Behavioral Economics, Law, and Liberty:

The Never-ending Quest for the Third Way

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Behavioral economics is one of the most significant developments in economics over the past 30 years. The field, a combination of economics and psychology, has produced a body of evidence that individual choice behavior deviates from that predicted by neoclassical economics in a number of decision-making situations. These deviations from rational choice behavior are the result of individual's "cognitive biases," that is, systematic failures to act in one's own interest because of defects in one's decision-making process. The documentation of these cognitive biases in laboratories and, to a lesser extent, in markets, has been behavioral economics' primary contribution to microeconomics. These biases, behavioral economists assert, demonstrate systematically irrational choice behavior by individuals and firms. This irrational behavior, in turn, breaks the link between revealed preference and individual welfare upon which neoclassical economic theory depends.

Emerging close on the heels of behavioral economics over the past 30 years has been the "behavioral law and economics" movement, which explores the legal and policy implications of cognitive biases. The legal academy widely disseminated the body of evidence documenting irrational behavior, and is largely responsible for the behavioralists' foothold in regulatory policy circles, in and out of the Obama administration. Regulatory proposals built upon behavioral economics include attempts to "debias" individual decision makers through a variety of methods running

the gamut from subtle forms of coercion, including mandatory disclosure of more or better information and altering legal default rules, to more overt forms, such as imposing "sin" taxes and the outright prohibition of the of certain products.

Behavioral law and economics regulatory proposals touch nearly every area of the law and of human behavior but contain a consistent animating theme -- so-called libertarian paternalism"-- a term meant by proponents to describe interventions that both: (1) increase individual economic welfare by freeing decision makers from the fetters of their cognitive biases; and (2) change individuals' behavior without limiting their choices.[1] In other words, the promise of behavioral law and economics is so to regulate as to improve economic welfare by more closely aligning each individual's actual choices with his "true" or unbiased preferences without reducing his liberty, at least as it is represented by the choices available to him. While others have scrutinized the behavioral claims regarding economic welfare, our focus is upon the implications of behavioral law and economics for the liberty of the individual.

In Part I we provide a brief history the treatment of irrational behavior in economics, identify the intellectual roots of behavioral economics, and summarize the existing literature.

In Part II we explore the critical role of the legal academy in disseminating the insights of behavioral economics through legal scholarship and policy proposals. We

[1] Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism is Not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003).

examine several examples of policy interventions based upon behavioral law and economics, and document the remarkable rise of these proposals in legal scholarship.

In Part III we examine the first of the behavioral claims, viz., that government intervention designed to "debias" individual decision making will improve economic welfare. We survey the objections that have been made to behavioralist welfare claims based upon insights from microeconomic theory, empirical analysis, and public choice. These arguments are significant, and many of them bring to bear theory and evidence sufficient to reject behavioralist policy interventions on the ground that they pose too great a risk of reducing welfare. Of course, where a behavioral intervention reduces economic welfare, it also restricts individual liberty and autonomy. Thus, the economic welfare critique of behavioral law and economics is also relevant to our analysis of its implications for individual liberty.

In Part IV, we shift our focus from economic welfare to liberty. We assume, for the purpose of isolating and evaluating the potential negative effects upon liberty, that a behavioral intervention offers a Pareto superior alternative to the status quo. In other words, we will assume for the sake of argument that behavioralist interventions increase expected economic welfare without reducing any specific participant's position– thereby increasing total gains without simply effecting a naked transfer of wealth. We demonstrate that the behavioralists cannot, even adopting their overly narrow conception of liberty, satisfy the "do no harm" principle. Indeed, the

behavioralist regulatory agenda poses a significant threat to liberty and individual autonomy that, if adopted, would reduce individual incentive to invest in cognitive capacity, retard development of decision making skills, and encourage malaise while discouraging entrepreneurial activity.

In Part V we turn to the question of what accounts for the great and increasing attraction of behavioral law and economics to legal academics despite its likely negative effects upon the welfare and liberty of the people? We relate the behavioral law and economics movement to the rise and fall of the critical legal studies movement in order to illustrate what appear to be fundamental forces at work within the legal academy. Both movements share a paternalistic premise grounded in a Marxist concept of "false consciousness," and offer law professors an endless source of legal scholarship with few, if any, testable implications.

In Part VI, we conclude by discussing the implications of this comparison for the future success or failure of behavioral law and economics.

I. From Bounded Rationality to Predictably Irrational: A Brief History of Behavioral Economics

A. Irrationality and Economic Theory

The neoclassical economic framework is built upon the foundational assumption that economic agents are rational maximizers. Indeed, within the model of perfect competition, economic agents do not make mistakes or commit errors of any kind. Sellers are homogenous and all transaction and information costs, including the costs of processing information required to make economic decisions, are zero. It follows that resources must instantaneously, and without the opportunity for erroneous allocation, flow to their highest valued use.

The above description does not offer a critique of price theory. After all, the model of perfect competition was not designed for the purpose of describing the competitive activities of economic agents. Indeed, as Harold Demsetz has pointed out, the neoclassical model has little to say about competitive activities at all and is better described as a model of perfect decentralization.[2] The purpose of the model was to demonstrate the relative efficiency of a decentralized allocation of resources.

With the academic battle among economists over the relative virtue of market allocation of resources largely settled by the 1950s, the economics profession would soon devote its attention to extending the neoclassical framework to explain real-world

[2] HAROLD DEMSETZ, *The Intensity and Dimensionality of Competition*, *in* THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES 137 (1995).

phenomena observed in markets. For example, beginning with George Stigler's *The Economics of Information*, economists began to consider the costs of obtaining and processing information required for economic decision making.[3] Armen Alchian's *Uncertainty, Evolution, and Economic Theory* also explored the role of markets in "correcting" irrational behavior.[4] The cost of information and the roles of error and of irrational behavior in consumer decision making also attracted the attention of Chicago School economists, including Gary Becker and Milton Friedman, who demonstrated that the tools of price theory were both consistent with and valuable for analyzing observed irrational behavior.[5]

While the price-theoretic framework was expanding to address irrationality from one direction, Herbert Simon offered insights from another direction, planting the seeds of what would become the modern behavioral economics literature. Simon's work began with the observation that humans do not possess the cognitive capacity to execute the functions necessary to maximize, and instead, human decision-making is better explained by "satisficing" behavior.[6] He explained the role of heuristics and mental shortcuts as economizing devices for limited cognitive capacity. This form of bounded rationality, as Simon described it, generated predictions for economic

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[3] George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961).
[4] Armen Alchian, *Uncertainty, Evolution and Economic Theory*, 58 J. POL. ECON. 211 (1950).
[5] Gary Becker, *Irrational Behavior and Economic Theory*, 40 J. POL. ECON. 1 (1962); MILTON FRIEDMAN, *The Methodology of Positive Economics*, *in* ESSAYS IN POSITIVE ECONOMICS 3-16 (1953).
[6] Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q. J. ECON. 99 (1955).

behavior that often differed from those offered by price theory as applied to both individual and firm behavior.[7]

The seminal work of Simon on the one hand, and of Alchian, Becker, and Stigler on the other, and the research programs stimulated by them, each applied somewhat different economic tools in order better to understand the costs of acquiring and processing information. Both research programs, however, applied the economic toolkit to explain irrationality and errors in markets.

In the 1970s, psychologists Daniel Kahneman and Amos Tversky would go on, using insights from the psychological literature to generate an alternative to the rational choice model, which they called "prospect theory."[8] This work, for which Kahneman would receive the Nobel Prize in Economic Sciences in 2002, provides the intellectual foundation of the modern literature on behavioral economics. Based upon a series of laboratory experiments, Kahneman and his various co-authors identified deviations from rationality and categorized these deviations by attributing them to one of three sources of bias: "representativeness," "availability," and "adjustment or anchoring."[9]

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[7] Richard Cyert and James March applied the bounded rationality concept to develop a behavioral theory of the firm. *See* RICHARD M. CYERT & JAMES G. MARCH, A BEHAVIORAL THEORY OF THE FIRM (1963).

[8] Daniel Kahneman & H. Tversky, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974).

[9] *See e.g.*, Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCHOL. 207 (1973); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979); Daniel Kahneman, et al. , *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON., 1325 (1990); Daniel Kahneman & Shane Frederick, *Representativeness Revisited: Attribute Substitution in Intuitive Judgment, in* HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 49-–81 (Thomas Gilovich et al. eds. 2002).

The modern research program of behavioral economics, which continues to use the psycho-social approach introduced by Kahneman and Tversky, has proceeded largely along two lines. The first line has expanded the set of documented cognitive biases, cataloging all possible systematic deviations from rational choice observed in experimental and field settings. This literature has focused particularly upon the availability heuristic, status quo bias, over-optimism bias, hyperbolic discounting, framing effects, and endowment effects.[10] The second line of research has been to test whether these biases, initially documented in experiments within the controlled laboratory setting, are generalizable to markets.[11]

Perhaps the two most well-known torchbearers of the modern behavioral economics movement are Cass Sunstein and Richard Thaler.[12] In a series of academic articles, Sunstein and Thaler, individually and together, made significant contributions to what now amounts to a vast literature documenting cognitive biases in a variety of

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[10] For a recent review of the literature, see Christine Jolls, *Behavioral Law and Economics*, *in* ECONOMIC INSTITUTIONS AND BEHAVIORAL ECONOMICS (Peter Diamond ed. 2007).

[11] *See, e.g.*, Steven D. Levitt et al., *What Happens in the Field Stays in the Field: Exploring Whether Professionals Play Minimax in Laboratory Experiments*, 78 ECONOMETRICA 1413 (2010); John A. List, *Neoclassical Theory Versus Prospect Theory: Evidence From the Marketplace*, 72 ECONOMETRICA 615 (2004) (arguing laboratory results are not robust enough to simulate market interactions where competition, expertise, and learning might be expected to ameliorate these biases); John A. List, *Does Market Experience Eliminate Market Anomalies?*, 118 Q.J. ECON. 41 (2003) (same); Michael S. Haigh & John A. List, *Do Professional Traders Exhibit Myopic Loss Aversion? An Experimental Analysis*, 60 J. FIN. 523 (2005) (same); John A. List & Uri Gneezy, *Putting Behavioral Economics to Work: Testing for Gift Exchange in Labor Markets Using Field Experiments* (Nat'l Bureau of Econ. Research, Working Paper No. 12063, 2006) (same).

[12] Sunstein was formerly a law professor at the University of Chicago and is currently Administrator of the Office of Information and Regulatory Affairs, U.S. Office of Management and Budget. Thaler is an economist at the University of Chicago Booth Graduate School of Business.

laboratory settings, and in some field experiments.[13] Sunstein and Thaler are best known for introducing the concept of "libertarian paternalism," which they define as "an approach that preserves freedom of choice but that authorizes both private and public institutions to steer people in directions that will promote their welfare."[14] As discussed below, the concept of libertarian paternalism has served as a catalyst, facilitating the creation of a behavioral law and economics movement in the legal academy and beyond.[15] Sunstein and Thaler thus attempt to provide the intellectual link between the *raison d'etre* of the behavioral economics literature — mapping the conditions under which economic decision makers err — and a theory of when and how the government should regulate those errors. We begin with a few preliminary observations on the research program of behavioral economics.

