
THE GEORGE WASHINGTON UNIVERSITY

WASHINGTON, DC

Working Paper¹

October 2016

Utilizing Behavioral Insights (without Romance) An Inquiry into the Choice Architecture of Public Decision-Making

Adam C. Smith, Visiting Scholar²

The George Washington University Regulatory Studies Center

ABSTRACT

Behavioral economics has been employed in a number of policy applications over the last decade. From energy requirements to tax compliance to consumer finance, policymakers are increasingly operating under the assumption that people consistently fail to make rational choices. While the benefit of this policy trend remains an open debate, behavioral economists have long neglected a complementary examination of public decision-makers themselves. By comparing two public agencies influenced by behavioral economics, the U.S. Consumer Financial Protection Bureau and U.K. Behavioral Insights Team, I show how different institutions create divergent policy outcomes across the two agencies in a way that cannot be accounted for without incorporating public choice theory. I argue that improvement of private choice architecture must be accompanied by careful understanding of the public choice

¹ This comment reflects the views of the author, and does not represent an official position of the GW Regulatory Studies Center or the George Washington University. The Center's policy on research integrity is available at <http://regulatorystudies.columbian.gwu.edu/policy-research-integrity>.

² Adam C. Smith is an Associate Professor of Economics at Johnson & Wales University. The author gratefully acknowledges Susan Dudley and the George Washington Regulatory Studies Center for their support of this research, and to Erik Kimbrough, Brian Mannix, Sofie Miller, Bruce Yandle, and Todd Zywicki for helpful feedback.

architecture in which policies are rendered if behavioral economics is to be a successful foundation for welfare-improving policies.

Introduction

It should be no surprise to learn that humans behave in ways that are far from optimal. Be it from poor planning or untoward circumstance, we rarely, if ever, experience the idyllic fantasy of optimality in our various day-to-day activities. Or as David Byrne of the Talking Heads once sang,

“Heaven, Heaven is a place
A place where nothing
Nothing ever happens.”³

Economists have spent decades investigating just how day-to-day choices can be improved. The older Welfare Economics research program, for example, sought to improve competition in the marketplace by correcting perceived market failures, with the intended result of reducing prices and improving product quality. The Chicago School of Economics, on the other hand, tended to emphasize the role of fiscal policy and regulation in creating bad incentives and misallocating market resources. Smaller and smarter regulation could therefore unleash dormant market potential. Despite their different orientations, both of these approaches rely on the canons of neoclassical price theory and highlight institutional factors as the source of observed shortcomings. Individuals are thought to be choosing optimally within the constraints produced by prevailing institutions, and thus undesirable outcomes could easily be avoided by ‘getting the rules right’.

In a different vein, starting with Nobel Laureate Daniel Kahneman and his co-author Amos Tversky, behavioral economics has exposed dozens of behavioral ‘anomalies’ through extensive laboratory investigation of behavior. These anomalies constitute observed behavioral deviations from the predictions of neoclassical economic theory, and behavioral economists have sought to explain the sources of such anomalous choices by identifying and cataloging a variety of cognitive limitations and psychological biases. Building on these findings, behavioral economists have even begun to export their psychological findings into policy prescriptions.⁴ This research program, led by such luminaries as Richard Thaler and Cass Sunstein—and known as behavioral

³ In other words, everyday observations of strictly rational behavior in the neoclassical sense is in the null set.

⁴ Not all experimentalists are enthusiastic about this application to policy. Smith (2007, p. 155) notes that the “connective interface between rationality at the individual level and the market level and how institutions modulate the interface is yet to be fully explored and understood.” See also Smith (1998) for a similar argument with respect to the difference between personal exchange at the individual level and impersonal exchange at the market level.

law and economics—seeks to apply the insights gleaned from studies of human behavior to improve existing institutions by designing rules to compensate for (or take advantage of) people’s various biases. Given that observed choices are inconsistent with neoclassical theory, behavioral economists argue that ‘getting the rules right’ with respect to neoclassical decision-makers will be insufficient to generate desirable outcomes. If people are not rational to begin with, in the neoclassical sense of the word, then solutions designed for rational agents will not necessarily lead to desired outcomes.

Thaler et al.⁵ provide a cogent outline of how we as observers might conceive of this dilemma. Their phrase “choice architecture” encapsulates the notion that choice itself is affected by the context in which it is made. Providing one set of incentives elicits certain responses, even when the actor is unaware of how they are being affected. Developing better choice architecture, defined as that which allows for optimal decision-making, improves choice outcomes. While this choice architecture can be improved through a variety of means, it is often policy prescription through the public sector that is proposed by behavioral economists.

This has led to the creation of several public agencies such as the Behavioral Insights Team in the U.K., and the Consumer Financial Protection Bureau in the United States. Furthermore, an executive order in September 2015 signed by President Obama creates a new Social and Behavioral Science Team mandated with the task of combing regulatory and other public activities for opportunities to improve choice architecture.⁶ Clearly public policy guided by the insights of behavioral economics is on the rise.⁷

But as Boettke et al.⁸ have pointed out, this program puts the cart before the horse in prescribing policy purely due to anomalous behavior. They show how behavioral approaches resemble previous efforts to curtail market activity based upon deviations from theoretically optimal conditions; they further argue that finding deviations from a theoretical optimum does not in and of itself justify market intervention. A variety of obstacles lie in the way between theory and practice. Coordination failures, third-party influence (or intervention), poor institutions, corruption, and simple unknowns all represent realistic considerations that any policy maker

⁵ Thaler, R. H., Sunstein, C. R., Balz, J. P. 2014. Choice architecture. *The behavioral foundations of public policy*.

⁶ White House. 2015. Executive Order—Using Behavioral Science Insights to Better Serve the American People. *The White House, Office of the Press Secretary*, Sept 15. <https://www.whitehouse.gov/the-press-office/2015/09/15/executive-order-using-behavioral-science-insights-better-serve-american>. Retrieved August 22, 2016.

⁷ Wright (2011, p. 2216) makes much the same observation in response to the development of the Consumer Financial Protection Bureau, offering that its creation represented a “meteoric emergence in the legislative and regulatory spheres” of behavioral influence.

⁸ Boettke, P., Caceres, W. Z., Martin, A. 2013. Error is obvious, coordination is the puzzle. *Hayek and Behavioral Economics*, p. 90-110. Palgrave Macmillan U.K.

must anticipate. Without understanding the nested context in which their insights will be embedded, theorists risk encouraging activity that little resembles what they are after.

These considerations revolve around the idea that public actors themselves act within a certain choice architecture, which can very well interfere with improving market outcomes. Thus, there is a ‘public choice architecture’ to be considered alongside the ‘private choice architecture’ that is the focus of behavioral law and economics.⁹ Put another way, behavioral economists cannot assume away the burdens of the political process. Desiring a simple, clean application of behavioral insights and attaining this through the political process are two very different things. Or as Mullane and Sheffrin put it, “It is typically easier to draw conclusions as to what behavioral tendencies caused policies to have certain outcomes than to demonstrate that these behavioral tendencies can be effectively used to *create* desired outcomes through their implementation in policy design.”¹⁰ [italics original]

This paper addresses this by organizing how we might conceive of improving choices through behavioral-minded policy while incorporating standard public choice considerations. Public choice economists have argued for decades that political actors are susceptible to incentives just like the rest of us, and as the public choice program has emphasized, in some cases, these incentives cause political decision makers to act against the public interest.¹¹ What seems implicit in many behavioral policy proposals (as discussed in Berggren 2011) is that either 1) the regulators are not themselves subject to the limitations and biases they aim to combat or 2) that knowledge of the biases will be sufficient to mute their effects. The first assumption is surely unjustified, and as for the second, informing regulators about their own behavioral biases will do little if not aligned with the proper institutional incentives. After all, if people are prone to bias in their own lives, it is safe to assume that people will be equally if not more prone to bias when dealing in other people’s lives.

Let’s be clear. To the extent that behavioral economics identifies consistent and predictable patterns in the way individuals make their decisions, it offers the theoretical potential to improve decision-making and policy outcomes by tailoring policies and institutions to human psychology. In addition, President Obama’s Executive Order now makes behavioral considerations the law of the land in guiding regulatory policy in the United States.¹² Nevertheless, successful implementation of any policy prescription requires a detailed knowledge of the existing political

⁹ See Smith (2012) for an earlier presentation of “public choice architecture.”

¹⁰ Mullane, M., Sheffrin, S. 2012. Regulatory Nudges in Practice. White Paper. P. 1-2.

¹¹ Smith, A. C. Yandle, B. 2014. *Bootleggers & Baptists: How economic forces and moral persuasion interact to shape regulatory politics*. Cato Institute.

¹² White House. 2015. Executive Order—Using Behavioral Science Insights to Better Serve the American People. *The White House, Office of the Press Secretary*, Sept 15. <https://www.whitehouse.gov/the-press-office/2015/09/15/executive-order-using-behavioral-science-insights-better-serve-american>. Retrieved August 22, 2016.

and market institutions and the resulting incentive structure through which any behavioral remedy would ultimately have to pass. Hence, careful consideration of the accompanying public choice architecture is surely warranted.

The paper is organized as follows. I first present the behavioral approach as a means to overcome so-called “behavioral market failures.” I then justify the need for public choice underpinnings to behavioral policies if these failures are to be addressed in practice. I show how consideration of political institutions, a crucial component to any policy prescription, has largely been left to others, as behavioral economists focus on correcting biases in an institutionless vacuum. Using the contributions of James Buchanan and Elinor Ostrom, I then make the argument that public choice insights can add to behavioral policy initiatives, and further show that without these public choice guidelines, behavioral policies are unlikely to attain the ends sought after. I demonstrate this latter concern by comparing the U.S. Consumer Financial Protection Bureau to the U.K. Behavioral Insights Team, both largely motivated by behavioral economics yet very different in practice and outcome. I conclude by explaining the need for behavioral economists to incorporate an accompanying public choice architecture to the improvement of its private choice counterpart.

The Need to Nudge

Before delving into the role of public choice architecture in improving private choices, it is prudent to examine why private choices need correcting in the first place. Behavioral economists have discovered a wide variety of biases that people are prone to display in the laboratory. The original experiments by Tversky and Kahneman¹³ and Kahneman and Tversky¹⁴ found a number of behavioral patterns that were difficult to reconcile with neoclassical theory. For example, one prominent finding was that losses loomed larger for their subjects than corresponding gains, a pattern of behavior that came to be known as loss aversion and closely tied to the notion of an endowment effect.¹⁵ Thaler popularized these findings by couching them in consumer theory,¹⁶ later importing them into mainstream economic conversations through a regular feature in the *Journal of Economic Perspectives*.¹⁷

¹³ Tversky, A., Kahneman, D. 1974. Judgment under Uncertainty: Heuristics and Biases. *Science* 185: 1124-1131.

