PUTTING HAYEK, BEHAVIORAL ECONOMICS AND PUBLIC CHOICE THEORY TOGETHER:

Remarks about the pros and cons of nudge paternalism to construct a rational order

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ABSTRACT

This article attempts to examine whether and how public choice theory, behavioral economics and a Hayekian approach to knowledge can be integrated so as to better inform us about the prospects of nudging and libertarian paternalism in a world where fallible knowledge and incomplete contracts seem to be pervasive phenomena (Sunstein 2014). Our contention is that, by putting together the foregoing approaches, we can have a more systematic account of the limits and objections to behaviorally informed regulation and paternalistic intervention, which purports to construct a rational order. Following Hayek (1945), we argue for the idea that the main problem is that policy makers tend to underestimate “the importance of the knowledge of the particular circumstances of time and place.”

The paper is organized as follows. Section 1 scrutinizes the behavioral approach to policy. It embarks on a critical assessment of the pros and cons of nudging and the dangers of particular choice architectures. Section 2 presents some Public Choice contributions in order to shed extra light on the fact that some of the cognitive biases detected in the behavioral economics literature also pervade judgment and decision-making among choice architects or nudgers. We argue that integrating behavioral economics with public choice economics make researchers even more skeptical about the prospects of nudge interventions, since they give room for government failures (Tullock et al 2005. Tasic. 2011, Lodge and Wegrich 2014, World Bank 2015). Section 3 analyzes whether Hayekian theory can be useful to think over libertarian paternalism and some of its unintended consequences. Section 4 sketches some features of a framework to assess critically nudge proposals. It goes on to wrap the overall argument up and concludes.

Keywords: behavioral economics, public choice, Hayekian economics, paternalism, nudge

JEL Classification: B 40; B41; D11; D91
Introduction

Behavioral Economics and its empirical applications to development policy and regulation has increased its popularity in the 21st century (Camerer et al. 2003, Thaler and Sunstein 2003; Barr, Mullanaithan and Shafir 2008; Thaler and Sunstein 2009; Sunstein 2011). Last year the so-called behavioral approach to policy gained extra appeal after the publication of the World Development Report “Mind, Society and Behavior” as well as U.S President Obama’s White House Executive Order that established the Social and Behavioral Sciences Team (SBST). The latter consists of a group of experts in applied behavioral science that translates findings and methods from the social and behavioral sciences into improvements in Federal policies and programs “to better serve the American people” (p.1).

In his Richard T. Ely Lecture for the American Economic Association, Harvard economist Raj Chetty 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 (Chetty 2015). To him, these tools for designing policies are subtle interventions that might improve policy outcomes and help individuals to pursue what it is in their best interests.

The foregoing line of argument is built on the idea that behaviorally informed policies de-bias individual’s biased judgments and choices and therefore enable policy makers and regulators to design and implement a rational order.

This paper attempts to examine whether and how public choice theory, behavioral economics and a Hayekian approach to knowledge can be integrated so as to better inform us about the prospects of nudging and libertarian paternalism in a world where fallible knowledge and incomplete contracts seem to be pervasive phenomena (Sunstein 2014). Our contention is that, by putting together the foregoing approaches, we can have a more systematic account of the limits and objections to behaviorally informed regulation and paternalistic intervention, which purports to construct a rational order. Following Hayek (1945), we argue for the idea that the main problem is that policy makers tend to underestimate “the importance of the knowledge of the particular circumstances of time and place.”

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framework to assess critically nudge proposals. It goes on to wrap the overall argument up and concludes.

1. The behavioral economics approach to policy

This section scrutinizes the main claims that justify a behavioral approach to policy, how bounded rationality relates to the pros and cons of nudging people’s behavior and what normative implications these complex issues carry.

1.1 Bounded rationality and the call for nudges

Bounded rationality had become a quite popular concept in the economics literature. Herbert Simon coined the term in the early 1950s to provide an alternative to the neoclassical approach to human behavior, which depends on very unrealistic psychological assumptions. According to him, human thinking and decision-making refer to complex phenomena (Simon 1992). In response to that, specialized heuristics or mental shortcuts have evolved to enable bounded rational agents to overcome constraints posed by their own computational powers and informational structure of the (natural as well as social) environments and therefore to allow for automatic judgments and choices (Gigerenzer and Selten 2001).

Interestingly enough, the concept of bounded rationality has been used quite differently. Sometimes it refers to (a) optimization under cognitive and emotional constraints, (b) irrational or suboptimal behaviors triggered by heuristics that bias probability judgments and choices, and (c) adaptive framework of fast and frugal heuristics (Gigerenzer et al 1999, Muramatsu and Hanoch 2005, for instance).

Contemporary literature on behavioral economics that has been lately invoked to inspire development programs, regulatory policies and welfare debates is largely inspired by Daniel Kahneman’s systems 1 and 2 map of bounded rationality (Kahneman 2003, among others).

This is premised on the idea that Homo sapiens has scarce cognitive powers, such as attention and memory. In response to the fact that information has distinct accessibility depending on the structure of the environment, the human brain has evolved with two information-processing modes. System 1 refers to human perception and intuition and is responsible for activation of fast, parallel, automatic, effortless, associative, and emotional mental processes. System 2 refers to reasoning that is accompanied by slow, controlled, effortful, rule-governed and emotionally neutral (higher order cognitive) processes (Kahneman 2013). Under particular information-processing tasks, both modes can be jointly activated to guide our thinking and decision-making capabilities. However, one can expect that system 1 is activated when agents face tasks that are regarded automatically as urgent or emotionally laden, such as responding to a dangerous situation or making inferences about people’s feelings. Slow thinking (system 2) or the reasoning mode in turn becomes relevant to enable individuals to resolve complex tasks, such as to prove a mathematical theorem. One advantage of system 1 is that it narrows our perception down so as to bring about
immediate behaviors, whereas system 2 is useful to calibrate emotional processing and to foster optimal outcomes because it accommodates a wide frame.