B. Behavioral Economics as a Theory of Errors

The fundamental link holding together the various strands of behavioral economics —or behavioral decision theory as it is sometimes called — is the

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[13] Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism is Not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003); Richard H. Thaler, *Doing Economics Without Homo Economicus*, *in* FOUNDATIONS OF RESEARCH IN ECONOMICS: HOW DO ECONOMISTS DO ECONOMICS? 227–37 (Steven G. Medema & Warren J. Samuels eds. 1996); Richard H. Thaler, *Toward A Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV & ORG. 39 (1980); Richard H. Thaler & Robyn M. Dawes, *Cooperation*, *in* THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE 6–20 (1992); Timur Kuran & Cass Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683 (1999); Cass R. Sunstein, *Moral Heuristics and Moral Framing*, 88 MINN. L. REV. 1556 (2004); Richard H. Thaler, *Mental Accounting and Consumer Choice*, 4 MARKETING SCI. no. 3, 199–214 (1985); Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*, 112 J. POL. ECON. S164–87 (2004).

[14] Sunstein & Thaler, *Libertarian Paternalism*, 93 AM. ECON. REV. 175, 179 (2003). *See also* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008).

[15] *See infra* Part II.

identification of errors in decision making, each of which is independently costly. . In identifying these various errors, behavioral economists correctly focus upon systematic deviations from rationality rather than the errors of particular individuals. As has long been observed, the rationality assumption of price theory is neither a behavioral postulate nor a characterization of the actual decision-making processes employed by economic agents. Rather, rationality is a simplifying assumption made to render modeling market outcomes tractable and to harness the mathematical tools of optimization. If, therefore, behavioral economics is to outperform price theory, then its superiority must be proven by its greater predictive power, not merely the assertion that its underlying assumptions are more "realistic."[16]

The behavioralists appear to embrace this challenge. Christine Jolls, Sunstein, and Thaler describe the behavioral law and economic research agenda as economic analysis of the law "with a higher R-squared," by which they mean it has a "greater power to explain the observed data."[17] Jolls similarly notes "behavioral economics attempts to improve the predictive power of law and economics by building in more realistic accounts of actors' behavior."[18] Thus, the behavioral economics research

[16] *See* FRIEDMAN, *supra* note 5, at 14–16.
[17] Christine Jolls, Cass Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1487 (1998).
[18] Christine Jolls, *Behavioral Law and Economics*, *in* ECONOMIC INSTITUTIONS AND BEHAVIORAL ECONOMICS (Peter Diamond ed., Princeton Univ. Press 2007). *See also* Jolls, Sunstein, & Thaler, *supra* note 17, at 1484 ("In this sense, our analysis is consistent with the precept originally proposed by Milton Friedman: Economics should not be judged on whether the assumptions are realistic or valid, but rather on the quality of its predictions").

program is overtly empirical. Incorporating "more realistic" psychological accounts of economic actors is a means to the end of generating greater predictive power than do existing economic accounts grounded in the assumption of individual rationality.

The remarkable complexity of the behavioral research agenda is also worth noting for several reasons. Perhaps most important, identifying irrational behavior that imposes costs upon the decision maker committing the error requires a theory of the "true" rather than the "revealed" preferences of the decision maker. Relatedly, the task requires a great deal of information, including some information not likely to be available to the researcher in many, if not most or all, market environments.[19]

The first stage of the behavioral economic research program is best described as a theory of errors. The theory-building exercise thus far has focused largely upon the effort to catalog circumstances in which economic decision makers deviate from rational choice behavior. The next required step in developing a policy-relevant theory of errors is to map the conditions under which specific errors are more or less likely to affect decisions and to generate estimates of the social costs imposed by those errors under the specified conditions. The third step would be to evaluate whether the costs of the proposed intervention outweigh any social benefits produced by reducing the rate of error. The development of this theory of errors does not appear to have evolved beyond the first step.

[19] Both of these reasons are discussed at greater length, *infra* Part III.

Consistent with this observation, Jonathan Klick and Gregory Mitchell also describe the research program of behavioral economics as focusing almost exclusively upon the task of documenting biases rather than of generating a theory capable of characterizing necessary and sufficient conditions for these biases to induce welfare-reducing error:

> The dominant research program in behavioral decision theory, the heuristics and biases program, consists of a collection of robust empirical findings bound together by high-level concepts rather than an integrative theory that can predict how particular features of the mind and environment are likely to interact in particular cases.[20]

The lack of an integrative theory of errors has not, however, discouraged ambitious attempts to leverage the biases documented in the first stage of the research program into specific regulatory applications. Indeed, the mere identification of systematic decision errors leads behavioralists almost without hesitation to ask: How can government "correct" those errors with "choice architecture" or other new forms of paternalism?

A minimal requirement for this second, or "error correction"step, in addition to identifying recurring and systematic errors, is an accounting of the social costs and benefits of those errors. In our view, upon which we elaborate in Parts III and IV, the behavioral economics literature (and thus, by extension, the behavioral law and

[20] Jonathan Klick & Gregory Mitchell, *Government Regulation of Irrationality: Moral and Cognitive Hazards*, 90 MINN. L. REV. 1620, 1628 n. 20 (2006).

economics literature) exhibits a strong tendency to ignore the social benefits of error. At the same time, it tends to overestimate the social costs of errors, or at least to assume the social benefits from reducing identified errors will generally be greater than the social costs of interventions aimed at correcting errors. This tendency explains the current condition under which "virtually every scholar who has written on the application of psychological research on judgment and choice to law has concluded that cognitive psychology supports institutional constraint on individual choice."[21]

We begin by exploring the behavioral economists' toolkit and providing a brief summary of the cognitive biases identified in the literature. These biases can be conveniently divided into two major categories: (1) contextualization errors and (2) self-control problems.[22]

1. Contextualization Errors: Framing, Prospect Theory, and Endowment Effects

Contextualization errors are those deviations from rational choice that arise from the context in which the individual makes his decision. Generally, these errors are associated with bounded rationality,[23] and arise because economic agents rely upon decision-making heuristics and apply "rules of thumb" instead of doing the calculations

[21] *See* Jeffrey J. Rachlinksi, *The Uncertain Psychological Case for Paternalism*, 97 NW. UNIV. L. REV. 1165, 1166 (2003). *See also* Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded For Behavioral Economics' Equal Incompetence*, 91 GEO. L. REV. 67 (2002).
[22] Jolls, Sunstein, and Thaler, *supra* note 17.
[23] I*d.* at 1477.

required for optimization.[24] Biases of this type are frequently described as "framing effects." These effects are seen when an individual faced with an identical choice problem in different contexts makes different choices, thereby implying an underlying inconsistency in preferences, or "preference reversals."[25]

Kahneman and Tversky's prospect theory is most commonly associated with framing effects. Prospect theory posits that decision makers evaluate expected outcomes not in isolation but relative to an initial reference point.[26] While it need not follow directly from this characteristic of individual decision making, prospect theory has also incorporated the empirical observation that decision makers weight losses from the reference point more heavily than gains, a phenomenon described a "loss aversion." These two features of prospect theory together imply that whether a decision is framed as a gain or as a loss relative to the status quo will have a significant effect upon decision making.

The classic experimental evidence in support of prospect theory is the now-famous "mug" experiment involving forty-four undergraduate students at Cornell University.[27] Jolls, Sunstein, and Thaler summarize the experiment:

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[24] *See* Daniel Kahneman & H. Tversky, Judgment Under Uncertainty: Heuristics and Biases, 185 Science 1124 (1974).
[25] *See* Amos Tversky & Richard H. Thaler, *Preference Reversals*, *in* THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC Life (Free Press 1992).
[26] Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 267, 277–79 (1979).
[27] Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and the Status Quo Bias*, 5 J. ECON. PERSP. 193 (1991).

> Half the students were endowed with tokens. Each student (whether or not endowed with a token) was assigned a personal token value, the price at which a token could be redeemed for cash at the end of the experiment; these assigned values induce supply and demand curves for the tokens. Markets were conducted for tokens. Those without tokens could buy one, while those with tokens could sell. Those with tokens should (and do) sell their tokens if offered more than their assigned value; those without tokens should (and do) buy tokens if they can get one at a price below their assigned value. These token markets are a complete victory of economic theory. The equilibrium price was always exactly what the theory would predict, and the tokens did in fact flow to those who valued them most.[28]

When tokens were replaced with mugs, once again markets formed and mugs were bought and sold. The results changed this time:

> The assignment of property rights had a pronounced effect on the final allocation of mugs. The students who were assigned mugs had a strong tendency to keep them. Whereas the Coase theorem would have predicted that about half the mugs would trade (since transaction costs had been shown to be essentially zero in the token experiments, and mugs were randomly distributed), instead only fifteen percent of the mugs traded. And those who were endowed with mugs asked more than twice as much to give up a mug as those who didn't get a mug were willing to pay. This result did not change if the markets were repeated. This effect is generally referred to as the "endowment effect."[29]

The key experimental finding is a gap between willingness to accept (WTA) and willingness to pay (WTP). WTA-WTP gaps are often assumed to flow from prospect

[28] Jolls, Sunstein, & Thaler, supra note 17, at 1484.
[29] *Id.*

theory generally and from loss aversion specifically.[30] Put simply, prospect theory predicts that economic agents will, in many cases, be reluctant to sell goods endowed to them even at prices greater than their own willingness to pay to acquire the good.

The endowment effect is the most celebrated, and certainly the most discussed, of the cognitive biases in the behavioral law and economics literature. This is so no doubt in part because behavioral economists and legal scholars claim it as the most robust of the biases,[31] but also no doubt because of its clear and obvious policy implications. As Jolls, Sunstein, and Thaler point out, the principal implication of the endowment effect generated by prospect theory is that the Coase Theorem does not apply,[32] which in turn has implications for virtually every area of substantive law. Legal scholars have certainly not missed many opportunities to draw out these potential implications.[33]

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[30] Indeed, Jolls, Sunstein, & Thaler introduce the concept of an "endowment effect" as "a manifestation of the broader phenomenon of 'loss aversion'-- the idea that losses are weighted more heavily than gains-- which in turn is a central building block of Kahneman and Tversky's prospect theory." *Id.* As we discuss in greater detail in Part III, prospect theory is one of several possible interpretations of the WTA-WTP empirical evidence, and one that is the subject of significant debate.

[31] *See, e.g.*, Daniel Kahneman et al., *The Endowment Effect, Loss Aversion, and Status Quo Bias, in* CHOICES, VALUES AND FRAMES 159, 170 (2000) (describing the robustness of the endowment effect as "part of our endowment, and we are naturally keener to retain it than others might be to acquire it"); Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. L. REV. 1227, 1229 (2003) ("The endowment effect is undoubtedly the most significant single finding from behavioral economics for legal analysis to date"); *See also* Samuel Issacharoff, *Can There Be a Behavioral Law and Economics?*, 51 VAND. L. REV. 1729, 1735 (1998) ("The endowment effect is the most significant empirical observation from behavioral economics.").

[32] Jolls, Sunstein, and Thaler, *supra* note 17, at 1497; *see also* Elizabeth Hoffman & Matthew L. Spitzer, *Willingness to Pay vs. Willingness to Accept: Legal and Economic Implications*, 71 WASH. U. L.Q. 59, 99 (1993).

[33] As of August 24, 2010, a search of the Westlaw JLR database reveals 924 articles in legal periodicals referencing "endowment effect." The same search on Google Scholar results in 1090 references from legal periodicals and court opinions. According to one legal scholar, a broader search for "endowment effect"

2. Self-Control Problems: Hyperbolic Discounting and Optimism Bias

With respect to self-control, the behavioral economics literature has focused largely upon two types of cognitive errors. The first involves systematic errors in decisions allocating resources over time. In other words, individuals place so much weight upon immediate gratification that they regularly make decisions they will come to regret tomorrow. Such time-inconsistent preferences go beyond merely placing greater weight upon present than upon future consumption; all economic models involve a discount factor that individuals apply to future costs and benefits, called "exponential discounting." Stable, time-consistent preferences require a constant exponential discount factor; hyperbolic discounting generates time-inconsistent preferences, sometimes described as "present-bias." Rather than discounting the future exponentially, as we do when calculating present values because the value of the future declines at an exponential rate, hyperbolic discounting refers to an individual placing an extremely high weight upon the present, after which future values decline exponentially.[34]

Hyperbolic discounting implies not only different subjective values for weighting future costs and benefits relative to the present, but also that an individual

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or "status quo bias" revealed that the terms were referenced in only two legal periodicals in 1990, but in 373 by 2003. *See* Korobkin, *supra* note 31, at 1229.