¹⁴ Kahneman, D., Tversky, A. 1979. Prospect Theory: An Analysis of Decision under Risk. *Econometrica* 47(2): 263-292.

¹⁵ Tversky, A., Kahneman, D. 1991. Loss aversion in riskless choice: A reference-dependent model. *The Quarterly Journal of Economics* 106(4): 1039-1061.

¹⁶ Thaler, R. H. 1980. Toward a positive theory of consumer choice. *Journal of Economic Behavior & Organization* 1(1): 39-60.

¹⁷ See Kahneman et al. (1991) for a highly influential presentation of various behavioral anomalies reported in this series including the endowment effect, status quo bias, and loss aversion.

In a replication of the classic Tversky and Kahneman experiments, this time with actual monetary payments, Holt and Laury reported that subjects were still averse to losses, even when addressed through multiple treatment effects such as higher payouts and using different demographics besides students as their laboratory subjects.¹⁸ The authors concurred that these framing effects led subjects to make decisions that were inconsistent with those predicted by a strict neoclassical framework. A behavioral framework that incorporated notable decision patterns observed in the laboratory would perhaps improve upon the traditional use of the neoclassical model in understanding and predicting human behavior.

As Chetty notes, however, “A common criticism of behavioral economics is that it does not offer a single unified framework as an alternative to the neoclassical model.”¹⁹ While it is certainly true that this relatively newer discipline has not yet achieved the maturity of the neoclassical approach, several have attempted to group its most prominent findings into a more coherent framework. Kling et al. consolidate these various findings into categorical areas where people are most likely to display bias in their decision-making.²⁰ These categories are *imperfect optimization*, *bounded self-control*, and *nonstandard preferences*.²¹ For example, going back to the seminal work of Herbert Simon, we find in laboratory environments that people are prone to “satisfice,” that is to fail to achieve optimal performance in favor of whatever works to consistently achieve positive, though suboptimal levels of success.²² Imperfect optimization is at the root of the widely applied “Save More Tomorrow” retirement savings plan developed by Thaler and Benartzi,²³ created to supplement a perceived hyperbolic discounting rate in the allocation of savings over time. In addition, people have a hard time aligning their short-term preferences with their long-term goals. Indeed, this lack of willpower (or bounded self-control) is one of the chief justifications used to empower policymakers to act in the consumer’s interest, by for example reducing access to certain credit options (e.g. payday loans, overdraft protection). Finally, the well-known behavioral trait of “loss aversion” shows that we are not always prone to a consistent set of preferences.²⁴ The Allais paradox, which demonstrated a larger aversion to

¹⁸ Laury, S., Holt, C. A. 2005. Further reflections on prospect theory. *Andrew Young School of Policy Studies Research Paper Series*, (06-11).

¹⁹ Chetty, R. 2015. Behavioral economics and public policy: A pragmatic perspective. *The American Economic Review* 105(5): 32.

²⁰ Kling, J. R., Congdon, W. J., Mullainathan, S. 2011. *Policy and choice: Public finance through the lens of behavioral economics*. Brookings Institution Press.

²¹ See Viscusi and Gayer (2015) for a more detailed analysis of this framework.

²² Simon, H. A. 1955. A behavioral model of rational choice. *The Quarterly Journal of Economics* 69: 99-118.

²³ Thaler, R. H., Benartzi, S. 2004. Save more tomorrow™: Using behavioral economics to increase employee saving. *Journal of political Economy* 112(S1): S164-S187.

²⁴ See Tversky, A., Kahneman, D. 1991. Loss aversion in riskless choice: A reference-dependent model. *The Quarterly Journal of Economics* 106(4): 1039-1061.

perceived losses than a corresponding benefit to expected gains, was a pioneering attempt to show that we make inconsistent choices when exposed to different framing contexts.²⁵

This is a mere glimpse of the many biases subjects display when placed in a laboratory environment. To move from a description of human biases to a prescription for how these biases should be addressed in a public forum required operationalizing this framework in way that demonstrated that correcting bias has the potential to improve consumer welfare. The field of behavioral law and economics seeks to do just this and in doing so transform these normative ideals into actual policy outcomes. An earlier article by Sunstein provided a framework for producing policy guided by behavioral insights.²⁶ Jolls et al. expanded on this and introduced the initial concept of “nudge” by way of its earlier, more cumbersome label “anti-anti-paternalism.”²⁷ The basic principle is the same, which is that behavioral insights reveal that people’s decisions can be improved and in a way they themselves would value.

Thaler et al. show how the concept of “nudge” is predicated on the assumption that some will inevitably serve as “choice architects”;²⁸ that is, those who structure the choice environment in which people make decisions. This emphasis on “choice architecture” leads to a variety of considerations including what incentives are created by the choice environment, how feedback operates, what defaults are in place, and how these choices can be structured in a manner that leads to welfare-improving outcomes. Or in other words, private choice architecture can be structured in a manner that is consistent with behavioral insights. The “nudge” concept has since gone on to capture a wide audience in the policymaking realm so much that Kahneman has described the insights of Thaler and Sunstein (2008) as “the basic manual for applying behavioral economics to policy.”²⁹

Allcott and Sunstein present a consideration that allows policymakers to transform these behavioral insights more generally into the realm of rulemaking.³⁰ They employ the concept of “internalities”; these are “costs we impose on ourselves by taking actions that are not in our own best interest.” So just as asymmetric information, externalities, and public goods concerns give way to charges of so-called “market failure” bias in the form of making suboptimal choices, failing to exercise self-control, or displaying inconsistent preferences allow for the possibility of

²⁵ See Allais, M. 1953. L’extension des théories de l’équilibre économique général et du rendement social au cas du risque. *Econometrica, Journal of the Econometric Society*, 269-290.

²⁶ Sunstein, C. R. 1997. Behavioral analysis of law. *The University of Chicago Law Review* 64(4): 1175-1195.

²⁷ Jolls, C., Sunstein, C. R., Thaler, R. 1998. A behavioral approach to law and economics. *Stanford law review*, 1471-1550.

²⁸ Thaler, R. H., Sunstein, C. R., Balz, J. P. 2014. Choice architecture. *The behavioral foundations of public policy*.

²⁹ Kahneman, D. 2011. *Thinking, fast and slow*. Macmillan.

³⁰ Allcott, H., Sunstein, C. R. 2015. Regulating internalities. *Journal of Policy Analysis and Management* 34(3): p. 698.

“behavioral market failure.” It follows then that policymakers can improve people’s lives in ways never attempted previously.

As Chetty explains, “expanding the policy set broadens the set of feasible allocations that can be achieved, which could ultimately increase welfare.”³¹ This pragmatic approach to behavioral economics would lend it the same access to policymaking that the older welfare economics program enjoyed. Bar-Gill and Sunstein directly placed behavioral economics on the same footing as the old welfare approach, arguing that, “Standard treatments of ‘market failures’ do not devote much discussion to the kinds of ‘behavioral market failures’ that, in our view, provide the strongest justification for prominent regulatory regimes.”³² Even the term, “behavioral welfare economics,” has emerged from this discussion, describing a normative approach guided by the work of behavioral economics to expand the set of outcomes that could conceivably improve consumer choices.³³

Because of these efforts, behavioral insights are increasingly being utilized to address so-called behavioral market failures, being employed in a wide range of regulatory policy fields including energy, health, consumer finance, among others. The growing use of this novel framework for thinking about how people make decisions would be welcome but for the fact that so little effort has been put into examining the bounded rationality of public decision-makers and accompanying public choice architecture within which these behavioral insights will ultimately be utilized.

In Search of Behavioral Public Choice

Though written over a decade ago, Lambert comments in a most telling way on the emergence of these behavioral policies. He states in reference to a study advocating the utilization of behavioral insights:

Professor Slovic [see Slovic (2000)] advocates a governmental fix *without first asking* whether the government is institutionally capable of correcting individuals’ affect-induced tendency to overestimate a risk of terrorism. This is a crucial oversight since the answer to the question is probably no. As an initial matter, there is no reason to believe that bureaucrats are any less susceptible to cognitive quirks than the citizens they seek to protect. More fundamentally, a democratically accountable agency faces *institutional* constraints that would

³¹ Chetty, R. 2015. Behavioral economics and public policy: A pragmatic perspective. *The American Economic Review* 105(5): 7.

³² Bar-Gill, O., Sunstein, C. R. 2015. Regulation as delegation. *Journal of Legal Analysis*, 7(1): 4.

³³ Bernheim, B. D. 2009. Behavioral welfare economics. *Journal of the European Economic Association* 7(2- 3): 267-319.

render it incapable of correcting affect-induced overestimation of terrorism risks.³⁴ [italics original]

Unfortunately, little has changed since. In a revealing study, Berggren analyzes contributions from behavioral economists in the last ten years in the top ten journals in economics.³⁵ The focus of his study is how behavioral economists treat political institutions when offering policy prescriptions. He specifically asks whether a) the authors offer explicit policy prescriptions and b) if they incorporate political institutions into their model/experimental design. The criteria for this latter element is fairly wide, as he only looks to see if they apply their findings to the political actor herself; that is, whether the politician is cognitively limited in the same manner as everyone else.

Berggren finds that 20.7 percent of behavioral economists offer policy prescriptions in the leading journals, with 95.5 percent of these articles not applying their analysis to the politician herself. Berggren concludes that while behavioral studies are worthwhile in understanding human cognition, they serve as poor indicators of actual policy performance with so little attention paid to the political institution itself. These figures are discouraging as without such an analysis, any policy prescription is premature; that is not to imply that any behavioral intervention will be applied perversely. In fact, the greater worry is that because these authors have not incorporated political institutions into how their insights should be applied, they are enabling a wide range of both positive and negative policy outcomes, with the accompanying uncertainty of actual policy outcome this entails (I will discuss this issue further when comparing the two agencies below).³⁶

While the search for a behavioral public choice remains open, behavioral economists have commented (albeit sparingly) on the application of their work to political actors. For example, Sunstein touches upon the problem of public officials exercising authority under the same biases as their private counterparts. He states that:

None of these points makes a firm case for legal paternalism, particularly since bureaucrats may be subject to the same cognitive and motivational distortions as everyone else. But they do suggest that objections to paternalism should be

³⁴ Lambert, T. A. 2004. Two Mistakes Behavioralists Make: A Response to Professors Feigenson et al. and Professor Slovic. *Mo. L. Rev.*, 69, 1059.

³⁵ Berggren, N. 2011. Time for Behavioral Political Economy? An analysis of Articles in Behavioral Economics. *The Review of Austrian Economics* 25(3): 199-221.