The foregoing dual portrait of human thinking allows for the conclusion that automatic judgment and decision-making underlying system 1 depends largely on mental shortcuts or rules of thumb 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. To illustrate, take the so-called availability heuristic. Such mental shortcut enables individuals to draw probability inferences based on what it comes to mind more vividly. Some rules of thumb suggest that under particular circumstances people do not change their behavior as if they followed automatically a default rule or status quo.

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 (Kahneman and Tversky 1974, Kahneman 2013). 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). At the core of Prospect Theory – the behavioral explanation of decision under risk – is the empirically grounded view that losses loom larger than gains (loss aversion effect) and that people value more highly to give up something they have than to get something else they are willing to get (endowment effect).

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 et al 2002. The latter is a mathematically tractable way of representing experimental evidence that discount rates decrease with time horizon, i.e., individuals prefer $100 now to $110 tomorrow but $110 in 31 days. Hyperbolic discounting implies that people have difficulty waiting for a higher delayed gratification when they have the chance to have an immediate (though lower) gain, while they can commit to the future more easily when both choice options yield gains in the future. This issue has received much attention among policy makers interested in detecting contexts in which individual intentions and action differ (Datta and Mullanaithan 2014).

It is important to stress that behavioral economics assumes that specificities of the social environment also shape thinking and decision-making of boundedly rational individuals that often deviate from predictions made by textbook neoclassical economics.
The foregoing sources of bounded rationality (and their individual as well as social welfare consequences) motivate a growing number of behavioral researchers to argue for designed choice architectures and default options that purport to help individuals overcome their cognitive limitations and achieve what it is best for them.


Based on field studies about retirement savings at the turn of the 21st century accompanied with casual observation about the impacts of choice frames and default rules on actual people’s behavior, the debate about the catch-all term nudge and libertarian paternalism gained its momentum and attracted political leaders worldwide (Thaler and Sunstein 2003, Thaler and Benartzi 2007).

Nudges are mild and choice preserving interventions that steer people’s behavior in direction of their own long-term goals. According to Thaler and Sunstein, 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. In what follows, we scrutinize reasons for nudging and some non-negligible objections to it.

1.2 Pros and cons of nudges and the so-called light “libertarian” paternalism

There are suboptimal decisions of economic relevance. Contemporary societies deal with many puzzles in the domains of savings, health, education, household finance, among others that call for behavior changes (World Bank 2015) or small interventions to steer people in ways that are in their own best interests.

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. As said, nudges serve to help boundedly rational people pursue and achieve what it is the best for themselves. Putting the issue somewhat different, nudges purport to de-bias people’s behaviors. In such perspective, individual as well as social welfare losses that accompany suboptimal heuristic-driven judgments and decision-making in particular contexts justify interventions. As a result, behavioral economists try to identify opportunities for improving human welfare through creative new choice architectures.

It is important to stress that nudges are justified in terms of the normative implications of the behavioral economic 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.

According to Sunstein (2014), 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. There are various forms of nudging and choice architecture. Some types of nudges are: (i) disclosure of information (for instance, details about the actual credit card rates and consequences of making minimum payments) and (ii) warnings and reminders (information about the benefits and costs of sticking to savings plans and eating healthy or stop smoking or drinking heavily). In addition, Sunstein also argues for nudging paternalistic interventions that help individuals to overcome two important bounds of human rationality - limited cognitive powers and willpower.

Thaler and Sunstein provide evidence that boundedly rational agents exhibit patterns of behavior resulting from the power of suggestion and default options. 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. This is because individuals can opt out of their retirement savings plans whenever they want to (Thaler 2007).

Experimental designs that shed light on the impact of default options (with welfare policy implications) abound. For instance, behavioral development economists encountered evidence that default options, lack of attention and scarcity of understanding partly explain why many mothers in developing world do not use ORS (oral rehydration solution) that can prevent children from dying of diarrhea (Datta and Mullanaithan 2014).

According to Ajuha, Kremer and Swane, home water treatment is a very complex decision task in many developing countries (Ajuha et al 2010, World Bank 2015). They designed a choice architecture drawing on the idea that it is not enough to inform people about the health benefits of water chlorination. Their randomized field experiment tested the hypothesis that the most cost-effective choice architecture would be to make people use chlorine automatically. Their studies suggested that providing free chlorine dispensers in a Kenyan village well that dispensed the proper amount of chlorine each time at the press of a button made things simpler to people decide over water treatment. To them, many people who knew the advantages of chlorine and had access to chlorine tablets simply forgot to use it. They found that in households with dispensers, the take up rate of the water treatment program was 60%, whereas the control group (those who had to make active choices over water chlorination via the use of chlorine tablets available to them) only had 7% take up rate. In a few words, default options also add to our understanding of why it is not effective to give chlorine tablets to help people fight against water-borne diseases.

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. With this in mind, some development programs inspire the design of microcredit, savings and insurance products or services (Armendáriz and Morduch 2010).

In a recent New York Times article, Thaler (2015) suggest that good nudges are transparent and easy to opt out. More fundamentally, such mild and choice preserving interventions aim to encourage improvements in individual as well as social welfare. Nudges are useful to enable agents to achieve their own and society’s long-term goals. We are not yet convinced that this is necessarily so at all. Furthermore, it is not clear whether and why some of the following sources of objections to nudges are pointless and incoherent. On the contrary, it is worth scrutinizing them.