[34] *See* Shane Frederick, George Loewenstein & Ted O'Donoghue, *Time Discounting and Time Preference: A Critical Review*, *in* TIME AND DECISION: ECONOMIC AND PSYCHOLOGICAL PERSPECTIVES ON INTERTEMPORAL CHOICE 13–86 (Loewenstein et al. eds. 2003).

would reverse his preferences at different times. For example, a person offered the choice between $5 today and $10 in one year might choose to wait for the larger sum given his relative weighting of the value of present and future consumption. When the year has passed, however, the same person would view their prior decision with regret, and wish they had taken the $5 at the time the decision was offered. The basic concept is that these preference reversals lead to a situation in which decision makers are left worse off because they systematically fail to resist temptation and to delay gratification. Behavioral economists have relied upon hyperbolic discounting to explain a wide array of self-control problems ranging from overeating, to excessive debt, to gambling and other forms of addiction.

The second type of error involving self-control problems is optimism bias. Behavioral economists have identified circumstances in which individuals appear to underestimate the likelihood of their being exposed to losses. Jolls, Sunstein, and Thaler describe optimism bias as "a common feature of human behavior" characterized by people tending to "think that bad events are far less likely to happen to them than to others."[35] The tendency to underestimate the likelihood of a bad outcome leads decision makers to take on too much. While optimism bias can be characterized as contextual, that is, giving rise to error because individuals fail to process information

[35] Jolls, Sunstein, & Thaler, supra note 17, at 1524.

that would allow them to perceive risks rationally,[36] the bias is often used to explain choices that invoke impulsivity, failure of self-control, and lack of will power. For example, optimism bias might induce individuals to take insufficient care in driving an automobile because they underestimate the risk of an accident,[37] borrow too much today because they underestimate the risk that they will be left with insufficient means to pay off the debt tomorrow,[38] or engage in too much criminal activity because they underestimate the probability of being sanctioned.[39]

As the preceding discussion reveals, the research program of behavioral economics has largely consisted of identifying, documenting, and classifying errors in decision making. What has thus far eluded the researchers in their attempt to create a theory of errors that can be confidently applied in regulatory settings is a robust empirical understanding of the conditions under which individual decisions will be fettered by these cognitive biases and when they will not.[40] This gap in the behavioral theory of errors is critical. The absence of a detailed understanding of these conditions

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[36] Another contextual element of the optimism bias might be cultural. For example, in countries with cultures rewarding entrepreneurship and risk-taking, "excessive" optimism might serve to encourage those activities. In countries (e.g. Russia) where those activities have not been historically rewarded and negative outcomes are more salient to decision-makers, irrational exuberance concerning risky behaviors is unlikely to be a significant problem.

[37] Christine Jolls & Cass R. Sunstein, *Debiasing Through Law*, 35 J. LEGAL STUD. 199, 205 (2006).

[38] Cass R. Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249 (2006); Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1395–1411 (2004); *see also* Lawrence M. Ausubel, *The Failure of Competition in the Credit Card Market*, 81 AM. ECON. REV. 50 (1991) (asserting that consumer irrationality explains observed pricing behavior in the credit card market).

[39] *See* Jolls, *supra* note 18.

[40] Gregory Mitchell, *Libertarian Paternalism Is an Oxymoron*, 99 NW. U. L. REV. 1245 (2005), and Klick and Mitchell, *supra* note 20, emphasize this point.

makes it inevitable that behavioral interventions will induce another sort of error: policy error.

The inevitability of policy errors can be derived from the insurmountable theoretical and empirical obstacles to the identification of any person', let alone all persons', "true preferences." One type of policy error will occur when a behavioral intervention is aimed at seemingly irrational behavior that is in fact rational for the decision maker in question. A second type of policy error occurs when an intervention is designed to improve the decision making of "truly" irrational economic agents, and also inevitably imposes costs upon all those who are not committing an error. These policy errors are "false positives" in the sense that the social cost associated with the behavioral intervention results from its imposition upon rational actors.

However, the risk of significant policy error is present even if the error rate for individuals is 100 percent. For example, behavioralists propose increasing taxes to reduce errors caused by hyperbolically discounting consumers of certain products, such as cigarettes. But even if all consumers in the market exhibit present-bias in cigarette consumption, and the intervention is successful in reducing the error rate, the question remains whether the social costs saved are greater than the costs of intervention. Thus, a third type of policy error occurs when the regulator allocates social resources to an intervention in excess of the social costs saved by error reduction. In the case of a cigarette tax, the likelihood of this type of policy error is exacerbated by the fact that

regulators do not, and likely cannot, have accurate knowledge of not only "true" preferences but also of the discount factors necessary to calculate the optimal tax rate. Errors committed in setting the tax rate, either too high or too low, can result in significant welfare consequences. The propensity to commit this third type of policy error is further increased because regulators are not likely to have knowledge sufficient to identify the underlying efficient error rate resulting from rational economizing on information and transaction costs. Without an understanding of the various social costs of the error reduction, the behavioralist regulator is left especially prone to committing welfare-reducing policy errors.

The risk of each of type of policy error turns, at least in part, on the claim that behavioral regulators will not and cannot have access to the information necessary to implement the proposed interventions without significant risk of reducing welfare. A fundamental point in support of this claim is that the heterogeneity of behavioral biases across individuals, contexts, and time implies that, lest behavioral interventions that reduce deviations from "true" preferences for some nonetheless impose costs upon others, one must have knowledge of the distribution of these effects across those dimensions in order to generate even a rough estimate of the likely welfare effects of the policy. While the behavioralists emphasize the inescapable nature of errors resulting

from cognitive biases, evaluation of the social costs and benefits of behavioral interventions largely ignores the inevitability of the policy errors described above.[41]

II. From Behavioral Economics to Behavioral Law and Economics

The quest to translate the insights of the behavioral economics literature into public policies intended to improve decision making and welfare has been remarkable. In addition to Thaler and Sunstein's recent book, *Nudge: Improving Decisions About Health, Wealth, and Happiness*,[42] a popular summary of the behavioral approach to law, and Dan Ariely's similarly-oriented *Predictably Irrational*,[43] evidence that behavioral law and economics is affecting public policy is not difficult to find. Indeed, a recent account in the popular press describes behavioral economics as "the governing theory" of the Obama administration's regulatory agenda.[44] To give a concrete example, behavioral economics provides the intellectual blueprint for the newly created Consumer Financial Protection Bureau.[45] A member of the Federal Trade Commission has discussed taking

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[41] We return to this issue *infra*, Part III.

[42] THALER & SUNSTEIN, *supra* note 14.

[43] DANIEL ARIELY, PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS (2008).

[44] Andrew Ferguson, *Nudge, Nudge, Wink Wink: Behavioral Economics – The Governing Theory of Obama's Nanny State*, THE WEEKLY STANDARD (Vol. 15, No. 29, April 29, 2010). Time Magazine described the Obama administration's advisers as a "behavioral dream team" that would rely on behavioral economics to "transform the country." Michael Grunwald, *How Obama is Using the Science of Change*, TIME, Apr. 2, 2009, ¶¶ 3-4, *available at* http://www.time.com/time/magazine/article/0,9171,1889153,00.html.

[45] *See* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 39 (2008); Elizabeth Warren, *Unsafe at Any Rate*, 5 DEMOCRACY J. IDEAS, (Summer 2007), *available at* http://www.democracyjournal.org/article.php?ID=6528; Michael S. Barr, Sendhil Mullainathan, & Eldar Shafir, *Behaviorally Informed Financial Services Regulation* 1 (New Am. Found., Working Paper, October 2008). For a criticism of the behavioral approach to regulating consumer credit, see David S. Evans & Joshua D. Wright, *The Effect of the Consumer Financial Protection Agency Act of 2009*, 22 LOY. CONSUMER L.

a more behavioral approach to enforcing the antitrust laws.[46] Regulatory proposals informed by behavioral law and economics span areas ranging from antitrust and consumer protection to employment and discrimination law. The depth and breadth of the regulatory agenda based on behavioral law and economics is in no small part due to the success it has found in the legal academy.

A. The Rise of Behavioral Law and Economics in the Legal Academy

The legal academy is the driving force behind the rise of behavioral law and economics and its growing influence in policy debates. Even without a working understanding of the conditions under which behavioral biases are likely to make individuals worse off, legal academics have found in the behavioral economics literature a rich supply of empirical findings that they can cobble together in support of a wide spectrum of paternalistic regulatory interventions. Within the legal academy, the growth of the behavioral law and economics movement has been dramatic, resulting in hundreds of law review and journal articles in a relatively short period of time.[47] Figure 1 illustrates the increasing presence of behavioral economics in legal scholarship over the last 30years, from a single article in Westlaw's JLR database

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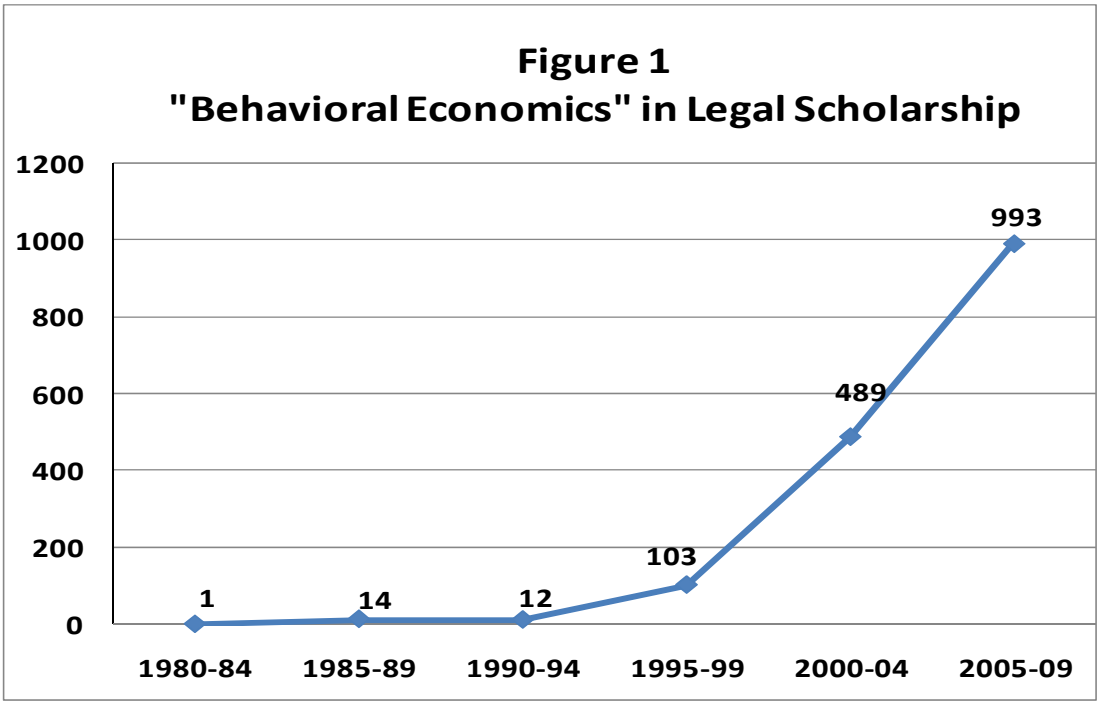
REV. 277 (2010). The new Consumer Financial Protection Bureau, and its roots in behavioral law and economics, are discussed *infra*, at Part III.B.2.