³⁶ It is worth noting that these academics display a certain “policy bias” in that they offer policy applications without fully treating the ramifications of such application within the analysis itself. Put another way, it may be that too many policy applications are offered, given the supporting argumentation, though this is surely a broader issue beyond those publishing on the topic of behavioral economics.

empirical and pragmatic, having to do with the possibility of education and likely failures of government response, rather than a priori in nature³⁷

Sunstein further expands upon and supplements the list by breaking challenges to behavioral policies down into five broad areas of concern: *information*, *competition*, *heterogeneity*, *learning*, and *public choice concerns*.³⁸ Briefly, these refer to the concern that *information* is most readily at hand at the local level and therefore public officials are at a disadvantage in utilizing the best information available. Intervention into markets also tends to stultify *competition*, be it intended or not. This can ultimately reduce welfare even if the intervention improves choices. Further, consumers are *heterogeneous* and any intervention must account for the fact that the market may support multiple preferences at any one time. Political interference tends to reduce this distinction. Market actors also *learn* from their mistakes. So if a behavioral problem presents itself, it is not a given that the consumer will fail to recognize the problem and correct for it in time. Finally, Sunstein groups a large number of considerations under *public choice* concerns, acknowledging again that public officials are both subject to influence by special interest groups and susceptible to the same biases as the consumers they govern (p. 33-38).^{39,40}

These are welcome—though limited—additions to the discussion of public choice architecture, which represents more than obstacles for successful policy prescription.⁴¹ They are the contextual features in which public decision-making unfolds. To take public choice architecture seriously is to incorporate this aspect into the policy framework directly. Otherwise, these policy advocates risk failure in changing private choice architecture in a way that improves consumer welfare. As Allemanno and Spina observe, “It is likely that without a rational, fully transparent mechanism to integrate behavioral research into policy-making, the wealth of knowledge of this science will continue to have only a haphazard, anecdotal and minimal or, as recently illustrated, even counterproductive effect on the activities of public administration.”⁴²

³⁷ Sunstein, C. R. 1997. Behavioral analysis of law. *The University of Chicago Law Review* 64(4): p. 1178.

³⁸ Sunstein, C. R. 2014. *Simpler: The future of government*. Simon and Schuster.

³⁹ See Gayer and Viscusi (2015) and Lucas and Tasic (2015) for surveys of this new area of “behavioral public choice.”

⁴⁰ See Shamoun and Yandle (2016) for a discussion of the public choice architecture and accompanying incentives generated by special interest groups for presidential policy. Sunstein himself led the Office of Information and Regulatory Affairs (OIRA) from 2009 to 2012 (see Broder 2012, Sunstein 2014).

⁴¹ Bar-Gill and Sunstein (2015, p. 7) exemplify this argument, noting that “political economy constraints limit the viability of such output in many cases” in the context of optimal regulation of markets. Their argument is telling in that it positions political considerations as a form of transaction cost that prevents optimality, as opposed to an underlying institutional concern that would challenge the use of behavioral insights more generally.

⁴² Allemanno, A., Spina, A. 2014. Nudging legally: On the checks and balances of behavioral regulation. *International Journal of Constitutional Law* 12(2): P. 440.

To take one example, Allcott and Sunstein present a model in which they attempt to estimate the potential bias of the consumer.⁴³ What is notable is that the analysis is not performed on the policymaker as well. For example, suppose as they do that the average consumer would make a biased choice of $b_1 > 0$ with market demand below the level preferred by a non-biased consumer (e.g. not eating enough apples in the cafeteria). Their result follows that the government could reduce this bias by subsidizing the good at level $s^* = b_1$. This would increase consumption to the social optimum level. Now let's apply this same parameter to the policymaker, assuming that the policymaker will make a biased choice of $b_2 > 0$, perhaps being too eager to subsidize against the bias. In this case, the equilibrium subsidy becomes $s^* < b_1$ with this decreasing as a function of b_2 . We see then that by parameterizing the policymaker, a narrower policy space emerges in which the policymaker can credibly improve consumer welfare.

The broader consideration of public choice architecture is not often appreciated, even by those directly involved in applying behavioral insights to public policy. Barr et al. propose a framework that would apply behavioral insights to a wide number of policy environments, noting that this framework needs to model both the relationship between the firm and consumer along with the firm and the regulator.⁴⁴ This second aspect could conceivably capture certain public choice architecture in the analysis, but the authors instead focus solely on the incentives regulators put into place for regulated firms, as opposed to the incentives placed before the regulators themselves. Put another way, the relationship is only examined in one direction and so does little to add to previous efforts that ignore public choice architecture altogether. Nevertheless, they claim that “behaviorally informed regulation is cognizant of the importance of framing and defaults, of the gap between information and understanding and between intention and action, and of the role of decisional conflict and other psychological factors that affect how people believe.”⁴⁵ It is remarkable that such an impressive list of insights is applied strictly to consumers and firms reacting to government policymaking and not the policymakers themselves.⁴⁶

Glaeser provides one notable exception to this trend. He models choice architecture across two corresponding contexts, one public and one private, starting from a position of behavioral symmetry across the two contexts and then introducing certain institutional parameters to estimate the capacity for bias.⁴⁷ He outlines three cases where the capacity for bias is endogenous

⁴³ Allcott, H., Sunstein, C. R. 2015. Regulating internalities. *Journal of Policy Analysis and Management* 34(3): 698-705.

⁴⁴ Barr, M. S., Mullainathan, S., Shafir, E. 2013. Behaviorally informed regulation. *The Behavioral Foundations of Public Policy* ed. by Shafir, E. Princeton University Press 440-461.

⁴⁵ *Ibid.*, p. 457.

⁴⁶ This is especially pertinent to this discussion of public choice architecture and the CFPB as one of the co-authors (Mullainathan) is currently Assistant Director of research at the agency (see http://files.consumerfinance.gov/f/201303_cfpb_org_chart.png).

⁴⁷ Glaeser, E. 2006. Paternalism and Psychology. *The University of Chicago Law Review* 73(1): 133-156.

to the private or public context—that is, generated by unique institutional features— and finds in each case that the public context is likely to generate more errors, not fewer, than the private context.⁴⁸ As he maintains, “the flaws in human cognition should make us more, not less, wary about trusting government decision making. The debate over paternalism must weight private and public errors.”

Glaeser’s work is just a start and as Allcott and Sunstein have noted, models with different assumptions than Glaeser’s could potentially show reduced error in certain public contexts.⁴⁹ Nevertheless, the point is not to show that public actors are always more error-prone, it’s that without incorporating political institutions into the actual positive analysis being performed, we are limited in our understanding of what policy outcomes will emerge once these behavioral insights are utilized. Despite (or even because of) the great potential for improving choices through behavioral intervention, it is essential to consider the public choice architecture in which use of the behavioral insights would have to navigate in order to improve consumer welfare.

To illustrate by way of example, Sobel and Leeson demonstrate just how much political context matters by looking at the Federal Emergency Management Association’s (FEMA) response to Hurricane Katrina’s devastating impact on the city of New Orleans in August 2005.⁵⁰ They claim that “The lack of government preparedness for Katrina was certainly not because FEMA was unaware of the potential for such a disaster in New Orleans. According to experts at the National Hurricane Center, the danger in New Orleans was known by many for years, giving FEMA plenty of time to devise a plan and work out its execution” (p. 68). Unfortunately, this information failed to generate the proper response to avert potential economic losses under a worst-case scenario. Sobel and Leeson claim that “This failure to invest current resources for future benefit can be explained by the widely-recognized ‘shortsightedness’ bias in government decision making. Political decision makers are biased toward current over future benefits” (p. 68).

In a similar vein, Viscusi and Gayer look at biases caused by poor risk assessment on the part of public actors. They claim that environmental relief fiscal sinkholes like Superfund are more likely due to the greater risk aversion of public actors who face little in the way of upside in efficiently regulating the environment but much downside should a certain environmental waste

⁴⁸ These results were primarily due to private actors having a greater incentive to discover and correct errors than public actors. The curious reader should refer to Glaeser’s original paper.

⁴⁹ Allcott, H., Sunstein, C. R. 2015. Regulating internalities. *Journal of Policy Analysis and Management* 34(3): p.714.

⁵⁰ Sobel, R. S., Leeson, P. T. 2006. Government’s response to Hurricane Katrina: A public choice analysis. *Public Choice* (127(1-2): 55-73.

issue become salient to the public. This in turn “leads to an overestimation of very small risks and comparative inattention to larger risks.”⁵¹

To be fair, Thaler and Sunstein emphasize the need for empirical verification that behavioral interventions are found wanting.⁵² While acknowledging the considerable challenges behavioral policies face, they argue that this in itself does not overwhelm the potential benefit that comes with improving choice architecture for the consumer. Nevertheless, the heavy lifting in this body of work resides with the analysis of private choice architecture, not the accompanying public choice architecture all policy recommendations must inevitably pass through.⁵³

Improving Public Choices

This lack of public choice analysis represents more than a pedantic oversight. It is an all too common occurrence as new ideas blind us to the institutional limitations in which we actually operate. Commenting upon the advancement of science, Hayek similarly claimed that,

a belief, seemingly shared by many scientists, [is] that the range of our ignorance is steadily diminishing and that we can therefore aim at more comprehensive and deliberate control of all human activities. It is for this reason that those intoxicated by the advance of knowledge so often become the enemies of freedom.⁵⁴

This is, of course, just the sort of statement that Thaler and Sunstein seek to dismiss on empirical grounds. But Hayek’s claim is a positive one. The assertion is that scientific advances so often lead to premature policy prescription, which given Berggren’s analysis is a reasonable assessment.

⁵¹ Viscusi, W. K., Gayer, T. 2015. Behavioral Public Choice: The Behavioral Paradox of Government Policy. *Harv. JL & Pub. Pol’y*, 38, 993.

⁵² Thaler, R. H., Sunstein, C. 2008. *Nudge*. Yale University Press.

⁵³ A related example demonstrates the shortcomings of previous behavioral policy specifically. Behavioral scientists are particularly keen on the notion of “shrouded fees,” which refer to costs that are especially likely to confuse consumers. A perennial target of this term is in how banks charge their customers for overdrawing an account. In 2010, the Federal Reserve—in which the CFPB is housed—required banks to give their customers the choice to opt in to overdraft protection. The idea was that consumers are prone to inertia and so may be paying fees that they actually would choose not to, if given conscious effort. To the surprise of many, customers overwhelmingly rejoined the protection plans. This caused some behavioral economists to argue that stronger restrictions on consumer choice were needed (see Willis 2013, Bubb and Pildes 2014). Others instead insist that the reaction of heavy users of overdraft protection to re-enroll in the service is a rational response to the necessity to meet their everyday financial obligations. The alternative for such customers is not an equity line or other line of credit but instead a payday loan or even less reputable source of short-term credit. Adjudicating between these two perspectives would surely be easier with a more coherent behavioral framework for measuring success.