The first source of criticism appeals to the (ethical) values of freedom of choice and autonomy (Sugden 2005, Klick and Mitchel 2006). Some designed choice architectures go beyond reminders and information disclosure. In response to obesity, a growing number of public as well as private companies in the USA and UK are requiring their employees to lose weight and to become more active. Some firms’ wellness programs try to promote behavior changes by weight loss diets and systematic biometric measures. At first sight, such moves are voluntary and therefore do not harm people’s autonomy. Rather, they provide ways to improve health savings by making some decisions automatic. However, some employers are not only using the carrot approach but also that of the stick that punishes workers if they do not join the program or fail to commit to the healthy plan. Some British and North American companies - like Lafarge U.S. (a big supplier of construction materials in the U.S. and Canada) - provide a voluntary health screening and coaching program. Employees who participate are rewarded, whereas those who do not have constrained choices to choose over company-sponsored health insurance plans. Despite the voluntary nature of the health program and of its opt-out clause, it is not clear whether this instance of nudge threaten individual perceived well-being and her autonomy. In addition, some of these programs make subtle use of peer pressure and social emotions that can undermine individual’s liberty.

A second critical remark concerns the constraints that nudge paternalism put on individuals’ learning potential and might even hurt people’s dignity (Sunstein 2014). Interventions are necessary because boundedly rational agents fail to pursue their true long-term preferences and this prevents them from achieving what it is the best for themselves. This view presupposes that the regulators play the role of removing people’s blunders. The question is that whether policy makers can achieve such task. To complicate matters, nudging is accompanied with a crowding out effect resulting from people’s increased difficulty with learning from their own mistakes, which in turn gives room for other stages of paternalistic interventions. Moreover, transaction costs tend to be higher since the targets of some nudge policies turn out to be treated and
regarded as infants, who ought to be protected from themselves. When this turns out to be the case, strong paternalism gains some appeal among some pressure groups.

The above criticism deserves our attention, since some small interventions to steer people in certain directions cannot last forever. Furthermore, there are doubts about whether nudges are effective to change behavior in the long term. To complicate matters, nudges might challenge individual’s values of autonomy and dignity by constraining an agent’s potential for learning. According to the philosopher Mark White,

> Nudges are ultimately counterproductive, particularly in terms of our decision-making abilities. It turns out that nudges are a lot like the adage about giving a man a fish versus teaching him to fish: even if nudges lead to better choices, they don’t help us to learn to make better choices in the future (White 2013, p.102)

A third criticism relates to the fact that private and public nudgers are also boundedly rational and therefore it is not clear whether they can have enough information to come up with a choice architecture conducive to what people judge in tune with their true preferences. In this case, a defense of human autonomy and criticism of paternalism can be justified by the recognition that human knowledge is fragmented, limited and therefore fallible (Rizzo and Whitman 2009b).

Public or private nudgers may not have the same information and incentives as those of individuals whose decision-making behaviors designed choice architecture try to influence. Edward Glaeser (2006) emphasizes that ‘who the planner is’ matters for the type of design and assessment of its welfare outcomes. Furthermore, nudgers are not clearly disinterested parties. Moreover, it is not necessarily true that experts’ decisions are cold and rational.

If this is so, interferences with individual freedom of choice might lead to unintended as well as intentional negative consequences that amplify government and market failures.

Finally, manipulation of choice is an important ethical objection to nudging and choice architecture. Changing automatically default rules, rearranging choice alternatives rather than using subsidies or taxes to influence people’s behavior is worrisome to the extent that they reveal a covert or manipulative nature (White 2013). In her book *Against Autonomy*, philosopher Sarah Conly claims:

> Libertarian paternalism is manipulative. That is, it does not suggest that we engage in free and open discussion in order to rationally persuade you to change your ways...The point of nudge is to push you in ways that bypass your reasoning...they use your cognitive biases, like your tendency to go with the default option, to bring about good effects (Conly 2013)

This type of criticism sensitizes and worries even proponents of nudge paternalism. Interventions that involve manipulation are coercive and intrude on the values of individual freedom and autonomy. This is because agents cannot really exercise their judgment and decision-making powers. A manipulative intervention does not fit well with Sunstein’s view of nudge as a type of GPS. Any type of intervention that
deliberately influences behavior unconsciously or subconsciously seems to be ethically objectionable regardless of its welfare consequences.

One example of problematic behavioral design is some increasingly popular health and education programs in which people receive monetary rewards to do things that increase their quality of life in the future, such as improving their own student academic performance, making use of preventive health services, and so forth (World Bank, 2015). It is important to stress that the foregoing paternalistic interventions presuppose that people are unable to make choices alone that are good for them. In response to that, policy makers or regulators design choice architectures that purport to destroy some behavioral bottlenecks just like loss aversion and myopia. However, it is hard to know whether few cognitive biases detected in randomized field experiments are enough to explain behaviors among heterogeneous agents.

In the following sections, we will integrate many of these doubts about the desirability of steering behavior in an institutionalist approach that uses insights from public choice and Austrian traditions.

1.3 Field experiments as new prospects for behavioral policy design and testing

Despite the troubling issues of nudging proposals, behavioral insights are useful to improve our understanding of why certain policies and regulations fail. Behavioral researchers claim that policy effectiveness depends on the assumptions made about human judgments and decisions. The main conjecture is that insights from behavioral economics help to explain some regulation problems and some reasons why policies might fail. To the best of our knowledge, there is also room for exploring the potential of behavioral economics to improve our understanding of why and under what contexts individuals, markets and governments fail, in order to help to develop an analytical point of view that compares the relative merits of alternative sets of institutions.

Until now, most behavioral applications concentrate on some cognitive blunders and context dependencies that prevent people from translating their intentions into actions. This leads to policy recommendations based on the premise that designed interventions can help the targets of policies achieve optimal outcomes. According to Datta and Mullanaithan (2014), a behavioral perspective on policy deals with three main issues: (a) diagnosis or finding behavioral bottlenecks, (b) design or deciding over a way to intervene to resolve a particular problem, and (c) test and redesign of a particular choice architecture.