[46] J. Thomas Rosch, Behavioral Economics: Observations Regarding Issues That Lie Ahead, remarks before the Vienna Competition Conference (June 9, 2010), *available at* http://ftc.gov/speeches/rosch/100609viennaremarks.pdf.

[47] As of August 24, 2010, a search of the Westlaw JLR database reveals 1789 articles in legal periodicals referencing "behavioral economics." A search on Google Scholar results in 2150 legal opinions and articles referencing the same term.

mentioning "behavioral economics" between 1980 and 1984 to 917 mentions between 2005 and 2009.[48]



The increasing footprint of behavioral law and economics in the legal academy extends beyond legal scholarship, via law school faculties, to the modern legal curriculum. For example, 8 of the top 20 law schools in the United States have offered at least one course in behavioral law and economics over the past five years.

There is also growing evidence that the influence of behavioral law and economics extends overseas. There has been a concerted effort to transplant the research agenda of behavioral economics to Europe, in particular. In April 2004, the European Network for the Advancement of Behavioral Economics (ENABLE), a joint

[48] Figure 1 updates data first appearing in Douglas H. Ginsburg & Derek W. Moore, *The Future of Behavioral Economics in Antitrust*, 6(1) COMPETITION POL'Y INT'L 89 (2010).

venture between European universities with nascent behavioral institutes and established programs at Harvard and Princeton, undertook a mission to "advance this emerging field of behavioural economics in Europe" by facilitating the "development of a critical mass of the brightest young researchers by concentrating the currently highly fragmented expertise in Europe."[49] While these efforts were aimed at creating the next generation of behavioral economists, European economists such as Ernst Fehr of the University of Zurich and Jean Tirole of Universite des Sciences Sociales at Toulouse, are already significant figures in the field.[50] It is not surprising, therefore, that we see an emerging literature in behavioral law and economics in Europe.[51]

Nor is it surprising that the behavioral law and economics scholarship has generated a flood of regulatory proposals. At the same time, there has arisen a separate debate in the legal literature over an appropriate identifier for their approach. Whether one adopts Sunstein and Thaler's favored description of "libertarian paternalism," the more restrictive "asymmetric paternalism,"[52] or the "new paternalism" label favored by

[49] The ENABLE network, funded in part by the European Commission, completed its work in March 2008. The research training network included several prominent figures in behavioral economics, including Daniel Kahneman and David Laibson of Harvard University.

[50] Fehr and Tirole are also among members of the 28 members of the Russell Sage Foundation Behavioral Economics Roundtable, which sponsors a summer workshop for graduate students and junior faculty interested in behavioral economics and funds research in this area.

[51] *See, e.g.*, Hans Van Ees, et al., *Toward A Behavioral Theory of Boards and Corporate Governance*, 17 CORP. GOVERNANCE 307 (2009); Guido Kordel, *Behavioral Economic Analysis of Collective Bargaining Agreements Under EC Antitrust Law*, 27 EUR. COMP. L. REV. 28 (2006); Lars Klohn, *Preventing Excessive Retail Investor Trading Under MiFID: A Behavioral Law & Economics Perspective*, 10(3) EUR. BUS. ORG. L. REV. 437 (2009).

[52] *See* Colin Camerer et al., R*egulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 141 U. PA. L. REV. 1211 (2003).

critics,[53] regulatory proposals built upon behavioral economics run from relatively gentle attempts to encourage retirement savings by changing the default option all the way to outright bans of certain products and, somewhere in between, interventions that would impose positive but not infinite costs upon individuals who wish to opt-out of the default approved by the government.

B. Recent Examples of Behavioral Law and Economic Regulatory Proposals

Common to each of these proposed behavioral interventions is the claim that it will improve decision making by reducing errors attributable to cognitive biases and bounded rationality, thus making individuals better off as measured by their own preferences. These proposed interventions vary across several dimensions, however. Many would modify legal default rules, in some instances invoking "choice architecture" to manipulate framing effects so as to improve decision making. Even among these default-switching proposals, there is variation with respect to the cost of "opting-out" of the regulator's preferred choice. The cost of opting-out can be imposed either directly or indirectly. For example, some behavioralist proposals do not restrict the set of choices available to consumers, but nonetheless impose costs in the form of cooling-off periods or some other burden placed upon sellers that, in turn, results in higher prices or reduced variety or both. Examples include the "plain vanilla" requirement, which would restrict a lender's ability to offer a "non-standard" credit

[53] *See* Douglas Glen Whitman & Mario J. Rizzo, *The Knowledge Problem of New Paternalism*, 2009 BYU L. REV. 905 (2009).

product until it had offered a satisfactory standard product approved by the regulator. Still other interventions would not allow individuals to opt-out of the default rule. Examples include significant "sin" taxes on cigarettes and fatty foods, and even banning certain products. We discuss four of these policy proposals to illustrate common themes in the behavioralists' regulatory agenda.[54]

1. Choice Architecture and Retirement Savings

The most frequently discussed example of a behavioral intervention invoking choice architecture is default enrollment in savings plans. Sunstein and Thaler have argued that switching the default from opt-in to opt-out for savings plans would be consistent with their notion of libertarian paternalism, as would be a law "requir[ing]" employers to provide automatic enrollment and allow employees to opt out."[55] Others less concerned with reserving the opportunity to opt-out have suggested a legal mandate requiring firms to offer automatic enrollment.[56]

The most common behavioral argument in support of automatic enrollment is that employees' true preferences would result in a higher enrollment rate but for their "status quo bias" and the "sticky" nature of defaults.[57] Sunstein and Thaler contend that if employees chose to think carefully about the enrollment decision, they would act

[54] We reserve welfare-based critiques of these and other proposals for Part III and discuss their implications for liberty in Part IV.
[55] Sunstein & Thaler, *supra* note 1, at 1176.
[56] Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1251–52 (2003).
[57] Behavioralists also rely on present-bias and hyperbolic discounting in support of nudges that would increase savings. *See* David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q. J. ECON. 443 (1997).

upon, and hence reveal, their true preferences, and enrollment rates would rise. The goal of the intervention is to alter the default to align actual behavior with these perceived true preferences.[58] Indeed, Sunstein and Thaler describe the Save More Tomorrow program, which resulted in increased enrollment and savings rates as "successful libertarian paternalism in action."[59] Paradoxically, the claim of successful behavioral intervention is based upon the failure of employees to opt-out of the new default.[60] In order to evaluate the success of the behavioral intervention on welfare, the behavioralists rely upon the preferences revealed by subjects' actual behavior — in this case, their failure to opt-out of the default — while simultaneously justifying the intervention on the ground that status quo and other biases render defaults "sticky" and revealed preferences therefore untrustworthy.[61]

2. The Consumer Financial Protection Bureau and the Regulation of Consumer Credit

Behavioral law and economics has provided the intellectual foundation for the new Consumer Financial Protection Bureau and a new approach to the regulation of consumer credit. The behavioralists argue that, when it comes to choosing and using financial products, consumers make systematically poor decisions that do not reflect

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[58] Sunstein & Thaler, *supra* note 1, at 1172-73 ("employers think (correctly, we believe) that most employees would prefer to join the 401(k) plan if they took the time to think about it and did not lose the enrollment form").

[59] *Id.* at 1185. *See also* Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*, 112 J. POL. ECON. 164 (2004).

[60] *Id.* at 1191 ("the fact that very few participants choose to opt out supports (though it does not prove) the claim that they are helped by a system that makes joining easy").

[61] For a discussion of this point, see Mitchell, *supra* note 40, at 1252 n. 24, and at 1254-55 n. 36.

their true preferences. They argue the Bureau can promulgate rules and regulations that improve consumers' decision making by altering the design of consumer credit products, mandating various disclosures, restricting consumers'choices, and instituting default rules in favor of standardized products approved by the Bureau.[62]

The Bureau's approach to regulating consumer credit is a direct outgrowth of the behavioral law and economics movement. Indeed, the Bureau itself is the outgrowth of a 2008 article written by law professors Elizabeth Warren and Oren Bar-Gill.[63] Another law professor, Michael Barr, now Assistant Secretary of the Treasury, contributed to a second article laying out a series of proposals to regulate consumer credit, including the "plain vanilla" requirement, which would require every lender to offer a product of the Bureau's design before offering its own product (and then only after making mandated disclosures concerning the risks of its own product).[64] A more extreme version of the rule would require consumers expressly to reject the "plain vanilla" product before a lender could offer an alternative.[65] The behavioral approach taken in these articles

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[62] *See* Evan & Wright, *supra* note 45, at 319-320.

[63] *See* Bar-Gill & Warren, *supra* note 45. Warren is currently the head of the Congressional Oversight Panel on TARP funding and among the Obama administration's two finalists to head the CFPB. At a White House news conference on September 10, 2010 the President declined to make an official announcement of his choice for the position but praised Warren's support for the CFPB and indicated he had spoken with her about leading the Bureau. Sewell Chan, *Vacancies Strain White House's Goals for Economy*, N.Y. TIMES , Sept. 11, 2010, at A1.

[64] This is consistent with the behavioralists' "preference for legal requirements to call attention to particular risks in order to offset consumers" optimism bias, which causes them to underestimate the likelihood that they will personally suffer bad outcomes. *See*, *e.g.*, Christine Jolls & Cass R. Sunstein, *Debiasing Through Law*, 35 J. LEGAL STUD. 199, 212 (2006).

[65] Barr et al., *supra* note 45.

assumes "many consumers are uninformed and irrational,"[66] resulting in "systematic mistakes in their choice of credit products"[67] and requiring behaviorally informed policy interventions in order to reduce these mistakes and to increase welfare. Other behavioralist proposals concerning consumer credit include banning subprime mortgages,[68] prohibiting credit cards,[69] requiring credit card companies to unbundle transaction and financing services so that consumers could not use the same card to make a purchase and then to finance it,[70] and applying state usury laws to credit cards.[71] The Bureau will have broad powers to implement these or other behavioral interventions in the consumer credit market.[72]

3. Behavioral Sin Taxes

Beyond switching default rules, behavioral economists have recently proposed taxes as an instrument for improving individual decision making and offsetting the effects of behavioral biases. Specifically, Koszegi and Gruber contend consumers would be made better off with higher taxes on goods over which they exhibit time-

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[66] Bar-Gill & Warren, *supra* note 45, at 21; Barr et al., *supra* note 45, at 1.
[67] Bar-Gill & Warren, *supra* note 45, at 26.
[68] Alan M. White, *The Case for Banning Subprime Mortgages*, 77 U. CIN. L. REV. 617 (2008) (proposing the ban on "subprime" lending practices because consumers hyperbolically discount).
[69] George Loewenstein & Ted O'Donoghue, We Can Do This the Easy Way or the Hard Way: Negative Emotions, Self-Regulation, and the Law, 73 U. CHI. L. REV. 183, 204 (2006).
[70] Bar-Gill, *supra* note 38, at 1425–26.
[71] *Id.* at 1426–28.
[72] *See* Joshua D. Wright & Todd J. Zywicki, *Three Problematic Truths About the Consumer Financial Protection Agency Act of 2009*, 1 (12) LOMBARD STREET (September 14, 2009), available at http://www.finreg21.com/lombard-street/three-problematic-truths-about-consumer-financial-protection-agency-act-2009.

inconsistent preferences.[73] While Koszegi and Gruber have focused largely upon the theoretical and empirical case in support of higher taxes on tobacco products, other behavioralists have favored sin taxes as a more general policy instrument to reduce errors committed by consumers who discount hyperbolically, especially with respect to the consumption of potentially unhealthful products, such as fatty foods, alcohol, and soda.[74]

As discussed above, hyperbolic discounting invokes the concept that people value immediate gratification so much they make decisions they will come to regret tomorrow.[75] The behavioralists couple this concept with the idea of "multiple selves" to argue time-inconsistent preferences result in lower lifetime well-being for consumers because they regularly make decisions today that their future "self" will regret. Paralleling the economic concept of externalities, the behavioralists argue the self of today makes mistaken decisions that impose costs on tomorrow's self, which costs they denominate "internalities."[76] The case for sin taxes based upon the logic of internalities

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[73] *See* Jonathan Gruber & Botond Koszegi, *Is Additional "Rational"? Theory and Evidence*, 116 Q. J. ECON. 1261 (2001); Jonathan Gruber & Botond Koszegi, *Tax Incidence When Individuals are Time Inconsistent: The Case of Cigarette Excise Taxes*, 88 J. PUB. ECON. 1959 (2004); Jonathan Gruber & Sendhil Mullainathan, *Do Cigarette Taxes Make Smokers Happier?*, 5 B.E. J.: ADVANCES IN ECON. ANALYSIS & POL'Y (Article 4, 2005).