⁵⁴ Hayek, F. A. 1960. *The Constitution of Liberty*. University of Chicago Press. P. 26.

Hayek's statement encapsulates a broad wariness of government intervention, even—and perhaps especially—intervention based upon scientific findings, into private enterprise. The problem, as Hayek points out, is that such control mechanisms, however scientifically informed, run the risk of generating unwanted consequences due to an over-estimation of the abilities of experts, often stifling the very creativity needed to foster the beneficial spontaneous order of the marketplace. Or as Schnellenbach and Schubert explain with respect to applying behavioral insights,

Behavioral welfare economists are currently at risk of repeating the mistake of neglecting the real-world political process with its many intricacies. Under these conditions, policy advice addressed to an imaginary social planner may not only be useless, but even dangerous, if it helps to promote policies that have unintended, negative consequences under real-world conditions.⁵⁵

To be sure, behavioral economists offer convincing evidence that choice is often uninformed and particularly vulnerable to the context in which it is made. Nonetheless, its application to the political realm has yet to grapple with the implications of decades of public choice scholarship. As Boulding explains, previous research has something to offer to current research paradigms through what he termed “the principle of the extended present.”⁵⁶ As new topics are explored and new knowledge gained, it is paramount that we not relegate old knowledge to the dustbin of history, particularly when this old knowledge is directly applicable and complementary to new research paradigms. It is often necessary to revisit the wisdom of previous scholars to gain perspective over current debates.

In the spirit of Boulding's claim, consider the words of James Buchanan in his Nobel address. He wrote that “The relevant difference between markets and politics does not lie in the kinds of values/interest that persons pursue, but in the conditions under which they pursue their various interests.”⁵⁷ In other words, the persons who populate the public sphere are much like their private brethren in that they are susceptible to the same values, biases, and incentives in how they choose. It is instead the context in which they act that largely determines the divergence in outcomes. Indeed the public choice program, which Buchanan helped shepherd, has sought to put decision-making within the public sphere on the same footing as decision-making within the private sphere. Once the same assumptions regarding preferences are maintained across both spheres, the challenge then becomes determining what institutional and environmental features determine choice in the operative setting.

⁵⁵ Schnellenbach, J., Schubert, C. 2015. Behavioral political economy: A survey. *European Journal of Political Economy* 40: 411.

⁵⁶ Boulding, K. E. 1971. After Samuelson, Who Needs Adam Smith?. *History of Political Economy* 3(2): 225-237.

⁵⁷ Buchanan, J. M. 1979. *What should economists do?* (pp. 17-39). Indianapolis: Liberty Press.

Behavioral economists are clearly right in that choice does not occur in a vacuum. This insight must be applied, however, consistently across public and private spheres. Using the language introduced earlier, there should be a public choice architecture to accompany the private choice architecture we are attempting to improve, at least if these theories are to be applied at the policy level. To operate effectively, Buchanan’s dictum not only applies to how we model the decision-maker but how we model the choice architecture in which they decide. This does not mean that we should assume that the same choice architecture exists across both contexts. Instead, as Schnellenbach and Schubert state, “Explanations of individual behavior in politics should rely on the same motivational assumptions that guide the economic analysis of market behavior.”⁵⁸ Put another way, it means that to competently advocate policy, we must examine both contexts with open eyes. As Buchanan has written elsewhere, we must examine “politics without romance”.⁵⁹

When compared with its private choice counterpart, public choice architecture is the choice environment faced by public decision-makers. This environment can influence decision-makers in a way that may lead to behavioral bias as noted above. Still more of it can elicit traditional public choice concerns like perverse bureaucratic incentives and a poorly informed electorate recommending welfare-reducing policies.⁶⁰ Smith and Zywicki demonstrate six categories of behavior in which public choice architecture creates significant obstacles to the use of behavioral insights, pointing out that 1) Consumers are just as bad at making public choices as they are at making private ones. Furthermore, 2) bureaucratic incentives contradict the assumptions contained in the behavioral law and economics framework described above and 3) are themselves susceptible to behavioral biases. Finally, 4) the behavioral framework often fails to provide policymakers with alternative explanations of consumer behavior. This is important not only to overcome confirmation bias of the bureaucrats but also because 5) experts can never know as much as the market can in guiding consumer behavior. And 6) lack of appropriate information leads to heavy-handed policy (“shoves”). These aspects of public choice architecture will be further developed and refined below.

Integrating public choice architecture into the analysis requires us to think of the relevant institutions that will ultimately determine the trajectory of subsequent policy outcomes. Elinor Ostrom, Nobel Prize Winner and intellectual leader of the Bloomington School, devised an agenda for the study of institutions in practice.⁶¹ Her short list of institutions helps identify what elements are core aspects of public choice architecture.⁶² These are:

⁵⁸ Schnellenbach & Schubert (2015). P. 395

⁵⁹ Buchanan, J. M. 1984. Politics without romance: A sketch of positive public choice theory and its normative implications. *The theory of public choice II*, 11-22.

⁶⁰ Smith, A. C., Zywicki, T. 2015. Behavior, Paternalism, and Policy: Evaluating Consumer Financial Protection. *NYUJL & Liberty*, 9, 201.

⁶¹ Ostrom was herself no stranger to behavioral theories, even remarking in her Presidential Address to the American Political Science Association that “We have not yet developed a *behavioral theory of collective action* based on models of the individual consistent with empirical evidence about how individuals make decisions in

- (1) *Position rules* that specify a set of positions and how many participants hold each position.
- (2) *Boundary rules* that specify how participants are chosen to hold these positions and how participants leave these positions.
- (3) *Scope rules* that specify the set of outcomes that may be affected and the external inducements and/or costs assigned to each of these outcomes.
- (4) *Authority rules* that specify the set of actions assigned to a position at a particular node.
- (5) *Aggregation rules* that specify the decision function to be used at a particular node to map actions into intermediate or final outcomes.
- (6) *Information rules* that authorize channels of communication among participants in positions and specify the language and form in which communication will take place.
- (7) *Payoff rules* prescribe how benefits and costs are to be distributed to participants in positions.

While not meant to be exhaustive, this list provides a useful template of what is needed to understand how choice operates in public contexts.

Translating this framework, known as Institutional Analysis and Development (IAD), into a useful guide for behavioral policies is no trivial task. Nevertheless, it is one of many useful models that behavioral economists would be at great advantage to adopt as a means of gauging the effectiveness of their policy proposals. Again, understanding the public choice architecture (or institutions) by which decisions are rendered is crucial in determining the likelihood that policies will succeed in promoting consumer welfare.

To make this framework operational, I will focus on three components of public choice architecture: 1) Scope of Authority, 2) Transformation of Outcomes, and 3) Information Retrieval. *Scope of Authority* refers to both who holds position of authority and what that authority entails. I will consider below how each organization is constituted and what policy areas the respective agency oversees. *Transformation of Outcomes* considers just how proposed policy solutions are actually rendered into enforceable rules and how these rules in turn will affect outcomes in practice. I will focus on what the actions of each agency entail and how this affects its intended audience. *Information Retrieval* examines just how pertinent information is collected and utilized by the public decision-making organization. Most importantly, this component captures the process and context by which information is collected, not just what information is available to the regulator.

social-dilemma situations. A behavioral commitment to theory grounded in empirical inquiry is essential if we are to understand such basic questions as why face-to-face communication so consistently enhances cooperation in social dilemmas or how structural variables facilitate or impede effective collective action” (see Ostrom 1998, p. 1). [italics original]

⁶² Ostrom, E. 1986. An agenda for the study of institutions. *Public choice* 48(1): 16.

There are a number of questions these components of public choice architecture bring to our attention that can aid in ensuring behavioral policies lead to welfare-improving outcomes. For example, who are the policymakers responsible for implementing the behavioral intervention? What is the scope of their (e.g. underlying agency) authority? What are the institutional incentives facing these policymakers? How do policymakers accumulate information used to formulate these policies? And from what sources? Is there any measurement by which we can estimate the effectiveness of the behavioral intervention? Does the choice environment encourage compliance with the proposals made by behavioral economists? Or are policymakers encouraged to break from these policy origin points?

To illustrate this approach in practice, consider the argument for the necessity of a default position (Sunstein and Thaler 2003, p. 1161).⁶³ Behavioral economists are right, of course, that in many cases a default must be chosen. Coase famously made this point⁶⁴ in reference to the establishment of property rights when transaction costs prohibit private adjudication. In cases like this, the choice of default is crucial, and perhaps enhanced if informed by insights from behavioral economics. It should equally be informed, though, by the insights of public choice. What does it matter if the proper behavioral considerations are taken into account at the formative level if the actual administrator simply chooses to ignore them, or worse, uses them to pursue an undesirable end?

Take the popular behavioral example of a school administrator considering where to place healthy food in a school cafeteria described at the beginning of *Nudge*.⁶⁵ In this particular case, the scope of authority is largely defined upfront.⁶⁶ The administrator has to choose something, as the food won't just sort itself. In addition, the administrator has a preference to have kids eat healthy food instead of junk food, and so could place healthier choices in the front of the line, which would make kids more likely to choose them, thereby providing a better outcome through behavioral correction, albeit of the softer variety (Sunstein and Thaler 2003, p. 1164).⁶⁷

Harford offers a counter-argument to even this simple choice environment. While noting that “most of the best examples Thaler and Sunstein suggest are innovations in the private or voluntary sectors,” he exposes the very different outcomes that emerge when behavioral interventions are imposed publicly rather than privately arranged.⁶⁸ When we take into account

⁶³ Sunstein, C. R., Thaler, R. H. 2003. Libertarian paternalism is not an oxymoron. *The University of Chicago Law Review*, 1159-1202.

⁶⁴ Coase, R. H. 1960. The Problem of Social Cost. *Journal of Law & Economics* 3: 1- 44.

⁶⁵ See Thaler, R. H., Sunstein, C. 2008. *Nudge*. Yale University Press. P. 1.

⁶⁶ Though see Sudgen (2008, p. 238) for an Austrian challenge as to the entrepreneurial feasibility of even this simple choice environment.

⁶⁷ Sunstein, C. R., Thaler, R. H. 2003. Libertarian paternalism is not an oxymoron. *The University of Chicago Law Review*, 1159-1202.