Based on experimental evidence about the relevance of heuristics and biases, the behavioral approach purports to change standard interpretations of some policy problems. One famous example in the literature on behavioral development economics is the phenomenon of fertilizer use. Despite the productivity gains, African farmers use very little (if any) fertilizer. A standard account of why this happens is in terms of unavailability of fertilizer or its high costs. Another refers to the fact that farmers do not know about the increased yields associated with fertilizer use.
Esther Duflo and her collaborators design field experiments suggesting that farmers do not use fertilizer even when it is available to them or even they can afford it and know about the higher future revenue resulting from land fertilization (Duflo et al 2011). Researchers find out that 66% of farmer in Kenya want to use fertilizer on their fields but fail to meet their plans. This behavioral pattern inspires the conjecture that procrastination (hyperbolic discounting) and self-control problem explain the time-inconsistent behavior.

In response to that, Esther Duflo and her team designed some experiments that test ways to nudge Kenyan farmers to use fertilizer. In one of the designs, they created a fertilizer voucher that served as a credible commitment to fertilizer purchases. This is because producers had the chance to buy the voucher after the maize harvest (when they had cash on hand). They found that those who opted for the voucher did use fertilizer at the subsequent moment where land fertilization was to happen. They also tested the idea that traveling to town involved some costs that made farmers to postpone fertilizer purchases and uses. Duflo and collaborators found out that home delivery raises fertilizer use by 70 percent. In addition, they designed and tested an intervention to de-bias farmers’ tendency towards procrastination by creating a fertilizer savings account. The latter kept farmers’ money “protected” during the long period between harvest and planting. The group of farmers given this option bought and used much more fertilizer than the control group (Duflo et al. 2011).

The foregoing results give extra support to the view that economic experiments give interesting insights for guiding agent-based policy-making. Furthermore, they bring the promise that it is possible for researchers to design intelligent interventions that de-bias individuals’ cognitive blunders and make them achieve those optimal outcomes predicted by rational choice theory.

Yet the behavioral approach seems to underestimate the fact that regulators and policy makers also have biased judgments and decisions. This might be so because of their illusion of control and overconfidence.

As Lord Bauer pointed out long time ago (Dorn & Mitra, 2009), based on his field studies, it is simply not true that western development experts have superior understanding of the situation of poor communities in Africa or India to that of the individual targets of their programs and policies.

The phenomena identified by the behavioral approach, which uncover deviations from the standard of rationality defined by traditional economic theory, in fact exist and give rise to suboptimal choices. However, mere identification of these biased phenomena, accompanied by discussion of their frequency and magnitude, is not enough to conclude that nudge policies are inevitable, beneficial and any objection to them are incoherent.

It seems to us that the behavioral approach had better avoid one of the biggest mistakes that marked the development of economic theory over the twentieth century - evaluation of concrete situations in terms of their proximity to ideal types derived from purely abstract models. The latter inevitably disregard alternative real word alternatives. For instance, economists evaluate market competition in terms of its
capacity to achieve efficient allocations according to the Paretian criterion, derived from equilibrium analysis.

To our minds, the foregoing type of behaviorally informed evaluation, characteristic of what Demsetz (1969) calls "Nirvana approach," deserves extra critical assessment in order to avoid a debatable comparison between idealized assumptions of individual time preferences underlying standard economic theory, for example, with the complex reality of heterogeneous agents in the real markets.

Instead, we suggest that behavioral experiments favor comparison between alternative institutional arrangements and their impacts of people’s actual choices and their transactions.

In the following two sections, we attempt to explain why, after the initial enthusiasm generated by the idea of nudge, the recent literature on the subject scrutinize more critically the potential and existing shortcomings of policy design, implementation and evaluation inspired by the behavioral approach. In order to accomplish the task, we first appeal to Public Choice Theory and subsequently to a Hayekian approach to knowledge to suggest that externalities and public goods, often regarded as market failures, do not make a non-disputable justification for government regulation and the recent overselling of nudge paternalism. Quite on the contrary, we argue for the idea that integrating behavioral economics with Public Choice theory and the Hayekian approach shed extra light on amplification of government failures.

2. Public Choice Theory: why applying economic reasoning to political processes improves our understanding of regulation

Public choice is a framework that draws on insights of economics to account for “the behavior of individuals with respect to government” (Tullock et al 2002, p. 3). More specifically it assumes that “people are people” and therefore are actuated by their own self-interest. This implies the view that individual voters, politicians, regulators are just like voters and consumers who exhibit different behavioral outcomes because of the incentives they have under contexts of public and private choices. In Phillip Booth’s words:

“At one level, Public Choice economics simply asks us to make the same assumptions about human behavior in the political sphere as we make when we analyze markets (...) The self-interest operating in the political system will lead to government failure which can be more serious than market failure because of the coercive power that government exercises and because government is not subject to a direct competitive process.” (Foreword of Butler 2012, p. 12)

To put it more succinctly, Public Choice Theory (also dubbed Political Economics) aims to approximate Homo politicus with Homo economicus so as to challenge the debatable view that individuals within the markets make private choices more self-interestedly than policy makers, bureaucrats and regulators often taken as motivated by other-regarding or social preferences to make collective choices.
It is important to stress that research in Public Choice is not committed to folk wisdom suggesting that bureaucrats and their government policies and small interventions are required to avoid some market failures and welfare losses resulting from individuals’ cognitive biases and asymmetric information. Even though the traditional literature on political economics assumes that individuals under private or public choice settings are rational, experimental findings from behavioral economics - often invoked strategically to legitimize nudges and designed choice architectures – also apply to judgments and decisions among policy makers or regulators. As consequence, regulatory schemes and government interventions might not overcome individual cognitive biases and anomalies. Rather they institutionalize them and create new demands for stronger paternalistic moves. (Viscusi and Gayer 2015).