[74] *See* Ted O'Donoghue & Matthew Rabin, *Studying Optimal Paternalism, Illustrated by a Model of Sin Taxes*, 93(2) AM. ECON. REV. PAPERS AND PROCEEDINGS 186 (2003).

[75] *See infra* I.B.2. The original analysis of such time-inconsistent preferences in economics is R.H. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization*, 23(3) REV. ECON. STUD. 165 (1955-56).

[76] The internality concept is inextricably linked to the "multiple selves" model, which originates with Strotz, supra note 75. Internalities are the "multiple selves" analog to the externalities. *See* Thomas Schelling, *Ethics, Law, and the Exercise of Self-Command*, in THOMAS SCHELLING, CHOICE AND CONSEQUENCE: PERSPECTIVES OF AN ERRANT ECONOMIST 84 (1984) ("people act as if there were two selves alternately in

requires both an aggregate loss of total welfare, if one sums up the utilities of all of the selves across time, and some assumption about which of the multiple selves represents the individual's true preferences. The standard approach in the literature, which we and others find problematic, is to assume that far-sighted, ex ante preferences are the appropriate ones, and to give them normative value.[77]

4. Eliminating At Will Employment

Sunstein and Thaler endorse the Model Employment Termination Act, which would eliminate "at will" employment in favor of a default rule allowing discharge only "for cause."[78] They offer this as an example of libertarian paternalism but do not explain why this change would make employees better off.[79] It is doubly puzzling because, as Rizzo and Whitman have observed,[80] the only aspect of liberty or libertarian thought with which Sunstein and Thaler concern themselves is what they describe as maintaining freedom of choice; they argue the Model Act does that because employers

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command . . . the ways in which people cope, or try to cope, with loss of command within or over themselves are much like the ways that one exercises command over a second individual.").

[77] *See* B. Douglas Bernheim & Antonio Rangel, *Behavioral Public Economics: Welfare and Policy Analysis with Non-Standard Decision Makers* (NBER Working Paper No. 11518, July 2005).

[78] Sunstein & Thaler, *supra* note 1, at 1175–1177, 1187. *See* Model Employment Termination Act, reprinted in MARK A. ROTHSTEIN & LANCE LIEBMAN, *Statutory Supplement*, EMPLOYMENT LAW: CASES AND MATERIALS 211 (Foundation 2003).

[79] Economists have long recognized that seemingly "unfair" contract terms, when analyzed more deeply in the context of the incentives of the transacting parties to perform and availability of reputational capital, are often efficient. *See* Benjamin Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. PAPERS & PROCEEDINGS 356 (1980).

[80] Mario Rizzo & Douglas Glen Whitman, *Little Brother is Watching You: New Paternalism on Paternalist Slopes,* 51 ARIZONA L. REV 685, 697 (2009).

and employees may contract around the "for cause" default rule.[81] Would that it were so; in fact, opting-out of the new "for cause" default into an "at will" arrangement under the Model Act requires the employer to make a severance payment of one month's salary for every year of employment as the cost of terminating an employee without cause. Sunstein and Thaler insist "freedom of choice is nonetheless respected" under the Model Act, conceding only that this policy is "less libertarian than it might be." To the contrary, it is clear the Model Act is not libertarian at all because it limits the choices available to employers and prospective employees: Transacting parties are prohibited from reaching a voluntary arrangement involving "at will" termination without incurring a penalty.

III. Behavioral Law and Economics and Economic Welfare

Sunstein and Thaler are clear in stating the goals of the behavioral approach: to make individuals better off. But what is meant by "better off" in a context where individuals' revealed preferences cannot be relied upon for inferences about welfare? Again, Sunstein and Thaler provide a clear answer: The appropriate welfare measure is economic well-being as would be expressed by the preferences of economic agents in the absence of behavioral biases.[82] Thus, the promise of behavioral law and economics lies in its potential to increase economic welfare according to these "true" preferences. The behavioral literature often appears to presume that a reduction in errors is prima

[81] Sunstein & Thaler, *supra* note 1, at 1187.
[82] Sunstein & Thaler, *supra* note 14, at 179.

facie evidence of a move closer to true preferences, and thereby, of an increase in welfare. Much of this literature, in our view, has overestimated the expected welfare benefits of behavioral interventions while underestimating some of their costs and failing to identify other costs altogether.

An economic analysis of the effects of a behavioral intervention, like any other, requires not only an agreed upon measure of welfare, but also information sufficient to trace its effects. At its core, the promise of behavioral law and economics' theory of errors is to design interventions that will make individuals better off by more closely aligning their choices with their "true preferences." If one begins and ends, however, with the premise that an individual's decisions cannot be trusted to align with his own preferences (and by extension, welfare), then the task of evaluating the behavioralists' welfare claims is difficult if not impossible. Indeed, the complex, and often indeterminate, welfare effects of behavioral intervention may be one reason the assumed link between error-reduction and welfare has been broadly adopted within the behavioral law and economics literature but rarely subjected to rigorous analysis.

Contrary to this assumption, at least three critical inputs are required before one can begin to analyze the effect any proposed behavioral intervention will have upon economic welfare. The absence of these critical inputs creates three corresponding categories of potential policy errors that weaken, if they do not defeat, the welfare-based case in support of behavioral policy intervention. First, without an economic

theory of "true" preferences, neither deviations from those preferences, nor can the social costs of those deviations can be measured. Second, and more practical, the welfare analyst must have a reliable and empirically sound method for identifying irrational behavior in the marketplace. Third, and perhaps most important, the welfare analyst must measure the full social costs and benefits of the proposed intervention. Those social costs include the costs of the policy errors described above. Even in the absence of policy error, however, the welfare analyst must also include in his assessment any effect the potentially error-reducing behavioral intervention has upon incentives to invest in human capital and decision-making capacity.

The central focus of our paper, in Part IV, is the threat behavioral law and economics poses to liberty. Our central claim regarding behavioralist interventions and liberty does not rely upon these critiques concerning cracks in the theoretical and empirical intellectual foundation of behavioral law and economics, which in turn raise significant doubts regarding its potential to design interventions that will reliably increase rather than decrease economic welfare. While we think many of the welfare-based objections are quite forceful, liberty is our unit of analysis, not welfare. To be sure, behavioral interventions that reduce economic welfare are also sufficient to demonstrate a coincidental reduction in liberty. In Part IV, however, we will separately emphasize the liberty-reducing aspects of the behavioral law and economics movement,

which have largely been ignored in the literature,[83] and which have considerable weight even if the welfare-based objections are overcome by perfect execution of behavioral interventions. In other words, we will assume a behavioral intervention offers a Pareto superior alternative to the status quo for the purpose of isolating the potential negative effects of behavioral interventions on liberty.

We begin, however, by focusing upon existing critiques of behavioral law and economics from an economic welfare perspective. Legal scholars and economists have raised a number of serious concerns about behavioral law and economics and its promise of welfare-increasing intervention that fall into the three categories described above: the lack of any measure for true preferences, the absence of a reliable way to identify irrational behavior, and the failure to measure the social costs of intervention. These concerns raise significant doubt regarding both the presumption that error-reduction alone increases welfare and the potential for behavioral interventions to improve welfare. Each of these objections is significant in its own right, and merits discussion.

A. The Behavioralist's Futile Search for True Preferences

[83] But not entirely. See Rizzo and Whitman, *supra* note 53, and Mitchell, *supra* note 40, at 1260–1268. Mitchell, for example, focuses upon the tension between welfare-based notions of behavioral intervention, like Sunstein and Thaler's libertarian paternalism, and upon libertarian principles that arise because "it is unlikely that the central planner can choose any objective measure of welfare that will not be objectionable to some set of people in any given context, and the adoption of a form of utilitarianism is likely to trample on libertarian principles." *Id*. at 1268.

Behavioral law and economics' claim to welfare-increasing intervention is built upon the proposition that actual choice behavior might deviate in systematic and predictable ways from that predicted by an economic agent' true preferences. Preferences revealed by choice behavior need not maximize utility because the various behavioral biases distort choice. This proposition alone is not objectionable. The behavioralists, however, go on to assume that the possibility of erroneous choice behavior requires one to disregard the no-error possibility, that is, that actual choice behavior is evidence of welfare; hence they search for "true preferences," defined to exclude revealed preferences. Indeed, the premise of behavioral law and economics is that interventions can be designed to bring actual choice behavior closer to these so-called true preferences. Because true preferences are not revealed by choice, the social planner must find and define them. As discussed above, Sunstein and Thaler propose that true preferences, the preferences that can then be used to evaluate the welfare of individuals, are those preferences that would be expressed by the economic agent in the absence of any behavioral bias.[84] Some economists have objected that the behavioralists' basis for identifying true preferences amounts to no more than the adoption of a set of arbitrary assumptions in place of economic theory, and facilitates an

[84] Sunstein & Thaler, *supra* note 14, at 175. Camerer et al., *supra* note 52, at 1214–15, adopt a similar standard.

unwarranted presumption that errors in decision making are prima facie evidence of welfare-reducing choice.[85]

How do behavioral economists identify these true preferences? The initial identification problem is one of theoretical vagueness. As Pesendorfer and Gul observe, the standard revealed preference approach to welfare is required by neoclassical economics:

> Economists use welfare analysis to identify the interests of economic agents and to ask whether existing policies can be interpreted as an expression of those interests or whether the understanding of the institutional constraints on policies remains incomplete. This use of welfare analysis requires the standard definition of economic welfare. There is no reason for economic agents to gravitate towards policies and institutions that yield higher welfare if the underlying notion of welfare does not reflect the interests of agents as the agents themselves perceive these interests.[86]

The standard economic approach to welfare thus assumes an individual is better off choosing x than he would be choosing y because the economic agent revealed a preference for x when he expended his limited economic assets to select it. Economics relies upon this definition of welfare in order to evaluate economic decision making, not to provide a theory of happiness.[87] The behavioralist, by contrast, rejects the standard

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[85] See Rizzo & Whitman, *supra* note 53.