⁶⁸ Harford, T. 2011. *Adapt: Why success always starts with failure*. Macmillan. P. 177.

how the transformation of outcomes takes place in practice, policies aimed at correcting individual choices often involve hardline coercion by way of regulation on firms.^{69,70} For example, using the cafeteria example, he ponders what would really happen if a law was imposed that required restaurants to display the healthier choices more prominently. Perhaps this would elicit greater advertisement of healthy choices or perhaps it would motivate restaurants to abandon healthier choices altogether to avoid the cumbersome legislation in its entirety. Just as “protecting” endangered species often leads to the unwanted consequence of “shooting, shoveling, and shutting up,” “protecting” healthy choices could serve to further marginalize their already tenuous existence.

Another troubling aspect of the cafeteria example is that it simplifies the information retrieval process to a degree far more trivial than what policymakers would find confronting consumers in actual nested choice contexts. As Schnellenbach states, “If information on individual preferences and beliefs cannot be centralized by a government planner, then neither soft nor hard paternalist policies can reliably move the economy closer to its utility possibility frontier, but they always redistribute welfare between heterogeneous individuals.”⁷¹ To reiterate the author’s point, even soft paternalism in the form of a nudge can only be demonstrated to be utility maximizing if it is known *ex ante* how consumers will react to a given policy. The reason for this is that nudges, like their harder paternalistic counterparts, redress biased behavior by making it more expensive, if not in terms of pecuniary cost then in some other form that would diminish its utility (e.g. requiring additional steps to opt out of a certain service that policymakers feel is beneficial). This is only utility maximizing if we know that consumers are indeed worse off as a result of their biased choices, a possible though strong assumption to make.⁷²

In short, each of these three institutional components can help inform us as to the veracity of behavioral policy in action to which we now turn.

Examining the Public Choice Architecture of Behavioral Policies

To better appreciate the role of public choice architecture, let’s compare two government agencies motivated by behavioral economics. This provides us with the means to both address Thaler and Sunstein’s challenge to provide empirical verification and helps showcase the need

⁶⁹ Mullane, M., Sheffrin, S. 2012. Regulatory Nudges in Practice. White Paper.

⁷⁰ Smith, A. C., Zywicki, T. 2015. Behavior, Paternalism, and Policy: Evaluating Consumer Financial Protection. *NYUJL & Liberty*, 9, 201.

⁷¹ Schnellenbach, J. 2012. Nudges and norms: On the political economy of soft paternalism. *European Journal of Political Economy* 28(2): 269-270.

⁷² As Chetty (2015, p. 12) explains in the choice context of retirement savings, “responses that appear to be consistent with optimization in the aggregate may mask significant deviations from optimization at the individual level.”

for behavioral insights to incorporate public choice architecture. Or as Hyman and Kovacic explain “Simply stated, what an agency is assigned to do and where it is located matters.”⁷³ Note that this discussion is not intended to be an exhaustive treatment of the activities of the two agencies. It is instead intended to showcase how public choice architecture is capable of transforming similar policy ideas into very different policy outcomes.

As it so happens, our two examples have emerged from like-minded policymakers on separate sides of the Atlantic Ocean. In the United States, the Consumer Financial Protection Bureau applies behavioral economics to regulating the financial industry. Previously located within the U.K. government structure, the Behavioral Insights Team or so-called “Nudge Unit” is tasked with improving a variety of government services. I do not attempt to provide an exhaustive analysis of the effectiveness of their respective policies. The curious reader should consult the articles cited to judge the efficacy of these policies in practice. Instead, I wish to illuminate how public choice architecture impacts how policies generated by behavioral considerations are applied in practice. As I will show, generating policy proposals with no mention of the underlying public choice architecture leads to undesirable variability in the actual policy outcome, in a way that reduces consumer welfare.

The Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau (CFPB) emerged as one of the key reforms in the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereafter the “Dodd-Frank Act”), itself a response to the global financial crisis of 2008-2010. The CFPB’s chief architect was Harvard Law Professor Elizabeth Warren, now Senator of Massachusetts. Professor Warren forcefully argued the need to protect consumers from the perceived harm rendered by their creditors in a way that consumers are not always alert to.⁷⁴ In a highly influential follow-up article, Bar-Gill and Warren demonstrated various shortcomings in consumer rationality with respect to credit transactions including framing effects, the influence of inertia, and optimism bias.⁷⁵ They ended their analysis with a call for a new agency that would assist consumers in making more rational decisions. They further argued that an agency with the proper motivation and authority needed to be created, as existing agencies lacked one or more of these two features.

Thus, the CFPB was born.⁷⁶ Its self-stated mission is as follows: “The CFPB is a 21st century agency that helps consumer finance markets work by making rules more effective, by consistently and fairly enforcing those rules, and by empowering consumers to take more control

⁷³ Hyman, D. A., Kovacic, W. E. 2014. Why Who Does What Matters: Governmental Design and Agency Performance. *Geo. Wash. L. Rev.*, 82, 4.

⁷⁴ Warren, E. 2007. Unsafe at any rate. *Democracy*, (5), 8.

⁷⁵ Bar-Gill, O., Warren, E. 2008. Making Credit Safer. *University of Pennsylvania Law Review* 157(1): 1–101.

⁷⁶ See Kovacic (2014, p. 38- 42) for a more extensive discussion of its inception.

over their economic lives.”⁷⁷ Currently led by the former state attorney general of Ohio, Richard Cordray, the agency is guided by a team of behavioral economists, including Richard Thaler.^{78,79} This group represents more than a backroom set of advisers. As Pridgen explains, the creation of this agency represents a “shift from the pure disclosures as consumer protection under the rational choice theory of economics, to a system of regulation-based on the more realistic view of consumer decision-making as revealed by behavioral economics.”⁸⁰ Accordingly, a secure advisory role has been laid for behavioral insights. Indeed, Wright maintains that this paradigm shift in the regulation of consumer finance has fully superseded the older welfare-based framework in guiding policy.⁸¹

Bar-Gill and Sunstein go so far as to claim that the CFPB is “structured in a way that aligns its interests with those of individual consumers.”⁸² This is a rather strong claim given that the agency is constituted in a peculiar way of particular relevance for this paper. Because of the arguments put forth in Bar-Gill and Warren, along with the stringent efforts of Warren herself when she was Assistant to the President,⁸³ the agency was set up to be extraordinarily insulated from legislative interference, a fact that has caused some to question the very constitutionality of the agency.⁸⁴ While it is housed within the Federal Reserve, its budget cannot be changed by the Fed. Furthermore, its Director has a five-year appointment by the President and cannot be removed once appointed except for “cause.” Indeed, on October 11, 2016, a Federal Appeals Court struck down this last feature, citing that it gave the Director more power than any

⁷⁷ Consumer Financial Protection Bureau. 2013. Strategic Plan FY 2013 - FY 2017. *Consumer Financial Protection Bureau*, Washington, D.C. <http://www.consumerfinance.gov/strategic-plan/>. Retrieved August 30, 2016.

⁷⁸ CFPB Announces Consumer Advisory Board Members. 2012. *Consumer Financial Protection Bureau*. <http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-announces-consumer-advisory-board-members/>. Retrieved September 7, 2014.

⁷⁹ In addition, Hyman and Kovacic (2014, p. 1492) point out that, “The CFPB hired a prominent behavioral economist (Sendhil Mullainathan) as its first Assistant Director of Research,” noting that “many behavioral economists believe insights from research in consumer psychology justify expansive regulatory intervention into financial services markets” (see also footnote 46 above).

⁸⁰ Pridgen, D. 2013. Sea Changes in Consumer Financial Protection: Stronger Bureau and Stronger Laws. *Wyoming Law Review*, 13(2). P. 406.

⁸¹ Wright, J. D. 2012. The Antitrust/Consumer Protection Paradox: Two Policies at War with Each Other. *Yale Law Journal* 121: 2216-2405.

⁸² Bar-Gill, O., Sunstein, C. R. 2015. Regulation as delegation. *Journal of Legal Analysis*, 7(1): 21.

⁸³ White House. 2010. President Obama Names Elizabeth Warren Assistant to the President and Special Advisor to the Secretary of the Treasury on the Consumer Financial Protection Bureau. *The White House, Office of the Press Secretary*, September 17. <https://www.whitehouse.gov/the-press-office/2010/09/17/president-obama-names-elizabeth-warren-assistant-president-and-special-a> Retrieved August 30, 2016

⁸⁴ See Dudley, S. E. 2016. Is The Consumer Financial Protection Bureau Unconstitutional? *Forbes.com*, April 15. <http://www.forbes.com/sites/susandudley/2016/04/15/is-the-consumer-financial-protection-bureau-unconstitutional/#63e770e151b3>. Retrieved August 22, 2016

officeholder besides the President of the United States.⁸⁵ Finally, the CFPB is not accountable to Congress, in terms of appropriations or oversight, an especially strong constraint as other similar agencies that regulate consumer products such as the Federal Trade Commission are subject to review by bipartisan commissions.⁸⁶

According to the agency's strategic plan, this peculiar form of public choice architecture was both necessary and given precedence by the independence provided to other financial regulatory bodies like the Federal Reserve. They claim that "The Congress, in implementing the Dodd-Frank Act, followed a long-established precedent in providing the CFPB with funding outside of the congressional appropriations process to ensure full independence as the Bureau supervises and regulates providers of consumer financial products and services and protects consumers. Congress has consistently provided for independent funding for bank supervisors to allow for long-term planning and the execution of complex initiatives and to ensure that banks are examined regularly and thoroughly for compliance with the law."⁸⁷

Nevertheless, Hyman and Kovacic summarize this agency's institutional structure by claiming that, "the combination of protections afforded by Dodd-Frank makes the CFPB distinctive. And, the bundle of autonomy mechanisms, along with the independent-agency-within-an-independent-agency structure, gives the CFPB unmatched insulation from the accountability devices that limit other federal regulators."⁸⁸ This was certainly the opinion of the Federal Appeals Court that found parts of the CFPB structure unconstitutional, even going so far as to label them a "gross departure" from the traditional agency model.⁸⁹ Furthermore, its institutional structure is likely to encourage standard bureaucratic pitfalls as "These risks are pronounced for the CFPB, given the breadth of its substantive mandate, its powerful implementation tools, and the absence or relaxation of institutional controls that constrain other regulatory bodies." Even if these pitfalls were somehow avoided, the agency has an enormous mandate to devise and enforce the duties imposed by the Dodd-Frank Act.⁹⁰

⁸⁵ Kendall, B., Hayashi, Y. 2016. Appeals Court Deals Setback to Consumer-Watchdog Agency. *The Wall Street Journal*, October 11. <http://www.wsj.com/articles/federal-appeals-court-finds-structure-of-cfpb-unconstitutional-1476197389>. Retrieved October 11, 2016.

⁸⁶ Zywicki, T. 2013. Consumer Financial Protection Bureau: Savior or Menace, *The Geo. Wash. L. Rev.*, 81, 856.