2.1 Room for Behavioral Public Choice?

In his analysis of articles in Behavioral Economics, Niclas Berggren (2012) argues for the rise of Behavioral Political Economics. This is because only “95.5% of the articles that contain a policy recommendation (64 articles), no behavioral analysis of policymakers is included.”

Like him, we claim that integrating behavioral economics with public choice theory is useful to rethink overselling of nudges and their unintended consequences, such as amplified government failures and severe challenges to important ethical values, such as autonomy, respect and freedom as absence from manipulation.

2.2 Biases to amplify government failures and implications

Standard Public Choice Theory assumes that voters are rational agents that put little effort in processing information about Politics. This is partly so because self-interested voters weigh the marginal costs and benefits of participation in the political sphere. Rational voters learn that there is a low probability that their single vote can be decisive for an election. In addition, voters learn that government failures like rent-seeking and capture emerge because of the fact that benefits are concentrated and costs dispersed in political choice contexts. Yet Public Choice theory fails to explain why voting behavior is an empirical regularity.

2.2.1 Social preferences, framing effects and voting behavior

Behavioral Public Choice draws on experimental evidence that individuals think “socially”, in other words, their judgments and decisions are also sensitive to social preferences and norms (World Bank 2015). Such development in the literature deviates from the simplifying assumptions underlying Public Choice Theory that voters are solely driven by their self-interest. In the 1950s, Downs and Samuelson detected some social determinants of voting behavior (Downs 1957, Samuelson 1954).
In a very interesting experiment, Quatrone and Tversky (1988) tested the voters’ illusion hypothesis. They suggest that many people vote because they believe that their choices influence other people with similar political orientation to do the same and this makes their individual vote somehow decisive. Quatrone and Tversky claim that this is due to some confirmation bias and voters’ difficulty with distinguishing correlation from causality.

Framing effects and perceived contexts of relative losses and gains also explain voters’ approval of some policies and regulations, such as conditional cash transfers or minimum wage laws. According to Chong and Druckman (2007), politicians know that approval of a particular labor policy depends on whether it is presented as a way to promote higher employment or lower unemployment (Schnellenbach and Schubert 2015).

2.2.2 Behavioral determinants of politicians’ behavior

The traditional literature of Public Choice Theory has the merit of representing government officials’ behavior in a less idealized way since they are just like other individuals pursuing in their interests. Due to the asymmetric information pervading the political spheres and voters’ rational ignorance, government failures (corruption, rent-seeking activities and regulatory capture) are phenomena predictable by the economic approach to politics, Public Choice. In response to that, political economics propose transparency and accountability for self-interested politicians and regulators to alter their incentives to behave cooperatively and avoid cheating voters.

One way to control opportunism among public officials is to engage in disclosure of information and to establish a punishment to discourage some patterns of behavior. However, insights from behavioral economics incorporated in Public Choice theory can inform us why this is not enough to promote cooperation. Some experimentalists like Aldo Rustichini have found that monetary incentives are not enough to change people’s perception of their incentives. For instance, imposing a fine to prevent from morally debatable behavior does not seem all the way effective. This is because agents are heterogeneous and some of them might regard the fine as the price to be paid for opportunistic or immoral behavior (Gneezy and Rustichini 2000). In addition, establishing monetary costs on unwanted behavior also brings some unintended consequences, such as the crowding out effect that involves intrinsic and extrinsic motivations among public officials and government representatives. In addition, politicians’ judgments and decisions are not cleansed from emotional influences, which might also bring social benefits and costs (Winden 2015).

2.2.3 Heuristics and Biases among government officials, politicians and regulators

Public Choice theory contributed a lot for improving the quality of the debate over public policy. Even though behavioral economics promises to provide an approach to
Policy-making and regulation that is agent-based and eventually accompanied with low-cost effective designs, our exercise to put together Public Choice economics and behavioral insights is built on the premise that bureaucrats, policy makers and development professionals are also boundedly rational and not immune to cognitive errors. As a result, some heuristics and biases among nudgers can amplify rather than minimize government failures and interventions that call for other stages of regulation and control of individual behavior. Of course, all these issues amount to an empirical matter. What we try to do is to briefly discuss some examples of heuristics and biases among policy makers and regulators.

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 and found the same results, since in the context of perceived gain 75 percent of World Bank staff preferred sure gain, whereas in a frame of relative loss, 66% preferred a lottery and 34 percent opted for certainty (sure loss). It is important to stress that the policy alternatives are equivalent.

According to Tasic (2011), there are some types of regulatory errors resulting from policy makers’ limited cognitive powers. One is called action bias. It refers to the human difficulty in representing and reacting to perceived risks and uncertainties. It is likely that some decision to regulate some activities to change individual behaviors is a result of some political pressure and some impulsive reactions it triggers. 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.

Confirmation bias is also a popular biased judgment among regulators. It suggests that policy makers 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 were presented as effective to make travelers’ lives better. Nevertheless, there were some 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.

2.3 Consequences for the debate over government failures in nudge regulation

Provided contexts play a major role in decision-making in economic as well as political domains, we presume that some policy makers respond to some political incentives that make them to opt for some policies that can promote special groups and to enhance their political bargaining power. As a result, there is more room for government failures especially when nudges are presented to fit well with a political agenda that purports to create low-cost effective policies and regulations based on the
presumption that regulators know better to help boundedly rational people achieve their goals. Such asymmetric position in which nudgers put themselves give room for increasing illusion of explanatory depth, proliferation of vested interests, rent-seeking activities and opportunities for extra regulation. In this case, behavioral policies uninformed by public choice theory face the risk of becoming unable to deal with what Martin Lodge and Kai Wegrich (2016) called the rationality paradox of nudge. As they wisely put it:

“What is specific about nudge is that this is an approach that emphasizes bounded rationality but does little to acknowledge these limitations in its own approach” (Lodge and Wegrich 2016, p. X)

