The Troubling Prospect of “Behavioral” Regulation

Regulatory Policy Commentary
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Soon after taking office, President Obama sent a memorandum to the heads of Executive Departments and Agencies requesting their recommendations on whether and how to change President Clinton’s Executive Order No. 12866 “Regulatory Planning and Review.” Clinton’s Executive Order established procedures for issuing regulations, and also codified a regulatory philosophy that, for at least 40 years, has represented a bipartisan consensus on the role that federal regulation should play in our lives.

> “*The Regulatory Philosophy*: Federal agencies should promulgate only such regulations as are required by law, are necessary to interpret the law, or are made necessary by compelling public need, such as material failures of private markets to protect or improve the health and safety of the public, the environment, or the well-being of the American people. In deciding whether and how to regulate, agencies should assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating. . .”

The twin pillars of this established philosophy are the primacy of private markets in providing for the health and welfare of the public, and, when private markets demonstrably fail, the primacy of the public’s own preferences – as determined by the analysis of benefits and costs – in deciding whether a regulatory intervention will improve their health and welfare. President Obama’s memorandum mostly talked about updating regulatory procedures, but it also hinted at possible substantive changes in the reigning regulatory philosophy. He asked the Director of OMB, working with federal agencies to:

> “. . . offer suggestions on the role of cost-benefit analysis; address the role of distributional considerations, fairness, and concern for the interests of future generations; . . . clarify the role of the behavioral sciences in formulating regulatory policy; and identify the best tools for achieving public goals through the regulatory process.”

The reference to behavioral sciences, in particular, has generated considerable commentary, including an article by Andrew Ferguson in this week’s *Weekly Standard* (“Nudge Nudge, Wink Wink”) and a column by Jonathan Weisman in the *Wall Street Journal* (“Economic Policy ‘Nudge’ Gives Way to a Shove”). Weisman reviews the mixed record of the Obama Administration’s behavioral economists in shaping its agenda, noting that they may now focus merely on “regulatory matters and small-bore efforts.” In regulation, however, their influence may not be small, and may not be what they really intended.

Behavioral economists take issue with the presumption of rationality that underlies neoclassical economic theory, arguing (and demonstrating in the lab as well as in the field) that people often make decisions inconsistent with what we might predict based on rational self-interest. Point taken; other economists counter that strict rationality on the part of all the participants is hardly more essential to the efficiency of markets than it is to the theory of evolution. Moreover, while the rationality assumption allows economists to construct elaborate mathematical models of how markets function, the fact is that markets functioned for thousands of years before anyone understood them mathematically. It is not markets, but regulatory interventions in markets, that depend upon careful and accurate modeling for their success.

The behavioralist challenge to neoclassical economics has made for an interesting academic debate in recent years, but it takes on a whole different complexion when setting government policy. Certainly it makes sense to use behavioral insights to shape regulation: to eschew the shove when a nudge will do. But if federal regulatory agencies abandon the assumption that citizens are rational, benefit-cost analysis will cease to be informative. Rather than summarizing the effect of a regulation on public health and welfare as the public experiences it, the analysis will simply document what the agency thinks the public *ought* to want. The result is a terminal case of Planner's Paradox, wherein an agency's decisions always look good because they are examined only through the lens of its own assumptions.

The chief danger is that regulatory agencies will take the irrationality of consumers as sufficient reason, by itself, to intervene in markets, and will give primacy to the government's own judgment of what is good for us. Ultimately, we insist that our regulators start from a presumption of rationality for the same reason that we insist that our criminal courts start from a presumption of innocence: not because the assumption is necessarily true, but because a government that proceeds from the opposite assumption is inevitably tyrannical.

President Obama asked for agency recommendations within 100 days of his January 2009 memorandum. So far, however, he has not acted to change the regulatory philosophy articulated in President Clinton's Executive Order.