⁸⁷ Consumer Financial Protection Bureau. 2013. Strategic Plan FY 2013 - FY 2017. *Consumer Financial Protection Bureau*, Washington, D.C. <http://www.consumerfinance.gov/strategic-plan/>. Retrieved August 30, 2016.

⁸⁸ Hyman, D. A., Kovacic, W. E. 2014. Why Who Does What Matters: Governmental Design and Agency Performance. *Geo. Wash. L. Rev.*, 82, 1488.

⁸⁹ Kendall, B., Hayashi, Y. 2016. Appeals Court Deals Setback to Consumer-Watchdog Agency. *The Wall Street Journal*, October 11. <http://www.wsj.com/articles/federal-appeals-court-finds-structure-of-cfpb-unconstitutional-1476197389>. Retrieved October 11, 2016.

⁹⁰ See Hyman and Kovacic, p. 1475.

While still early in its development as a Washington bureau, the CFPB has displayed a muscular effort in a number of areas, most notably with credit card fees, mortgage loans, auto lending, student loans, and general consumer banking practices. In each case, the CFPB has exercised formidable powers in regulating consumer markets. For example, in the case of consumer banking practices, the CFPB has been very attentive to the kinds of fees banks charge their customers. These fees often offset, however, the costs of maintaining accounts with low-income customers. The pressure put on banks to reduce or eliminate these fees has resulted in a reduction of free checking accounts by half since the enactment of Dodd-Frank.⁹¹

One of the initial efforts by the new agency was to define so-called “qualified mortgages,” based upon the customers’ ability to pay. In other words, mortgages offered to consumers with a proven FICO score are labeled “qualified.” Though the measure was meant to increase customer awareness of their ability to pay, the added consequence of the policy is to discourage loans to low-income households. Federal Reserve Chair Janet Yellen stated in 2014 that, “Banks, at this point, are reluctant to lend to borrowers with lower FICO [credit] scores. They mention in meetings with us consistently their concerns about put-back risk, and I think they are—it is difficult for any homeowner who doesn’t have pristine credit these days to get a mortgage.”⁹²

Another policy area the CFPB has made efforts to address is auto lending. The agency claims prejudice on the part of auto lenders. According to the Equal Credit Opportunity Act, lenders cannot discriminate in offering borrowing terms on the basis of race, color, religion, national origin, sex, marital status or age. The overtones of racism in the lending practices are a leading argument on behalf of the CFPB, with Director Cordray exclaiming, “Consumers should not have to pay more for a car loan simply based on their race.” The solution for such discriminatory practices, Cordray claims, is to offer a uniform markup rate across consumers.⁹³

As a consequence, the CFPB expanded the scope of its mandate to not only include large lending institutions, but non-bank lending organizations located in the automotive industry. This constitutes a significant and somewhat surprising shift in responsibilities as the Dodd-Frank Act, which established the CFPB, specifically barred the agency from going after motor vehicle dealers.⁹⁴ Regardless, the CFPB has moved forward claiming that these targets represent a market being under-represented and misinformed. The basis for their intervention is whether the auto dealers are breaking existing law. Since the agency is not technically creating new rules (at

⁹¹ Zywicki, T. 2015. The Dodd-Frank act five years later: are we more stable?. Congressional testimony, p. 3.

⁹² Yellen, Janet. 2014. Transcript of Chair Yellen’s Press Conference. The Federal Reserve, June 18.
<https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20140618.pdf>. Retrieved September 6, 2016.

⁹³ Taha, N. 2013. Consumer Agency Warns Lenders on Bias in Auto Loans. *The New York Times*, [March 21](http://www.nytimes.com/2013/03/21/consumer-agency-warns-lenders-on-bias-in-auto-loans/?ref=autoloans),
<http://bucks.blogs.nytimes.com/2013/03/21/consumer-agency-warns-lenders-on-bias-in-auto-loans/?ref=autoloans>. Retrieved July 1, 2013.

⁹⁴ See Pridgen, D. 2013. Sea Changes in Consumer Financial Protection: Stronger Bureau and Stronger Laws. *Wyoming Law Review*, 13(2). P. 413.

least for now), this ostensibly keeps them in the confines of the mandate provided by Dodd-Frank.⁹⁵

The major complaint again is that terms and conditions are not well-specified, leading under-informed consumers into financial obligations they cannot afford. The automotive industry does provide a significant number of in-house loans, usually geared towards those with lower credit and/or fewer outside lending options. These loans tend to have a longer term period and can have increasing rates, should the consumer get behind on payments, as these loans are structured to assist high-risk debtors.

As a result of this pressure to charge flat rates across different consumers, several companies such as Honda Motors' financing arm have raised their wholesale rate while reducing the amount of loan markup discretion of their dealers, with the total cost of the loan increasing in many cases.⁹⁶ The long-term result will more than likely be a massive downturn in auto lending, particularly for low-income households. This prompted a number of minority-sponsored interests to challenge the CFPB's assessment. Damon Lester, president of the National Association of Minority Automobile Dealers, stated that, "The CFPB is refusing to share how they came to the conclusion that dealerships have unintentionally discriminated or why," and further claiming that "The CFPB is fundamentally changing the multi-billion dollar automobile marketplace and yet the bureau is not clear on how their actions will impact auto lending, consumers or the economy." In addition, a letter to the CFPB included signatures from Democratic Representatives Joyce Beatty of Ohio, William Lacy Clay of Missouri, Gregory Meeks of New York and David Scott of Georgia, all members of the black caucus.⁹⁷

A third policy area of interest for the CFPB has been student loans. Here the CFPB has primarily targeted the private sector, which only encompasses around 15 percent of the overall market. The reason for this focus is that the Department of Education regulates the public provision of student loans. That said, the CFPB has been particularly aggressive in its suggestion that this legal boundary may be crossed at some point in the not-too-distant future. In a March 2013 rule proposal, the agency sought to oversee nonbank student lending institutions, especially those with more than a million accounts. This would include the government's largest student loan

⁹⁵ Sidel, R., Zibel, A. 2013. Regulators Scrutinize Auto Lenders over Add-Ons. *The Wall Street Journal*, May 3. A1.

<http://online.wsj.com/article/SB10001424127887324582004578459170902840306.html?KEYWORDS=auto+loan>. Retrieved July 1, 2013.

⁹⁶ See Andriotis, A., Nagesh, G. 2015. Crackdown on Racial Bias Could Boost Drivers' Costs for Auto Loans. *Wall Street Journal* (Aug 31) <http://www.wsj.com/articles/crackdown-on-racial-bias-could-boost-drivers-costs-for-auto-loans-1441038864> Retrieved August 22, 2016.

⁹⁷ Dougherty. 2013. Biased Loans by Auto Dealers to Bring Bank Suits by CFPB. *Bloomberg.com* (March 22): <http://www.bloomberg.com/news/2013-03-21/banks-to-be-held-liable-for-biased-auto-loans-under-cfpb-rules.html>. Retrieved July 1, 2013.

vendor, Sallie Mae, which is currently overseen by the Department of Education. It has also involved itself in the investigation of private for-profit schools at the behest of the Obama administration.⁹⁸

Its primary goal has been to reduce the amount of student loan debt, a goal not necessarily consistent with behavioral foundations. After all, if consumers are entering into loan agreements rationally, then another argument would need to be invoked to justify intervention. Nevertheless, the agency has called for loan companies to consider certain debt consolidation schemes not currently offered in the marketplace. What is telling about these efforts is how the CFPB specifies the ideal outcome without explaining how companies should achieve it.

The Nudge Unit

The Behavioral Insights Team or “Nudge Unit” was founded in 2010 at the behest of Prime Minister David Cameron’s coalition government. It was originally situated within the U.K.’s government’s Cabinet Office, but is now a mutual venture between the U.K. government and private interests, which I will address further below. Led by psychologist David Halpern, the team was originally designed to help create efficiencies within the U.K. government but has since broadened its goals to impact a number of areas, not all confined to the U.K. The agency now describes itself as follows: “The Behavioural Insights Team (BIT) is a social purpose company. We are jointly owned by the U.K. Government; Nesta (the innovation charity); and our employees.”^{99,100}

The Nudge Unit operates in a different manner than the CFPB. It has a flatter hierarchy with a far smaller staff. It also is largely able to manage its own agenda and so avoids much of the bureaucratic pitfalls that most agencies face such as the short-run bias noted by Sobel and Leeson.¹⁰¹ The group has also had little turnover, a markedly different result than the CFPB, which has contributed to more consistency and solidarity in pushing forward the group’s agenda.¹⁰²

Like the CFPB, the Nudge Unit is relatively new organization and so has not generated a large number of observations to study. Nevertheless, there are several policy areas the team has had a

⁹⁸ Obama’s For-Profit Execution. *Wall Street Journal*, August 29. <http://www.wsj.com/articles/obamas-for-profit-execution-1472511905>. Retrieved September 9, 2016.

⁹⁹ The Behavioral Insights Team. Who we are. The Behavioral Insights Team, Cabinet Office. <http://www.behaviouralinsights.co.uk/about-us/>. Retrieved August 30, 2016.

¹⁰⁰ It is worth noting that *Nudge* co-author Richard Thaler is a formal advisor of this group as well (see John 2014, p. 259).

¹⁰¹ Sobel, R. S., Leeson, P. T. 2006. Government's response to Hurricane Katrina: A public choice analysis. *Public Choice* (127(1-2): 55-73.

¹⁰² See John, P. 2014. Policy entrepreneurship in U.K. central government: The behavioural insights team and the use of randomized controlled trials. *Public Policy and Administration*. p. 262-263.

noticeable impact with, first and foremost, in the area of tax collections. Hallsworth et al. (2014) describe a series of experiments in which tax delinquency notices were accompanied by different messages. Some of these messages appealed to social norms (e.g. “Nine out of ten people in the U.K. pay their tax on time. You are currently in the very small minority of people who have not paid us yet,” p. 4) while others invoked the government services that taxes provide. In each case, tax compliance went up with the most effective messages increasing tax collection by 5 percent.¹⁰³

Because of the success with this, the Nudge Unit ran a second series of experiments that attempted to ascertain just what motivated the highest levels of tax compliance. Specifically, the experiment compared the effects of descriptive (i.e. what others do) and injunctive (i.e. what others think should be done) norms.¹⁰⁴ They found that simple description of the norms of tax compliance were most effective in increasing payments. As they point out, targeting tax delinquency with different messages is virtually cost-free to the government and as a result has been widely adopted by various government bureaus in the U.K. government.