Quite similarly, Rizzo and Whitmann (2009a) argue that even with rational public policy makers, proposals for libertarian paternalism can result in long-term restrictions of freedom, thus negating the desired libertarian character by their formulators. If we take into account that the regulations do not occur in an institutional vacuum, initially small interventions made by rational experts might call for new paternalistic moves in later stages. This is largely so because of the fact that policy makers, rent-seekers and the nudged agents are not immune from new biases and incentives that generate other government failures and externalities, including some of the new cognitive errors identified by the behavioral literature. Thus, it is not hard to imagine how a change without costs in the order of presentation of the alternatives turns into something that involves costs, followed by options “subtly prohibited” and subsequently strong choice controls. If the experts are also subject to hyperbolic discounting, they might ignore the risks of such slippery slope over time. There might be room for some harm for learning processes and self-regulation by the public. Such unintended negative consequences are predictable because policy makers under some specific asymmetric frames of political loss or gain can favor some policies and regulations to match the wisdom of the median voter.

With all this bearing in mind, we also think it is more than time for research on Behavioral Political Economics. The latter gives us researchers the chance to address and scrutinize thoroughly three big issues. First, it is necessary to inspect the government failures commonly associated with market regulations, such as the design and implementation of laws to bar competition that serve some vested interests of politically powerful groups. Second, it is worth scrutinizing the methodological precepts that recommend the use of behavioral assumptions to explain actual decision-making in different environments. Therefore, one must assess critically whether and why policy makers are not subject to the same deviations from economic rationality that afflict the targets of the regulation proposals. Finally, it is important to examine whether some nudges do not bring about situations in which the irrational behaviors do pay off. Tackling the above troubling issues is important for critical thinking about the pros and cons of nudging.

The increasingly debate over some pitfalls of overselling behavioral paternalism largely explain why cross-fertilization between public choice and behavioral economics is a fascinating intellectual road to be taken.
In the following section, we will argue that the Behavioral Public Choice approach can enhance its explanatory value by incorporating insights from Austrian economics, more precisely, F. Hayek’s thoughts.

3. In search of Hayekian lessons for behavioral economics and public choice theory

In this section, we pave the way for making a very bold claim – integrating behavioral economics, public choice and the Hayekian ideas about the knowledge problem, paternalistic trends and economic planning enable to re-examine the debate over behavioral failures of individuals interacting in the economy. To the best of our knowledge, the behavioral approach to politics, policy and regulation underestimates the major roles particular institutions play in fostering individual learning. To pursue this task and shed light on such explanatory gap, we turn to a brief incursion into the Hayekian economic thought.

3.1 The fallibilist economics of F. A. Hayek

Hayek, throughout his career, contemplated various aspects of the problem of formation orders in the social sphere. Instead of just studying the properties of equilibrium states in markets where, by definition, the plans of the agents are compatible with each other, to the author the *explanandum* of economic theory should be the very emergence of coordination of these individual plans.

In his most important article, Hayek (1937) presents the coordination problem and goes on to ask for a theory of learning to explain it more thoroughly. Provided that coordination is indeed complex and agents’ cognitive ability is limited, then knowledge is fallible. The perfect knowledge assumption is then replaced by the hypothesis that agents formulate entrepreneurial conjectures about subset of the fundamentals of the economy. Economics should then explain how such potentially erroneous knowledge become compatible with the actual fundamentals of the economy.

In his most famous article, Hayek (1945) shows how the price system is critical to the solution of this problem, as a) the entrepreneurial plans take into account prices that signal scarcity and b) the realization of gains and losses function as a selecting mechanism of the same conjectures.

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

In all cases in which the author dealt with coordination (capital theory, the price system, theory of mind, institutional evolution) or discoordination (monetary theory and business cycles), two central elements are present: complexity and subjectivism.
How is it possible increase the degree of complexity of structures if knowledge about its working details is limited?

The answer to this question, present in all his theories, involves an evolutionary process of learning by trial and error, which assumes both mechanisms of negative feedback and the initial freedom to undertake new solutions. This theme is so central that it can be used as the defining element of the author's research program:

It is that the case for individual freedom rests chiefly on the recognition of the inevitable ignorance of all of us concerning a great many of the factors on which the achievements of our ends and welfare depends. (Hayek, 1979, p. 29)

We should note that decentralized mechanisms of learning by trial and error are essential for the class of knowledge relevant to the problem of coordination. This is not the abstract knowledge possessed by the social scientist, but the practical and dispersed knowledge of the agents about the "particular circumstances of time and place." For Hayek, the pretension of control of social process by central planners and regulators is due to confusion between these two forms of knowledge. We can say that without proper methodological sophistication, the analyst runs the risk of transferring the simplicity of the model to the complex systems that are modeled, fueling in this manner the belief in centralized solutions to social problems.

Thus, the author's work invites us again to think about economic policies in constitutional terms. Which set of rules allows or inhibits the discovery, use and transmission of dispersed knowledge among members of society? The Hayekian perspective on social sciences is analogous in this sense, to the philosophy of science of his friend Karl Popper, who investigates the institutional causes of the progress of fallible knowledge.

This Austrian-institutional approach, finally, must consider economic activity not exclusively as a state of equilibrium, but the proposed regulation must be view in terms of market processes. This requires that we do not bar by such regulation the competitive activity responsible for the discovery of new information.

3.2 Hayek’s knowledge problem to guide critical thinking about nudge paternalism

There is plenty of space for research that addresses the problem of knowledge applied to economic regulation and, in particular, to those inspired by nudge. In fact, there is already in the literature texts dealing with Hayekian themes, explicitly or otherwise.

Tasic (2009), as already mentioned, analyzes deviations from rationality applied to the action of regulators. This author shows that regulators incur in a form of action bias, when they try to correct government failures originating from unintended consequences of previous regulations. They tend to react with more regulations of the same nature instead of abandoning the original plan. This fits perfectly into the description of the dynamics of interventionism studied by Mises (Ikeda, 1996), in which appear the same “conviction spirals” in the regulatory process mentioned here.
This suggests that we must consider chains of interventions and not only isolated ones when studying nudge proposals.

