics, one important qualification is that many of the ideas have only been tested in the laboratory. Moreover, nearly all the subjects of these experiments have been university students and, as one scholar noted, "while there are cultural differences among student populations throughout the world, these differences are small compared to the range of all social and cultural environments."[9] Given the lack of 'real world' evidence, it is unclear whether psychological models would be better to underpin policymaking than the assumption of self-maximisation.[10]

Some argue that libertarian paternalism may be a slippery slope that leads inexorably to outright prohibitions and mandates. If nudging fails to achieve all that was expected, there may be a temptation to start shoving. Worse, libertarian paternalism risks being misunderstood by policymakers. The chairman of Health England was attacked in the press over a proposal that smokers be required to opt-in to smoking each year by buying a £10 license with paperwork intentionally designed to be complex.[11]

How are policymakers to decide in which direction to nudge? Thaler and Sunstein insist that the state should influence citizens' choices for the better as judged by the citizens themselves.[12] The problem is that preferences are neither fixed nor predictable, leaving discretion in the hands of professional policymakers. In this sense, libertarian paternalism is open to the same criticism as old-fashioned paternalism – it involves one small section of society deciding what is best for the rest.

As a result, there are certain areas in which even a gentle nudge may be unwelcome. Mandatory waiting periods before weddings have been recommended to reduce the number of people who get married on an impulse and later regret it. However, one journalist objected: "It is hard to see why this is any business of the state. Our frailties may often be irrational, but they remain ours."[13]

Finally, libertarian paternalism is built on the unrealistic assumption that politicians and policymakers are themselves perfectly rational, unaffected by herding behaviours or excessive discounting. In addition, this approach assumes that policymakers always make decisions with a view to maximising the public good. The field of public choice economics, which is dedicated to the proposition that policymakers are sometimes motivated by personal gain, lends weight to this criticism.

Nudging by contract

There is one area of public administration where nudging has been developed into a science over many decades. Behavioural economists could learn much from public service contracting, where incentives have long been employed to encourage providers to deliver desired outcomes. Indeed, the history of contracting is rich in its experience both of successful performance regimes and perverse incentives that have resulted in unintended outcomes.

At the same time, there may be lessons that commissioners and contractors can learn from behavioural economics. It has been argued, for example, that financial incentives framed as rewards are more effective than those designed as penalties.[14] It appears that by changing the way in which the incentive is framed, the client changes the reference point by which the contractor judges whether actions are hostile or friendly, which affects the way in which she decides to reciprocate.[15]

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While financial incentives are important, it is also clear that no contract for a complex service can ensure compliance by means of such incentives alone.[16] The behaviour of some contractors and their staff in delivering public services suggests the existence of non-financial motivations.[17] Classical economics has difficulty explaining this phenomenon since self-maximising individuals are thought to respond only to financial or reputational incentives. Behavioural economics, however, suggests that people can be 'intrinsically' motivated; this is especially apparent in front-line public service providers who may have personal or professional reasons for providing exceptional service.[18] Research indicates that in some circumstances, explicit financial incentives may 'crowd-out' intrinsic motivation, undermining voluntary cooperation with the client. In some cases, this crowding-out effect is so strong that a fixed-price contract may be more efficient than an incentive contract.[19]

Other studies have demonstrated the importance of perceived fairness. A contractor who believes a contract is fair may provide better service than one who thinks the client is behaving unreasonably.[20]

Research on employment contracts has identified what has been called the 'psychological contract'. Quite apart from what the written contract may say, theorists have suggested that there is an implicit contract between the parties, built on a bond of reciprocal good faith between contractor and client. If the contractor believes this implicit agreement has been breached, then she is less likely to reciprocate and more likely to work to the letter of the contract.[21]

Conclusion

Behavioural economics is the flavour of the month and is likely to remain prominent in public discourse in the near future. Many of the insights of behavioural economics are not new; however, policymakers must welcome the analysis and debate that has accompanied the popularisation of academic research that would otherwise have remained largely inaccessible. The danger lies in relying too heavily on popular accounts of unfamiliar policy interventions where the consequences are not well understood. Even in the field of public service contracting, where there is now a wealth of experience with the science of 'nudge', the conditions for success and failure are not always predictable, and much of the accumulated wisdom rests with practitioners making incremental improvements at the front line. Behavioural economics might learn from this history of trial-and-error rather than relying so heavily on laboratory results.

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3 Ian McAuley, "Behavioural Economics and Public Policy: Some Insights," *University of Canberra* Working Paper February 2007: 3 <www.home.netspeed.com.au/mcau/academic/bepubpol.pdf>.
4 Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O'Donoghue and Matthew Rabin, "Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"," *University of Pennsylvania Law Review* 3 (2003): 1219.
5 Cass R. Sunstein and Richard H. Thaler, "Libertarian Paternalism Is Not an Oxymoron," *The University of Chicago Law Review* 4 (2003): 1159. In 2008 when the same authors published *Nudge*, they argued that libertarian paternalism was a kind of asymmetric paternalism "in which the costs imposed on the sophisticated user are kept close to zero." (Thaler and Sunstein (2008): 249.)
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13 Richard Reeves, "Why a nudge from the state beats a slap," *The Observer* 20 July 2008 <http://www.guardian.co.uk/books/2008/jul/20/politics.society1>.
14 Ernst Fehr and Simon Gächter, "Do Incentive Contracts Undermine Voluntary Cooperation?" *Institute for Empirical Research in Economics* Working Paper No. 34 (2002): 1.
15 *Ibid.*
16 Debra Maynard, "The lessons of behavioural economics," *Australian Graduate School of Management Magazine* 2 (2003): 16 <http://www2.agsm.edu.au/agsm/web.nsf/Content/AGSMMagazine-behaviouraleconomics/$FILE/03_Iss2_Res_BehaviouralEconomics_p16-19.pdf>.
17 See, for example, Megan Mathias and Briony Smith, *HMYOI Ashfield – the Health Service Case Study* (London: The Serco Institute, 2007): 12.
18 Briony Smith, *What Gets Measured: Contracting for Delivery* (London: The Serco Institute, 2007): 11-12.
19 Fehr and Gächter (2002): 1.
20 Bruno S. Frey, *Inspiring Economics: Human Motivation in Political Economy* (Cheltenham: Edward Elgar, 2001): 91.
21 *Ibid*. See also Neil Conway and Rob B. Briner, *Understanding Psychological Contracts at Work: A Critical Evaluation of Theory and Research* (Oxford: Oxford University Press, 2005): 63-88.