Haynes et al. present a closely related set of experiments that are targeted at those owing court fines. The experimental team sent different text messages indicating either the person’s name, the amount owed, or a combination of the two. They found these text messages to be an effective way of reaching an otherwise reticent target population. Simply including the person’s name in the text message nearly tripled the amount of fines collected compared to when no text was sent.¹⁰⁵

The Nudge Unit has found success in a number of other areas with similar experimental approaches including pension plan sign-ups, university applications, charitable giving, electoral registration, and organ donations, among others.¹⁰⁶ In each case, the Nudge Unit conducts experiments to test the most effective method of achieving the outcome intended by the team. They also point out where nudges fail and certain pitfalls to avoid when applying behavioral insights. Above all, the team emphasizes that context matters and so each environment will need certain adaptation in order for nudges to be successful.

¹⁰³ Hallsworth, M., List, J. A., Metcalfe, R. D., Vlaev, I. (2014). *The behavioralist as tax collector: Using natural field experiments to enhance tax compliance* (No. w20007). National Bureau of Economic Research.

¹⁰⁴ Ibid, p. 5.

¹⁰⁵ Haynes, L. C., Green, D. P., Gallagher, R., John, P., Torgerson, D. J. 2013. Collection of delinquent fines: An adaptive randomized trial to assess the effectiveness of alternative text messages. *Journal of Policy Analysis and Management* 32(4): 724.

¹⁰⁶ For a more detailed description of these experiments, See BIT East. Four Simple Ways to Apply Behavioral Insights. *Behavioral Insights Team*. http://www.behaviouralinsights.co.uk/sites/default/files/BIT%20Publication%20EAST_FA_WEB.pdf. Retrieved August 21, 2014. Also see a list of the BIT’s publications at <http://www.behaviouralinsights.co.uk/academic-publications/>.

Due to its success, the Nudge Unit has since spun off the U.K. Cabinet and is now a mutual joint venture between the cabinet, Nesta (the U.K.'s innovation foundation), and the BIT staff.¹⁰⁷ This has enabled the team to work with others vendors besides the U.K. government and broadened the potential areas that the nudges they design can be used. It also enables the team to profit from their activities.¹⁰⁸

Institutions Matter

While the two agencies, the Consumer Financial Protection Bureau and Behavioral Insights Team, both apply behavioral insights and even share the guidance of one of the *Nudge* co-authors, Richard Thaler, the strategies employed and consequent outcomes of their policies could not be more different. While the Nudge Unit utilizes experimental design and adaptive learning, the CFPB is more heavy-handed and subject to tunnel-vision in its use of policy tools.

As noted above, to apply the IAD framework in its entirety to the two organizations would take us beyond the scope of this paper. I will confine my analysis to a circumscribed list of considerations that will capture many of the questions asked above, without belaboring the thesis of this paper. The discussion of institutional parameters will be confined to the 1) scope of authority, 2) transformation of outcomes, and 3) information retrieval practices across the two agencies.

Scope of Authority

The scope of authority and accompanying administrative mandate are obviously quite different between the CFPB and BIT. While the BIT must elicit cooperation from various departments within the U.K. government—along with the private companies it now works with—in order to pursue its behavioral agenda, the CFPB is more or less responsible for its own domain of consumer activity, a domain that it has strived on numerous occasions to expand.

Zywicki predicted that the CFPB's relatively loose constitutional structure would elicit just this kind of bureaucratic overreach, noting with respect to these tendencies that "Several are particularly relevant in understanding the flaws in the CFPB's institutional design: a tunnel-vision selection bias and commitment to regulatory mission, systematic risk-averse bias in agency decision making, a tendency toward agency overreach and expansionism, and a heightened risk of regulatory capture by industry participants."¹⁰⁹ As Zywicki's prescient

¹⁰⁷ John, P. 2014. Policy entrepreneurship in U.K. central government: The behavioural insights team and the use of randomized controlled trials. *Public Policy and Administration*. p. 261.

¹⁰⁸ Wintour, Patrick. 2014. Government's behaviour insight team to become a mutual and sell services. *The Guardian*. <http://www.theguardian.com/politics/2014/feb/05/government-behaviour-insight-nudge-mutual-nesta-funding>. Retrieved September 7, 2014.

¹⁰⁹ Zywicki, T. 2013. Consumer Financial Protection Bureau: Savior or Menace, *The Geo. Wash. L. Rev.*, 81, 856.

analysis demonstrations, institutions map into predictable outcomes, even when these outcomes depart from the underlying set of motivating ideas.

Limiting the scope of authority increases focus and concomitantly reduces the variability of policy. By setting the CFPB up to operate aggressively and independently of other government organizations, the result has been a deviation from the agency's original goals into areas of consumer choice and policy interventions that exceed the guidelines set out by behavioralists. As Hyman and Kovacic explain, "an agency with a sweeping, adaptable mandate has incentives to extend the boundaries of its authority, to show it is fulfilling the goals Congress set for it. Open-ended assertions of authority invite carelessness in implementation."^{110,111} One particular case of this led to the Federal Appeals Court decision described above, where the CFPB was found enforcing a certain administrative provision erroneously.¹¹²

One of the *Nudge* authors argued elsewhere that agencies should have certain institutional checks such as mandatory cost-benefit analysis, peer review by other agencies, and/or congressional oversight, in order to avoid overly aggressive intervention into consumer practices.¹¹³ This makes sense as public acrimony is hardly a reliable gauge by which policy should be adjudicated, as Thaler and Sunstein propose. After all, consumers who are believed to be incapable of making their own choices are surely incapable of evaluating the actions of regulators. Because the CFPB faces so little in the way of institutional constraints, it has become prone to much of the excesses feared by Kuran and Sunstein.

The BIT, on the other hand, is considered a successful endeavor by a wide swath of interested parties despite (or perhaps because of) the fact they have "very little money and no power to do its job."¹¹⁴ In having so little authority *ex ante*, the group has to ensure that the relevant parties truly benefit from the proposed policies, in contrast to the more aggressive practices of the

¹¹⁰ Hyman, D. A., Kovacic, W. E. 2014. Why Who Does What Matters: Governmental Design and Agency Performance. *Geo. Wash. L. Rev.*, 82, 1502.

¹¹¹ The Wall Street Journal's Peter Wallison (2016) describes the agency as follows: "The consumer bureau, on the other hand, roams the financial landscape enforcing 18 statutes and bringing actions that can cost hundreds of millions of dollars. It writes rules governing a wide swath of American business, has the power to define what is 'unfair' or 'abusive' in financial services, investigates companies and imposes penalties." Playful language aside, the comment is telling in how it describes the broad authoritative responsibilities of the CFPB, which include investigation, enforcement, and adjudication of an incredible range of market interactions, all with little oversight by outside authority.

¹¹² Kendall, B., Hayashi, Y. 2016. Appeals Court Deals Setback to Consumer-Watchdog Agency. *The Wall Street Journal*, October 11. <http://www.wsj.com/articles/federal-appeals-court-finds-structure-of-cfpb-unconstitutional-1476197389>. Retrieved October 11, 2016.

¹¹³ See Kuran, T., Sunstein, C. R. 1999. Availability Cascades and Risk Regulation. *Stanford Law Review* 51(4): p. 751-4.

¹¹⁴ John, P. 2014. Policy entrepreneurship in U.K. central government: The behavioural insights team and the use of randomized controlled trials. *Public Policy and Administration*. p. 258.

CFPB. By showing how these policies work through experimental practice, the agency is better able to convince others of the efficacy of its practices.

The underlying lesson here is that overwhelming government authority and improving social welfare are hardly mutually enforcing. Public organizations that are forced to be cooperative by way of their institutional constraints (e.g. having a budget set by congressional oversight), are more likely to deliver policies that are consistent with a broader set of interests than organizations with no such incentives.

Transformation of Outcomes

It is difficult to determine just how the CFPB formulates its policies. This regime uncertainty is indeed a prominent concern among the agency's adversaries. It is one thing to hold firms accountable to a set list of policies. It is quite another to hold them accountable to a set of policies to be formulated at a future date. While the former can be severely constraining, the latter discourages economic activity altogether, as firms are unable to formulate plans of production in the wake of this increased economic uncertainty

Compliance complaints are more than simple bickering by affected firms, but can result in a substantial reorientation of the underlying market. A study by the Mercatus Center found that:

71 percent of small banks stated that the CFPB has affected their business activities. Sixty-four percent of small banks reported that they were making changes to their mortgage offerings because of Dodd-Frank and 15 percent said that they had either exited or were considering exiting residential mortgage markets entirely. Nearly 60 percent of small banks reported that the CFPB or the qualified mortgage rule had a 'significant negative impact' on their mortgage operations. Nearly 60 percent said that the CFPB has had a significant negative effect on bank earnings and more than 60 percent said that changes in mortgage regulations had had a significant negative effect on bank earnings.¹¹⁵

These compliance costs associated with policymaking are particularly onerous to small banks as they reduce the competitive pressure these firms are able to put on larger banks.¹¹⁶ The CFPB has also been noted as failing to properly notify firms of the results of its examination process and further finding difficulty with the terms of ending its investigation.¹¹⁷ An additional criticism

¹¹⁵ Zywicki, T. 2015. The Dodd-Frank act five years later: are we more stable?. Congressional testimony, p. 6.

¹¹⁶ Boovey, B. 2016. Banks look for regulatory relief on Nov. 8. GSA Business, August 25. <http://gsabusiness.com/news/banking-finance/70341/>. Retrieved September 6, 2016.

¹¹⁷ See Bipartisan Policy Center (BPC). 2013. The Consumer Financial Protection Bureau: Measuring the Progress of a New Agency, *Bipartisan Policy Center*, Sept. 2013, <http://bipartisanpolicy.org/library/report/consumer-financial-protection-bureau>. Retrieved April 21, 2014. P. 24.

is that the CFPB publishes enormous policy documents, a far cry from the simplicity so emphasized in *Nudge*.¹¹⁸

The criticism perhaps most pertinent to the validity of welfare-improving outcomes of the CFPB involves the cutting off of credit; that is, when policy rules eliminate certain aspects of the marketplace altogether, despite the market alternatives that will inevitably arise as a result. The issue here is not about whether a policy is successful or not but the deeper reality that markets will create new, less desirable platforms for trading (e.g. black markets) in response to market bans. It also captures what Congdon describes when he maintains that “too narrow a focus might result in policy recommendations that are locally effective but globally counterproductive.”¹¹⁹ By eliminating a perceived localized behavioral market failure, the agency risks disrupting the underlying market in a manner that reduces consumer welfare.

The BIT, on the other hand, transforms ideas into policy through experimental design. As Smith outlines, experiments provide a space in which to test existing theories, establish empirical regularities to create new theories, evaluate policy proposals, and prototype novel institutional designs.¹²⁰ The BIT approaches policy solutions through a series of experiments generated to test appropriate means of eliciting desired outcomes. Once success is found, the agency then builds upon these findings to identify why the strategy is successful. They then provide recommendations on how to implement it.