Hayek (1989) discussion of on the "pretence of knowledge", coupled with the confusion between practical and theoretical knowledge, also arises in the discussion of another effect, reported by Tasic (p. 426); namely, the tendency of excessive confidence by regulators about their knowledge regarding the functioning of complex phenomena. This is associated by the author with the phenomenon of "illusion of explanatory depth" already mentioned. If we remember, following Hayek (1967), that theoretical knowledge of complex phenomena can only be abstract, in the sense that cannot yield detailed predictions, but only pattern predictions of general characteristics of the object studied, the scope for successful regulation that required detailed information about dispersed information is severely reduced. This, in turn, suggests that nudge proposals should explicitly include the premise that some knowledge about the problem situations of the agents will not be known to regulators.

Regulators tend to belief 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 particular cognitive errors that prevent people from behaving optimally. In addition, some policy areas are emotionally charged. They distort bureaucrats’ capacity to distinguish scientific knowledge and practical information. Some approved social policy measures like unemployment insurance and minimum wage laws bias bureaucrats’ attention in a way that they focus on goodness of intentions without evidence of their real effects and some disastrous unintended consequences.

Rozenblit and Keil (2002) show that illusion of explanatory depth is also an expression of what behavioral researchers also regard as overconfidence and confirmation biases. People overestimate their understanding of complex phenomena and often appeal to superficial knowledge about patterns to draw conclusions about the nature/essence of a phenomenon. This also influences regulators’ thinking and decision-making. 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. Consider the issue of retirement savings. Based on randomized field experiments, regulators believe that they understand why people save little more tomorrow and appeal to individual behavioral factors like hyperbolic discounting, status quo bias, loss aversion to redesign commitment savings policies to make individuals and society achieve what they consider their long term goals.

The bias in the direction of expansion of regulation is reinforced by an institutional element. The regulatory apparatus, said Tasic (p. 425), tends to attract experts in favor of regulatory activity. Hayek (. 1979, p 290) describes accurately the positive feedback effect favoring expansion of regulation:

The new kind of expert ... is an expert in a particular institutional setup. The organizations we have created ... have grown so complex that it takes more or less the whole of a
person's time to master them. The institutional expert is not necessarily a person who
knows all that is needed to enable him to judge the value of the institution, but frequently
he is the only one who understands its organization fully and who therefore is
indispensable. ... [A]most invariably, this new kind of expert has one distinguishing
characteristic: he is unhesitatingly in favor of the institutions on which he is expert. This is
so not merely because only one who approves of the aims of the institution will have the
interest and the patience to master the details, but even more because such an effort
would hardly be worth the while of anybody else: the views of anybody who is not
prepared to accept the principles of the existing institutions are not likely to be taken
seriously and will carry no weight in the discussions determining current policy.

These observations lead us directly to consider regulations inspired by behavioral
literature not in terms of specific problem solutions, as commonly occurs in the
literature, but explicitly taking into account the development of market and regulatory
processes over time. This suggestion is carried out in the discussion of Rizzo and
Whitmann (2009a) on the tendency to occurrence of slippery slopes in regulatory
processes, as mentioned earlier.

Besides explaining the expansion of regulatory apparatus due to traditional
government failures and behavioral effects, it remains to be carried out an analysis of
the fundamental reasons to question the effectiveness of nudge policies. The same
authors cited above explicitly adopted an Austrian point of view for this task. Rizzo and
Whitmann (2009b) argue that, for nudge policies to be effective, it would require that
regulators have access to detailed information on individual behaviors are manifested
in deviations from the optimal predicted in the literature. In addition to identifying
what the effects are, how they interact, how the existing mechanisms of error
correction work and how the nudge proposals replace or reduce this correction, it
would be necessary to estimate the magnitude of each effect, considering also the
heterogeneity of the population.

The knowledge listed above, of course, is a) dispersed in the population, b) subject to a
continuous flow of change and c) in large extent unobservable. The attempt at a
solution via empirical estimates of averages suffers from the confusion between
abstract theoretical knowledge and practical knowledge about local situations. Failure
to distinguish these categories results in the transfer of the simplicity of the model to
reality. This, in turn, generates unintended consequences that cause the spiral of
corrective actions mentioned at the beginning of the section.

A particular example exploited by Rizzo and Whitman (p. 22) refers to the arbitrary
character of the identification of genuine preferences of agents about intertemporal
choices. If there is hyperbolic discount applied continuously, there would be infinite
discount rates. It is therefore arbitrary (or paternalistic in the original sense of the
word) to fix one of them as the target of the proposed policy.

In order to deal with this kind of problem, we recommend that a systematic analysis of
behavioral paternalism incorporate the discussion of how regulation affects
decentralized learning mechanisms. One possible way of pursuing the foregoing task is
to appeal to the Austrian view of regulation, which draws on the market process
theory (Kirzner 1985, ch.6). For the Austrians, the entrepreneur exerts a vital role in the functioning of markets, being alert to opportunities that would remain unnoticed due to regulation. Putting it somewhat different, increased regulation does not only undermine some complex processes underlying individual attempts to solve market problems. It also prevents the markets from playing the role of discovery mechanisms and channeling entrepreneurial action to seek opportunities. This is partly so because the regulatory apparatus modifies the problem situation faced by agents. To our minds, such framework can be useful to investigate how nudges and behaviorally informed regulations would crowd out decentralized forms of dealing with some of the cognitive problems that nudges purport to solve.

The acknowledgement that behavioral biases are pervasive phenomena triggered in various contexts that cannot be perfectly perceived, represented, diagnosed and even tested by experts leads us to explore an institutional approach that aims to tackle such individual failures and the prospects of nudging and regulation at a broad (institutional) level of analysis.