[86] Faruk Gul & Wolfgang Pesendorfer, *The Case for Mindless Economics* (unpublished paper), *available at* http://economics.uchicago.edu/pdf/Pesendorfer040306.pdf.).

[87] *Id.* at 30 ("Standard economics offers no substantive criterion for rationality because it has no therapeutic ambition; it does not attempt to cure decision-makers who make choices that do not generate the most pleasure. The more modest economic definition of welfare is mandated by the role of welfare analysis in economics.").

definition and renders happiness and welfare synonymous. This critical difference concerning conceptions of economic welfare leads to a methodological divide: When the neoclassical economist finds that the economic agent's actual behavior deviates from the prediction of his model, he suspects that the model is to blame; when a behavioral economist observes a gap between actual and predicted behavior, he concludes that the agent is acting against his best interests.[88]

The neoclassical economic critique of the behavioralist's view of the relationship between preferences and welfare is best illustrated by examining the behavioralist's model of the individual as multiple and distinct selves with conflicting interests. Recall that this model, especially when combined with hyperbolic discounting, results in decisions made by one self can conflict with the interests of another. This approach is a significant departure from the standard economic approach that treats the individual as the unit of analysis. If the conflict between selves is serious enough, the behavioralists say that individuals will suffer from "preference reversals." Behavioralists view evidence of such preference reversals, that is, evidence that individuals treat the same intertemporal trade-off differently at different times, as irrational behavior. Behavioralists further assert that this form of irrationality leads to lower welfare.

[88] *See* Alchian, *supra* note 4, at 216 n. 12 ("It is not even necessary to suppose that each firm acts as if it possessed the conventional diagrams and knew the analytical principles employed by economists in deriving optimum and equilibrium conditions. The atoms and electrons do not know the laws of nature; the physicist does not impart to each atom a willful scheme of action based on laws of conservation of energy, etc. The fact that an economist deals with human beings who have sense and ambitions does not *automatically* warrant imparting to these humans the great degree of foresight and motivations which the economist may require for his customary analysis as an outside observer or 'oracle.'").

However, while it is clear why such preference reversals could be consistent with a particular psychological model of an individual's happiness, economists have rejected the behavioralist claim that such preference reversals repudiate models of *economic* rationality or imply a reduction in welfare.[89]

Consider the behavioralists' welfare calculation in the case of hyperbolic discounting. The behavioralists' claim that observed choices should be evaluated against the individual's own normative standard for the purposes of welfare analysis fails in the context of hyperbolic discounting models with multiple selves. The failure is both theoretical and empirical.[90] The theoretical failure is simple: economics does not provide a basis for identifying which of the multiple selves' decisions express so-called true preferences for the purposes of welfare analysis. The convention in the behavioral literature, in order to make utility tradeoffs between the various selves, has been to

[89] Pesendorfer & Gul, *supra* note 86, at 38. Pesendorfer & Gul entirely reject welfare analysis based upon multiple selves, observing that "standard economics has neither need nor use for a welfare criterion that trades off utility among the various selves of a single individual." *Id.* They argue that the multiple selves model, in the hands of the behavioralists, provides "both an opportunity and a rationale for activism." *Id.* Mitchell, *supra* note 40, at 1266, makes the related point that evidence of irrational choice behavior cannot support conclusions about individual economic welfare, but "only that the irrational individual has failed to do what he or she most prefers, for rational choice theory employs an ordinal definition of utility that does not permit the kinds of external normative evaluations or interpersonal welfare comparisons that an objective measure of welfare, such as monetary wealth or healthiness, would permit." *See also* David K. Levine, *Is Behavioral Economics Doomed: The Ordinary Versus the Extraordinary*, http://levine.sscnet.ucla.edu/papers/behavioral-doomed.pdf, at 12 ("our 'rational' self is not intrinsically in conflict with our impulsive self. In fact the evidence is that our rational self often facilitates rather than overrides the activities of our impulsive self.").

[90] We discuss the empirical obstacles facing behavioralists relying on hyperbolic discounting models *infra*, Part III.B.

adopt the long-run ex ante preferences.[91] However, neither standard economic theory nor anything in behavioral economics justifies this approach to identifying "true" preferences.[92]

To illustrate how the behavioral approach abandons the conventional revealed preference approach to welfare in favor of this arbitrary alternative, Pesendorfer and Gul consider a simple multiple selves model over three periods.[93] Preferences are characterized by the utility function, $U(c1, c2, c3)$, where c represents consumption in each period, β is the hyperbolic discount rate, and δ is the standard exponential discount rate. Utility in each period is:

$$U_1(c_1, c_2, c_3) = c_1 + \beta\delta c_2 + \beta\delta^2 c_3$$

$$U_2(c_1, c_2, c_3) = c_2 + \beta\delta c_3$$

$$U_3(c_1, c_2, c_3) = \delta c_3$$

The conventional behavioral approach is to formulate the appropriate welfare criterion as:

$$U_0(c_1, c_2, c_3) = c_1 + \delta c_2 + \delta^2 c_3$$

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[91] *See e.g.*, O'Donoghue & Rabin, *supra* note 74, at 5; Gruber & Koszegi, *supra* note 73, at 1287.

[92] See Rizzo & Whitman, *supra* note 80, at 701 ("the normative standard inherent in any attempt to 'help' agents with hyperbolic preferences is inherently vague. We do not know where 'reasonable' impatience ends and 'excessive' patience begins."). *See also* Pesendorfer & Gul, *supra* note 86, at 38 ("Economists often note the arbitrariness of using U_0 as a welfare criterion in the multiselves model. It is not clear what hedonic utility calculations have led neuroeconomists to decide that U_0 represents the right trade-off among the hedonic utilities of the various selves.").

[93] Pesendorfer & Gul, *supra* note 86, present a similar model.

In other words, the behavioralist welfare criterion assumes that the long run ex ante preferences, unfettered by present-bias in the form of hyperbolic discounting, reflect the individual's true preferences. Notice that U_0 is not only an arbitrary normative welfare criterion, setting $\beta = 1$, but also that, as Pesendorfer and Gul observe, it assigns greater welfare to (1,0,11) (the consumption pattern of the "smart retiree") than to (2,3,0) (the "spend now pay later" consumption pattern) despite the fact that the selves in the majority of time periods (both period 1 and period 2) prefer the latter consumption path. This manipulation of the standard welfare criterion in favor of the behavioral alternative is without basis in economics, and provides a thin reed upon which to claim that deviations from the latter represent defects requiring a legal intervention. Untethered from the standard economic approach to welfare, the behavioralist's approach becomes "both an opportunity and a rationale for activism," and implicitly assigns to the economist the task of convincing individuals to improve their own decision making and the welfare of their future selves or, alternatively, persuading a third party to intervene on behalf of the future selves.[94]

More generally, as Rizzo and Whitman observe, a similar problem arises with claims of welfare-reducing choices biased by context-dependence.[95] As discussed

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[94] *Id.* Pesendorfer & Gul describe this stance as "therapeutic" and "paternalistic," and "similar to the position of medical professionals who attempt to cure a patient's addiction." *Id.* at 38. *See also* Gary S. Becker & Kevin M. Murphy, *A Theory of Rational Addiction*, 96 J. POL. ECON. 675 (1988) (defining addiction as current behavior positively influencing future behavior).

[95] Rizzo & Whitman, *supra* note 80, at 703.

above, many of the documented behavioral biases involve contextualization errors, or framing effects, including the status quo bias and the endowment effect. As with hyperbolic discounting, the behavioralist theory claims empirical proof of internal inconsistency of choices but cannot offer a basis for identifying which choice represents one's "true" preferences. In the framing context, the question is not how to resolve conflicts between multiple selves, but rather, how to determine which context-dependent choice expresses the preference that maximizes welfare. Economic theory, behavioral or otherwise, does not provide an answer to that question once revealed preference rationale is ruled out. Libertarian paternalism requires the behavioralist to choose a welfare criterion by selecting the context in which so-called true preferences are expressed. Untethered from an economic theory linking choice to welfare, the imposition of an arbitrary criterion imposed by the modeler or by a third party is inevitable and seriously undermines the behavioralist's claims regarding economic welfare.

B. Empirical Shortcomings, Robustness Problems, and Data Interpretation

Setting aside the theoretical infirmities plaguing the behavioralist's attempts to identify true preferences, behavioral law and economics faces a number of serious empirical challenges. We categorize these challenges into three distinct categories: (1) the documentation of behavioral biases must be robust; (2) experimental results in

laboratory settings must generalize to field settings and markets; and (3) economic data must be interpreted carefully, distinguishing irrational behavior from efficient mistakes.

1. Problems of Generalization: From Laboratories to Markets

Unless experimental results are shown to be robust and reliable, the documentation of behavioral biases in the laboratory is of little benefit in informing policy analysis in the real world. While a few of the cognitive biases documented in the laboratory setting have also been identified in the field,[96] others disappear when exposed to real world market mechanisms and institutions, and to the profit motive. Unfortunately, behavioral law and economics scholars have advanced policy proposals in many cases that ignore these critical distinctions and thereby stretch the existing evidence beyond what it can possibly justify.

One need not (and we do not) reject the existence of behavioral biases in order to raise doubts about the policy relevance of purely experimental results. A significant concern for the behavioral law and economics policy agenda is that the existing and documented biases will prove sensitive to exposure to market institutions.[97] And there is good reason to expect that laboratory evidence of behavioral biases may not be robust to market institutions. In addition to the greater reward in the marketplace for

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[96] For a review of the field experiment literature, see Steven D. Levitt & John A. List, *Field Experiments in Economics: The Past, The Present, and The Future*, 53(1) EURO. ECON. REV. 1 (2009); John A. List, *Introduction to Field Experiments in Economics*, 70(3) J. ECON. BEHAV. & ORG. 439 (2009).

[97] *See generally* Steven D. Levitt & John A. List, *Viewpoint: On the Generalizability of Lab Behaviour to the Field*, 40(2) CANADIAN J. ECON. 347 (2007).

overcoming biases,[98] experiments also naturally restrict the options available to individuals to improve decision making relative to those available in the market.[99]

Indeed, as others have pointed out, many (but not all) of the behavioralist's findings are fragile, and disappear when exposed to market discipline and the profit motive, which creates incentives for specialization and learning that reduce errors; these are features that do not exist in the laboratory.[100] Accordingly, while laboratory evidence of behavioral biases purportedly found in markets may potentially teach us something useful about how one might model real world behavior, without more, such evidence cannot support policy intervention in the real world. Given the important role that market institutions play in mitigating the effects of irrational behavior, caution is warranted in relying solely upon experimental results to support the behavioral policy agenda without affirmative evidence that the relevant behavioral bias persists in markets.

2. Quality of Experimental Evidence

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[98] *See* Vernon L. Smith & James M. Walker, *Monetary Rewards and Decision Cost in Experimental Economics*, 31 ECON. INQUIRY 245, 246–250 (1993) (explaining that incentives decrease errors).

[99] *See* Edward L. Glaeser, *Paternalism and Psychology*, 73 U. CHI. L. REV. 133, 140 (2006) ("in experiments, individuals have few tools with which to improve their reasoning, and their only real method of responding to incentives is to think harder").

[100] See Joshua D. Wright, *Behavioral Law and Economics, Paternalism, and Consumer Contracts: An Empirical Perspective*, 2 NYU J. L. & LIBERTY 470, 471-–472 (2007); Jennifer Arlen et al., *Endowment Effects with Corporate Agency Relationships,* 31 J. LEGAL STUD. 1 (2002); John A. List, *Neoclassical Theory Versus Prospect Theory: Evidence From the Marketplace*, 72 ECONOMETRICA 615 (2004) (arguing that laboratory results are not robust to market interactions where competition, expertise, and learning might be expected to ameliorate these biases); John A. List, *Does Market Experience Eliminate Market Anomalies?*, 118 Q.J. ECON. 41 (2003); Michael S. Haigh & John A. List, *Do Professional Traders Exhibit Myopic Loss Aversion? An Experimental Analysis*, 60 J. FIN. 523 (2005).