Again, it is most likely due to the lack of authority and financial support that forces the agency to make policy agreeable to a large group of interested parties. John notes, “the team operates collaboratively which largely reflects its small size and the need for willing partners to carry out its interventions.”¹²¹ Policies that benefit all (or at least most) of the parties involved are crucial in justifying interventions based upon behavioral insights. As Lunn notes, “BE has had its most concrete effects on policy where findings point to policies that are in the interests of all parties affected by the decision being influenced.”¹²²

¹¹⁸ See Caveat vendor: A new regulator takes an expansive view of its remit. 2014. *The Economist*. <http://www.economist.com/news/finance-and-economics/21595488-new-regulator-takes-expansive-view-its-remit-caveat-vendor>. Accessed September 7, 2014.

¹¹⁹ Congdon, W. J. 2013. Psychology and economic policy. *The Behavioral Foundations of Public Policy*, ed. by Eldar Shafir. Princeton University Press, p. 465.

¹²⁰ Smith, V. L. 1994. Economics in the Laboratory. *Journal of Economic Perspectives* 8(1): 113-131.

¹²¹ John, P. 2014. Policy entrepreneurship in U.K. central government: The behavioural insights team and the use of randomized controlled trials. *Public Policy and Administration*, p. 260.

¹²² Lunn, P. D. 2013. Behavioural economics and policymaking: learning from the early adopters. *The Economic and Social Review* 43(3): 443.

Information Retrieval

The BIT retrieves information mostly through their experimental testing. It describes its information retrieval tactics as follows: “We are also highly empirical; we test and trial these ideas before they are scaled up. This enables us to understand what works and (importantly) what does not work.”¹²³ This last aspect refers to its use of randomized control trials as a means of not only collecting, but refining the data it analyzes.

The CFPB, on the other hand, employs a wide number of information gathering tactics.¹²⁴ According to its strategic plan, “The CFPB is a data-driven agency. We take in data, manage it, store it, share it appropriately, and protect it from unauthorized access. Our aim is to use data purposefully, to analyze and distill data to enable informed decision-making in all internal and external functions.”¹²⁵ The agency collects information through several avenues, most importantly through its own requests to firms. These requests have been called excessively burdensome and often outside the scope of the agency’s jurisdiction. Furthermore, often the purpose of the information request is not disclosed to the targeted firm and has been called excessively burdensome when compared to the ultimate outcome of the agency’s investigation.¹²⁶

For example, one of criticisms levied against the CFPB is their use of enforcement staff at its examination meetings with banks, a practice which departs from other similar agencies.¹²⁷ By using these sorts of aggressive tactics, the agency appears to desire compliance at the expense of nuance in finding the appropriate solution. This is a predictable outcome given Hyman and Kovacic’s observation that “Enforcement involves selective, ex post intervention and the identification of wrong-doers.”¹²⁸ The result is a “chilling effect” on targets of inquiry that inevitably leads to a reduction in crucial information that would identify appropriate policies. Surely such an outcome does not serve all consumers and it is easy to argue that it constitutes a far departure from the framework developed by Thaler and Sunstein.¹²⁹ But as Hyman and Kovacic describe, “Repeated exposure to business misconduct, coupled with a mandate to attack

¹²³ The Behavioral Insights Team. Who we are. The Behavioral Insights Team, Cabinet Office. <http://www.behaviouralinsights.co.uk/about-us/>. Retrieved August 30, 2016.

¹²⁴ Research and partial data collected by the CFPB can be accessed at <http://www.consumerfinance.gov/data-research/>. Retrieved August 30, 2016.

¹²⁵ Consumer Financial Protection Bureau. 2013. Strategic Plan FY 2013 - FY 2017. *Consumer Financial Protection Bureau*, Washington, D.C. <http://www.consumerfinance.gov/strategic-plan/>. Retrieved August 30, 2016.

¹²⁶ Bipartisan Policy Center 2013. p. 27-28.

¹²⁷ Bipartisan Policy Center 2013. p. 26-27.

¹²⁸ Hyman and Kovacic 2014, p. 1489.

¹²⁹ Thaler, R. H., Sunstein, C. 2008. *Nudge*. Yale University Press.

apparent episodes of illegal behavior aggressively, could lead CFPB personnel to develop a ‘shoot first, ask questions later’ approach to enforcing Dodd-Frank.”¹³⁰

The CFPB also collects information from consumers directly by allowing credit customers to post comments about banks to their website. Hence, this information is not collected through random survey but through self-identified credit consumers, which of course leads to a number of selection biases. Critics have argued that this information should be better categorized by the agency so as to avoid presumptions of guilt.^{131,132}

A final criticism leveled at these modes of data collection involves security. According to analysis reported by former House Speaker Newt Gingrich (2015), the agency collects information on literally millions of mortgage products, credit card use, student loans, and bank transactions involving fees every day. The potential for a security breach of such a massive hub of financial data is non-trivial, as admitted by Director Cordray himself in congressional testimony.¹³³

Conclusion

Boettke et al. explain that the behavioral movement resembles previous episodes in the history of economic thought that sought to change market outcomes based upon a perceived deviation from a theoretical optimum.¹³⁴ As they explain, though, deviation does not condone intervention, at least not until greater understanding of market coordination and the political institutions by which such policy would be rendered is given. And as Berggren notes, the acknowledgment of crucial political institutions in behavioral economics is sorely lacking. Until this lacuna is filled, policy prescription is ultimately unconvincing and premature.¹³⁵

¹³⁰ Hyman and Kovacic 2014, p. 1491.

¹³¹ See Zibel, Alan. 2014. CFPB Proposes Publishing Detailed Complaints Against Banks. *The Wall Street Journal*. <http://online.wsj.com/articles/cfpb-to-propose-publishing-detailed-complaints-against-banks-1405526806?KEYWORDS=cfpb>. Retrieved September 7, 2014.

¹³² In the example of auto lending described above, the CFPB determined bias based upon a controversial method that assigned the most likely ethnic background of the customer according to their last name. So, for example, names like Johnson, Williams or Robinson indicated that the customer was African-American, at least according to the employed methodology (see Hayashi and Andriotis 2015).

¹³³ Cordray, R. 2014. Consumer Financial Protection Bureau Report. *C-Span*, June 10 1:14:20. <https://www.c-span.org/video/?319846-1%2Fconsumer-financial-protection-bureau-report>. Retrieved September 6, 2016.

¹³⁴ Boettke, P., Caceres, W. Z., Martin, A. 2013. Error is obvious, coordination is the puzzle. *Hayek and Behavioral Economics*, p. 90-110. Palgrave Macmillan UK.

¹³⁵ Berggren, N. 2011. Time for Behavioral Political Economy? An analysis of Articles in Behavioral Economics. *The Review of Austrian Economics* 25(3): 199-221.

While this paper does not fully address this shortcoming, it does provide a framework for those who wish to utilize behavioral insights in a way that accounts for the public choice architecture by which these ideas will ultimately be turned into policy outcomes. A larger lesson for those seeking to use behavioral insights to achieve specific policy outcomes is to incorporate not only behavioral economics but public choice, new institutional economics, and even market design theory. The chief contribution of this last aspect is to learn from error in order to better anticipate how policies may fail to achieve the desired results. A more experimental approach as is employed by the BIT is surely warranted while this research program is in its formative stage, as market design can enhance and complement the use of behavioral insights. Far from invalidating the approach, careful institutional analysis can provide behavioral economics with a platform to move forward as a progressive research program.

Nevertheless, there is much to do before behavioral insights can become widely adopted to attain favorable policy. The *Nudge* movement is a telling example of this claim. While the ideas propounded by Thaler and Sunstein are compelling, their adoption by different agencies have shown remarkably divergent results. While the BIT has worked alongside government agencies and market actors to produce efficient outcomes, the CFPB has shown a far less nuanced—and at least in part an unconstitutional—approach that relies more on intimidating firms into choices that regulators unilaterally deem appropriate, with less regard to ultimate set of choices left before the consumer. As Mannix and Dudley put it, the improvement of “‘choice architecture’ cannot produce benefits by destroying choice.”¹³⁶

The more general lesson is that without the proper public choice architecture in place, there is little hope for improving private choices in practice. These insights are especially important as the United States adopts its own version of the Behavioral Insights Team. Led by Maya Shankar, an Oxford alum with behavioral credentials, this initiative looks to duplicate much of the work of the BIT.¹³⁷ Further, the executive order in September 2015 puts behavioral insights on the same footing as cost-benefit analysis in guiding regulatory policy. The order stipulates that government “should design its policies and programs to reflect our best understanding of how people engage with, participate in, use, and respond to those policies and programs.”

In its inaugural year, this group found itself in much the same institutional setting as the Behavioral Insights Team, with no real authority or power over other agencies. In order to succeed in its mission, the team “focused on projects in two areas where behavioral science had a strong role to play and impacts could be demonstrated relatively rapidly: (1) streamlining access

¹³⁶ Mannix, B. F., Dudley, S. E. 2015. The Limits of Irrationality as a Rationale for Regulation. *Journal of Policy Analysis and Management* 34(3): 711.

¹³⁷ Nesterak, Evan. 2014. Head of White House “Nudge Unit” Maya Shankar Speaks about Newly Formed Social and Behavioral Sciences Team. *The Psych Report*. <http://thepsychreport.com/current-events/head-of-white-house-nudge-unit-maya-shankar-speaks-about-newly-formed-us-social-and-behavioral-sciences-team/>. Retrieved September 7, 2014.

to programs and (2) improving government efficiency” (p. XII). Notably, the team also relied heavily on random control trials to best ascertain the effectiveness of its proposals.¹³⁸ The group has reported success in areas such as increasing retirement savings and encouraging college enrollment, mostly in disseminating information more effectively.

While this group finds its feet, the most important work will be to better appreciate the public choice architecture in which behavioral policies will be rendered. As I have shown by comparing the CFPB and BIT, institutions matter. Indeed, getting the institutions right may be more salient than the ideas the policies are based on. Without proper understanding of context and the institutional constraints regulators will inevitably face, it is unlikely that behavioral ideas will lead to better private choice architecture. While these efforts are encouraging for attempting to improve the choices people face, this paper exposes the importance getting the institutions right. Those who truly wish to improve private choice architecture should take greater care in understanding the public choice architecture in which their theories are applied.

¹³⁸ Alemanno and Spina (2014, p. 442) explain that “The rationale behind the extension of RCT from the pharmaceutical sector to that of public policymaking lies in the promises of low-cost, highly effective results inherent in the appeal of behaviorally informed regulation.”