4. Implications and concluding remarks

Let us begin the task of “putting behavioral economics, public choice theory and Hayekian economics together” with a methodological remark. When contemplating the study of complex phenomena, Hayek (1967) argues that the greater the complexity of the phenomenon under study is, the lower the empirical content of a theory (built up to account for it) it will be. This is partly so because of its very general assumptions. The alternative use of very domain-specific assumptions would bring the risk of immediate (empirical) refutation.

It matters a great deal to the complex phenomenon of rational choice how decision tasks are framed to individuals. But this is not the whole story. It is also important to understand how researchers interpret rational choice theory and its purpose. Until now there is no consensus at all among social scientists about how to explain human rationality of choice. The analyst may adopt definitions of this situation according to different degrees of subjectivism and his or her philosophical predilections. According to philosophers Debra Satz and John Ferejohn (1994), there are internalist and externalist interpretations of rational choice. The former is committed to the idea that it is possible to describe: “what is actually going on inside us when we reason” (p.73). As a result, rational-choice theory explains individual action by reference to his or her psychological or mental states. In other others, rational choice explanation calls for a psychological theory. The externalist account of the nature of rational choice does not draw on any theory of human psychology of choice. The externalist approach to rationality does not aim to “explain a particular agent’s behavior, but general regularities that govern the behavior of all agents” (ibid, p. 74). As a result, an externalist interpretation of the rationality theory aims to uncover complex structures of social interactions under particular markets and institutions. In tune with the externalist portrait of rationality, what explain people’s behavior are not their psychologies of choice but the institutional contexts they live.
Yet the choice over the nature of rational choice explanation brings about a methodological dilemma. If the economist opts for the first alternative, we fall into a Procrustean error of calling “irrational” choices that are in fact consistent if only we take into account the objectives and real alternatives as defined by the agents themselves. In this case, we often come across with false paradoxes of choice. At the other extreme, if we identify rationality with purposeful action, as Mises (1949) did, we avoid the mistake of disregarding subjectivism, but we run the risk of falling into a Panglossian error, according to which we are always in optimum situation, if we take into account all the variables that the analyst cannot anticipate. This bars by definition, the possibility of richer explanations of errors and learning.

We are inclined to suggest that when the allocative problem is investigated at the theoretical level (usually said “in the abstract”), the subjectivist alternative is appropriate. This is because accounts of interactions explore the relationship between means and ends. In this particular research context, it is prudent to avoid Procrustean accounts on behalf of problematic welfare standards that are results from variants of utilitarianism and overestimated experimental finding about cognitive errors (Whitman and Rizzo 2015). This is because such analyses require an empirical treatment of a specific decision problem in a domain-specific context that is hard to undertake.

Nevertheless, radical subjectivism is not a good research strategy for those interested in explanation of learning, either. This is because it brings the risk of Panglossian errors. Then, how could researchers then overcome the foregoing mistakes?

One possibility is to formulate an abstract learning theory that focuses on the description of error correction mechanisms rather than on empirical learning processes. This is the Austrian choice. To our minds, the behavioral political economics approach, which depends on experimental findings, might benefit from some Anti-Procrustean warnings (GPS types of nudges?) by Austrian economists.

After identifying possible errors arising from inconsistent choices, behavioral researchers had better examine under what institutional arrangements cognitive biases emerge or disappear. It seems to us that such research directions are promising and do not imply the debatable view that policy makers or experts have superior particular (not theoretical) knowledge than the individuals, who are targets of the behavioral economic policies or development programs.

This article puts forth the idea that systematic account of libertarian paternalist proposals enable behavioral public choice researchers to pursue three goals. First, to incorporate government failures resulting from standard economic assumptions like self-interest and opportunism that accompanies asymmetric information and political settings with concentrated benefits and disperse costs. Second, to uncover heuristics and biases in public choice environments. Finally, to compare the performance of more or less centralized institutional arrangements or behavioral choice architectures.
from the perspective of learning processes under hypothesis dispersed and fallible knowledge.

At first sight, analyzing nudge proposals with the proposed behavioral political economic approach that draws on insights from will become a costly endeavor. This might give extra boost to critics of libertarian paternalism. We agree with that.

Yet it seems to us that decisions over nudging are to be made on a case-to-case basis. The troubling issue is that it requires that 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 to the extent that it involves a \textit{petitio principii} type of (circular) argument. This is because it implicitly assumes that a more or less centralized analysis of costs and benefits (made by experts capable of intelligently designing choice architectures that de-bias people´s behavior) is better than to enable people achieve their own best interests.

There are alternative ways to assess behavioral policy alternatives. One promising research direction is consolidation of an eclectic analytical framework that draws on insights from Public Choice, Austrian Economics and New Institutional Economics. Boetkke (2007) identifies what he calls “mainline economics”, in contrast to the mainstream. The latter refers to what is regarded as modern economic theory. It has favored a world-view of social engineering, with technical people indicating optimal solutions to be implemented by the state. The mainline economics in its turn refers to theoretical frameworks such as Adam Smith´s. It puts philosophy, politics and economics together to provide (causal) explanations of the complex functioning of (decentralized) institutional arrangements.

In the spirit of mainline approach, we suggest that the most promising way to help people achieve their own goals is not to design choice architectures committed to some default rules that subtly constrain people´s autonomy and freedom of choice. Rather, it is worth facilitating development of institutional settings with more freedom of choice. If knowledge is decentralized, as taught Hayek and applied by Rizzo to the knowledge problem in question, then it is prudent to remain skeptical about experts´ ability to identify the people´s true preferences and to plan a rational economic order via contracts, regulations and nudges that make people behave optimally. This inspires us to end up with Turgot´s wise advice to nudgers and the nudged ones:

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, pp. 109-110).
References