Even assuming all laboratory results may be safely generalized to the market setting, the experimental results themselves must be sound and reliable before they should influence policy analysis. Laboratory evidence in particular must be robust and reliable, and not the product of experimental procedures. Of course, behavioral economists are aware of the need to conduct experiments that allow researchers reliably to isolate and identify behavioral biases. Still, much of the available evidence offered in support of the behavioral law and economics policy agenda is neither well-tested nor the result of reliable methods. The most prominent example of robustness and reliability issues plaguing an experimental result that is heavily relied upon in the behavioral law and economics literature involves the endowment effect.

As discussed above, the experimental result itself is the gap between WTA and WTP, which means that individuals will report a lower WTP for a particular good than their WTA after they are given the same good. The term "endowment effect" imputes to that empirical finding a behavioral explanation, namely "prospect theory," implying a preference reversal. But as economist David Levine explains, it is not clear that evidence of a WTA-WTP gap implies a preference reversal at all:

> On the surface this is not a paradox: we all know to buy low and sell high. However: the elicitation of values is done using a method called the Becker-Marschak-DeGroot elicitation procedure. A willingness to pay or accept payment is stated, then a random draw is made. If the random draw is lower than the stated value (in the willingness to pay case) then the item is sold at the randomly drawn price. If the draw is higher than the stated value then no transaction takes place. Is it obvious to you that when this procedure is used that the

> unambiguously best course of action is to bid your true value and not buy low and sell high? It is true, and subjects are often informed of this fact. So: is there a paradox here, as some behavioral economists and psychologists would argue, or is it simply the case that people have trouble understanding a complex and unfamiliar procedure?[101]

Zeiler and Plott acknowledge that WTA-WTP gaps can be observed, but turn their attention to a different question: What explains the gaps?[102] They show the observed gaps are explained by subjects' misconceptions about the nature of the experimental task; employing a full set of experimental controls designed to eliminate subject misconceptions, the gap disappears; and the experimental evidence finding a gap does not support an interpretation in favor of prospect theory.

The Zeiler and Plott results do not eliminate the possibility that prospect theory will be found to explain the WTA-WTP gap in some experimental setting in the future. Such a finding could do no more, however, than suggest that the literature is unsettled and one should approach skeptically the claim of irrationality grounded in the endowment effect interpretation of the WTA-WTP gap. Unfortunately, the approach in the legal academy has been quite the opposite. As noted above, nearly 1,000 articles appearing in legal periodicals reference the "endowment effect." Of the 342 such articles published from 2006 to present (the original Zeiler and Plott analysis was

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[101] Levine, *supra* note 89, at 13–14.

[102] Kathyrn Zeiler & Charles R. Plott, *The Willingness to Pay–Willingness to Accept Gap, the "Endowment Effect," Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95 AM. ECON. REV. 530 (2005); Charles R. Plott & Kathy Zeiler, *Exchange Asymmetries Incorrectly Interpreted as Evidence of Endowment Effect Theory and Prospect Theory?*, 97 AM. ECON. REV. 1449 (2007).

published in 2005, though available as a working paper and presented to legal audiences earlier), only 35 cite either of the Zeiler and Plott articles. At a minimum, the evidence calling into question the robustness of the endowment effect should be sufficient, when combined with the methodological commitments embraced by the behavioral economics literature, to create an obligation to disclose and to discuss competing evidence and theory. That just ten percent of the legal articles discussing the endowment effect mention the leading contrary literature, even in passing, suggests that the behavioral law and economics policy agenda is minimally constrained by those methodological commitments.

Similar problems of robustness plague the literature on framing effects. As Gregory Mitchell has observed, while the existence of framing effects is not disputed, the effects are not robust to even small changes in experimental settings.[103] For example, small manipulations in the decision-making context, such as asking choosers to think about the possible success or failure of options, to give reasons for their choices, or to deliberate more analytically, can reduce or eliminate the influence of framing effects.[104] Mitchell also highlights evidence that stable preferences prevail in choice settings where choices are made frequently, involve less emotion, involve deliberation or reflection, involve a small number of options, or where the chooser is well

[103] *See* Mitchell, *supra* note 40, at 1256 n. 40.
[104] *Id.* at 1256.

informed.[105] Further, framing effects might be reduced or eliminated at low cost without the sort of interventions proposed by the libertarian paternalists.[106]

Both the endowment and the framing effect examples show that the findings are not robust in a sense that is relevant to policy intervention. While framing effects are easy to find in the laboratory, and even in the field, the fact that slight changes in the contextual setting eliminate these effects suggests that these biases can be reduced at low cost without resorting to regulatory intervention. The behavioral law and economics literature appears to ignore this option in favor of assuming that a policy intervention will improve welfare. As Mitchell persuasively demonstrates, however, behavioral interventions inevitably reduce the choices available to rational individuals. Insofar as lack of robustness significantly undermines the behavioralists' claims that the collected empirical evidence regarding behavioral biases is sufficient to warrant policy interventions, the substantial reductions in welfare Mitchell identifies (and upon which we expand in Part IV) are not justified.

3. Data Interpretation and Policy Error

[105] *Id.* at 1253.

[106] *Id.* at 1255–60. Libertarian paternalists have relied upon framing effects, and particularly the endowment effect, to justify interventions including switching the legal default rule from at will to "for cause" termination, various proposals to redistribute property rights, and a preference for liability rules over property rules. *See* Sunstein & Thaler, *supra* note 1, at 1187 (advocating the Model Employment Termination Act); Korobkin, *supra* note 31, at 1262–69, 1283–87 (discussing proposals to redistribute property rights relying on the endowment effect and favoring liability rules to property rules, respectively).

Economic data must be interpreted with great care when attempting to identify irrational behavior and to distinguish it from mistakes that are efficient and which we expect to occur because rational economic agents economize on both information and transaction costs. In short, not all error implies irrationality because perfection is costly. Without sufficient attention to detail, subtle distinctions between rational and irrational decision-making can be missed, leading to policy error. Indeed, even with robust field evidence of choice behavior that is seemingly irrational in light of available evidence, the data required to distinguish the irrational from the rational, much less to estimate the magnitude of any welfare losses caused by the errors, are significant. Data interpretation problems are not limited to the failure carefully to consider and reject hypotheses of rational behavior before concluding that a person is acting irrationally against his own welfare. Even if one were to concede that the data demonstrated irrational and socially costly behavior conclusively, the risk of policy error remains, unless the third party implementing the behavioral policy intervention has access to the information required to estimate the costs and benefits of intervention.

The complexity of the task facing the behavioralist regulator is remarkable. The task is rendered even more difficult by the demands placed on the behavioralist to interpret economic data in order to identify true preferences, distinguish rational from irrational error, and design interventions. A straightforward example involves erroneous interpretation of economic data to infer an irrational choice where such

irrationality does not, or at least has not been shown to, exist. The behavioral law and economics literature often fails to distinguish between rational and irrational error, assuming instead that the efficiency consequences of error reduction are always positive. Yet, the efficient level of error is not zero where there are information and transaction costs.

For example, if a consumer could switch from Credit Card A to Credit Card B by incurring $10 in switching costs, but Credit Card B is only $5 superior to Credit Card A, then the consumer's failure to switch is not evidence of his irrationality.[107] Consider the problems encountered if a behavioral economist tries to interpret the following stylized facts from an empirical study of consumer credit card selection following a natural experiment in which a card company offers two cards to consumers: (1) one has a higher interest rate but no annual fee card and (2) the other has a lower interest rate and an annual fee. What do the behavioral theories of consumer credit predict we will observe?

Oren Bar-Gill, who, along with Elizabeth Warren spearheaded the new CFPB, argues that consumers consistently underestimate their future borrowing due to a potpourri of behavioral biases such as imperfect self-control, hyperbolic discounting, and systematic underestimation of the probability of negative consequences.[108] Rather

[107] There is substantial literature considering the rationality of credit card consumers and testing behavioral theories of choice in consumer credit markets. *See* Wright, *supra* note 100, at 475–482.
[108] Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1395–1411 (2004).

than viewing "teaser rates," zero annual fees, and rewards programs as signs of intense and healthy competition among credit card issuers, Bar-Gill and others have argued the card issuers design such products and contracts to exploit the behavioral biases of consumers. Bar-Gill argues competition on these margins leaves consumers worse off because their expressed credit choices do not reflect their true preferences.[109] This "predatory lender" interpretation of the credit market gives rise to a few testable hypotheses about the underlying behavioral theories. First, we would expect to see a significant fraction of consumers selecting the wrong card. Second, we should expect the consumers' error rate, which is the product of irrationality, to remain invariant to the cost of the error. Third, we should also expect that consumers who revolve monthly balances instead of paying them off will hold cards with high rewards and no annual fee. What actually happens?

Agarwal et al. find that approximately 60 percent of consumers select the "optimal" card.[110] Of the 40 percent who do not, many consumers correct their errors as a result of learning from their experience and only "a small minority of consumers persist in holding substantially sub-optimal contracts without switching."[111] The authors find these errors are bounded in magnitude by the level of the annual fee (typically around $25). Further, and consistent with neoclassical economic

[109] *Id.* at 66.
[110] Sumit Agarwal et al., Do Consumers Choose the Right Credit Contracts? (Dec. 18, 2005) (unpublished working paper, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=843826).
[111] *Id.*

theory, the probability of selecting the sub-optimal credit card contract decreases with the cost of the error and increases with repeat decisions, which suggests that learning mitigates the effects of the relevant biases.[112] All of these findings are consistent with rational (but not perfect) choice, and more specifically, price theory. Of course, there is also further evidence that the behavioral "seduction" theory of consumer credit does not hold.[113] That is, researchers have found, contrary to the seduction theory, "more nonrevolvers than revolvers carry cards with average minimum APRs of greater than 10 percent," and note that "this result does not support the hypothesis that hyperbolic discounting results in consumers bearing credit card debt at high interest rates."[114]

We interpret the available data as a strong indicator of rational consumer choice in the consumer credit card market. Even the initial 40 percent error rate, where losses are less than $25, suggests that switching costs might dominate any benefit from moving to a superior card and imply an efficient, positive but rational error rate. How would a behavioralist interpret these same data? Elizabeth Warren, a behavioralist and the driving intellectual force behind the CFPB, has commented on the study.[115] Describing the error rate as "staggering," Professor Warren makes the following observation about her approach to interpreting the evidence:

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[112] *Id*.
[113] Tom Brown & Lacey Plache, *Paying with Plastic: Maybe Not so Crazy*, 73 U. CHI. L. REV. 63 (2006).
[114] *Id.* at 80 & Fig. 2.
[115] Elizabeth Warren, Posting to Credit Slips, *Economic Model Almost Working or Broken?* (Dec. 26, 2006) http://www.creditslips.org/creditslips/2006/12/economic_model_.html

> Would it help to frame the policy question from the provider angle? What's the point of offering two different products, except to hope that the number of consumers who get it wrong will exceed in dollar volume the number who get it right. Or, from an informed consumers' perspective, perhaps the optimal system is one in which they make good decisions and hope for cross-subsidization from less-clever consumers who help keep credit cards highly profitable and easy to use in a variety of settings (e.g., grocery stores, cabs, pizza deliveries, etc.). I realize it is heresy in many circles to ask if consumers should have fewer choices. But at some point the empirical studies about high error rates bring into question the assumptions that underlie the claim that more choice is always good.[116]

Professor Warren's answer is simple: A high error rate implies irrationality, and irrationality implies the need for choice-reducing regulation. Her interpretation of the data reveals her methodology, which results in three specific and significant errors in this case. First, the initial error rate of 40 percent is evaluated without reference to the costs of switching, and thus no attention is paid to the fundamental question of identifying the efficient error rate. Second, no weight is assigned to the error rate decreasing both with the cost of error and with repeat decision making, facts that are both consistent with rational choice but are difficult to reconcile with the behavioral models of consumer behavior in credit markets put forth by Bar-Gill and others. Third, Warren describes the errors as "staggering," but does not address the finding that the magnitude of these costs is bounded by the size of the typically small annual fee. While the initial error rate is indeed high, her evaluation of the rationality and welfare

[116] *Id.*

properties of the choice occurs in a vacuum where the costs of error or of investment to correct the error are ignored. The approach that leads Warren from identification of the error rate to questioning whether "more choice is always good," illustrates what Harold Demsetz famously described as the Nirvana Fallacy, that is, the failure to ask "compared to what?"[117]

Our point is not merely that we disagree with Professor Warren's interpretation of this single study. Though we do disagree with the specific application, the relevant point is that Warren's analysis ignores fundamental economic concepts and threatens to subject consumers to serious policy error by conflating rational choice with irrational behavior — namely, by ignoring switching and other costs incurred everywhere except Nirvana, and by avoiding comparative institutional analysis. Any method of cost-benefit analysis incorporating these flaws will inevitably tend toward policy error. The behavioralist policy agenda appears to be especially susceptible to this form of error by mistaken interpretation.

Consider the empirical evidence on hyperbolic discounting. Recall that the hyperbolic discounting model assumes that preferences are characterized by the utility function $U(c1, c2, c3)$, where c represents consumption in each period, β is the

[117] *See* Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J. L. & ECON. 1, 1–3 (1969) ("The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing 'imperfect' institutional arrangement. This *nirvana* approach differs considerably from a *comparative institution* approach in which the relevant choice is between alternative real institutional arrangements.").

hyperbolic discount factor, and δ is the standard exponential discount factor. As we shall see, the empirical evidence concerning the hyperbolic discount factor gives one little confidence that the behavioral policymaker has access to information sufficient to implement most, if any, of the proposed policies based on this form of bias; on the contrary, it generates substantial risks of welfare-reducing policy errors.[118]

Policy error in the context of interventions relying upon knowledge of the hyperbolic discount factor, such as setting the optimal tax on cigarettes, would result in significant welfare losses.[119] Of course, any such intervention requires reliable data concerning the hyperbolic discount factor. How precise are estimates of the discount factor? Not very. In a comprehensive review of the behavioral economics literature, Frederick et al. reports the range of estimated discount factors as exhibiting "extraordinary variation across studies, and sometimes even within studies."[120] The differences in estimates, even when using the same data set, can be quite significant and leaves room for costly policy errors by relying upon one or another estimate, given the

[118] *See* Rizzo & Whitman, *supra* note 80, at 706 (discussing the information requirements of behavioral regulation aimed at correcting present-bias).
[119] These losses would be even more significant when one incorporates the economic reality that at least some fraction of the population does not hyperbolically discount. O'Donoghue & Rabin, *supra* note 74, consider two situations where half of the population hyperbolically discounts, but with present bias of B= .99 in the first and B=.90 in the second, the optimal tax rate changes from 5.15% to 63.71%. A policy maker relying on an estimate of .90 when the true value was .99 would cause significant consumer harm by creating a tax nearly twelve times too large.
[120] Frederick et al., *supra* note 74, at 56.

"spectacular disagreement among dozens of studies."[121] The wide variation in point estimates is not altogether surprising, given the difficulties of isolating hyperbolic discounting from other theoretically distinct considerations such as uncertainty, intertemporal arbitrage, inflation, expectations of changing utility, and habit formation. Further, there does not appear to be any convergence upon an estimate or even a plausible range of estimates that are reliable for policy analysis. Accordingly, it is also unsurprising that the wide variation in plausible estimates is found both in experiments and in field study.[122] Nonetheless, the dearth of reliable empirical evidence concerning discount factors, and the risk to consumers of, for example, calibrating an optimal tax to an erroneous discount factor, presents a serious risk to economic welfare from that policy intervention.[123]

C. Tilting the Scale: Errors of Omission in Behavioral Cost-Benefit Analysis

Yet another concern regarding behavioral law and economics is that it proceeds from premises that ignore significant costs of intervention. Sunstein and Thaler claim

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[121] *Id.* Consider, for example, that estimates of the discount rate range from -6% to infinite. Further, Frederick et al. note "there is no evidence of methodological progress; the range of estimates is not shrinking over time." *Id.* at Figure 2.

[122] For example, Frederick et al., *supra* note 74, at 84, discuss three estimates of discount rates involving home appliances. The estimates, even within this category, range from 17-20 percent (for air conditioners) up to 243 percent for electric water heaters. The range of estimates for refrigerators alone spans from 45 to 300 percent.

[123] See Rizzo & Whitman, *supra* note 53, at 935 ("current estimates are unable to provide a basis for policy prescriptions that reliably increase welfare").

choice architecture, or selection of a default rule, is "inevitable."[124] The notion that some sort of default rule must be selected by someone may be correct in some instances, but it is not the case that the state or anyone else must always select a default rule. Nor is it obvious the state will be able to select a default that more closely aligns individual choice with true preferences, as defined by the central planner. As Mitchell points out, the inevitability claim regarding "manipulation of choices by central planners" holds "so long as individuals remain subject to these irrational influences."[125] Mitchell demonstrates the claim of inevitability is not justified by the psychological literature, which identifies conditions under which individuals are not likely to be affected by framing.[126] Inevitability is rightly rejected on the ground that a less intrusive measure is often sufficient to eliminate the framing effect without exposing individuals to the risks of the policy errors described above.

In addition to the underestimation of the social cost associated with manipulating choice frames through legal default rules, there is another error of omission in behavioral cost-benefit analysis. Some scholars have expressed skepticism about the behavioralist policy agenda on the ground that a more complete analysis of the long run costs and benefits of paternalistic regulations would support a more limited role for government intervention. These scholars have pointed to specific costs

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[124] Sunstein & Thaler, *supra* note 1, at 1173.
[125] Mitchell, *supra* note 40, at 1251. *See also* Jeffrey J. Rachlinksi, *Cognitive Errors, Individual Differences, and Paternalism*, 73 U. CHI. L. REV. 207 (2006).
[126] *See* Mitchell, *supra* note 40, at 1251.

of behavioral policy proposals-- including the diminished incentive to learn and invest in cognitive capacity and human capital that would reduce errors and improve decision making generally-- and to the possibility that behavioral interventions would exacerbate irrational behavior by introducing the element of moral hazard.[127]

Economists have identified the potential for behavioral intervention to create a particular form of dynamic inefficiency. Individuals have a greater incentive to invest time and money into human capital and assets that improve decision making when they bear the costs of their errors.[128] This idea is not new, and has deep roots not only in economic theory,[129] but also in libertarian philosophy observing that restraints upon human behavior that does not harm others would impede the development of individuality.[130] Klick and Mitchell describe this cost of libertarian paternalism as a type of moral hazard, which in the long run would raise error rates because people

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[127] *See, e.g.*, Glaeser, *supra* note 99; Klick & Mitchell, *supra* note 20; Richard A. Epstein, *Behavioral Economics: Human Errors and Market Corrections*, 73 U. CHI. L. REV. 111 (2006).

[128] Klick & Mitchell, *supra* note 20, at 1622-23 (explaining that behavioral intervention immunizing individuals from bearing the cost of their mistakes can be socially costly and reduce welfare due to "inhibition of the development of the regulated parties' decision-making skills").

[129] *See, e.g.* Gary S. Becker, *Investment in Human Capital: A Theoretical Analysis*, 70 J. POL. ECON. 9 (1962). Becker, in turn, relies on "the earlier works of Smith, Mill, and Marshall." *Id.* at 10, note 3. It was Marshall who observed that "the most valuable of all capital is that invested in human beings." *See* ALFRED MARSHALL, PRINCIPLES OF ECONOMICS (1890). The notion that incentives decrease errors is also familiar to experimental economics. *See* Vernon L. Smith & James M. Walker, *Monetary Rewards and Decision Cost in Experimental Economics*, 31 ECON. INQUIRY, 245, 246-50 (1993); *See* Bruno S. Frey & Reiner Eichenberger, *Economic Incentives Transform Psychological Anomalies*, 23 J. ECON. BEHAV. & ORG. 215, 225 n. 16 (1994); *see also* Ralph Hertwig & Andreas Ortmann, *Experimental Practices in Economics: A Methodological Challenge for Psychologists?*, 24 BEHAV. & BRAIN SCI. 383, 391–96 (2001).

[130] JOHN STUART MILL, *On Liberty, in* ON LIBERTY AND OTHER ESSAYS 1, 70 (John Gray ed., 1991) (1859).

would invest less in error-correction.[131] Behavioralist cost-benefit analyses generally omit the potential for these dynamic costs when assessing the potential economic effects of proposed policy interventions.[132]

A second error of omission in behavioralist analyses of policy interventions is underestimating or ignoring the cost of opting-out. The claimed "libertarian" aspect of behavioral interventions is that the manipulation of choice frames respects freedom of choice, and so the individual can always reject the regulator's preferred choice in favor of expressing his own preference, even if irrational. As we discuss above, many of the proposed behavioral interventions simply do not live up to claim of "choice-neutrality" and, upon close inspection, can be seen to reduce the set of available choices. Many of the proposed behavioral policy interventions, including sin taxes and product bans, contemplate eliminating the ability to opt-out entirely, which overly reduces the number of choices.

Other proposed interventions, such as the "plain vanilla" requirement or the cooling off period, would impose significant costs upon those who prefer to opt-out. Sunstein and Thaler's support for the Model Employment Termination Act, which would switch the legal default rule from "at will" to "for cause" employment, is another example of a behavioral policy intervention that purports to respect freedom of choice.

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[131] Klick & Mitchell, *supra* note 20, at 1626.

[132] These costs are discussed in greater detail in Part IV, at which point they are relevant not because they affect the economic cost-benefit analysis but because they are aspects of liberty or autonomy, valuable for their own sakes, which are diminished by choice architecture.

But, as we have observed, the proposed intervention would actually require employers to pay significant penalties for opting out of the "for cause" default into the "at will" regime. Accordingly, the choice set of mutually agreeable employment contracts available to employers and employees is restricted, and opting out entails significant costs, which are likely to be borne in part by the employee who is the intended beneficiary of the scheme. Behavioralist policy analysis that simply assumes the cost of opting out is zero, or at least sufficiently low that it can be assumed to be negligible, skews in favor of intervention that may reduce welfare.

Another distinct sub-category of skewed cost-benefit analysis of behavioral intervention involves a tendency to underestimate the costs of government actors implementing the proposed policies. This tendency arises from a number of sources. The first is that it is unclear that either bounded rationality or plain irrationality favors a larger role for the government, but this is exactly the policy prescription favored by the behavioralist. If one believes, rightly or wrongly, that individuals are predictably irrational, a central planner must necessarily identify true preferences so that individual choice can be manipulated in that direction. But the more relevant policy question is what irrational behavior implies for the incentives of private decision makers relative to government.[133]

[133] *See* Glaeser, *supra* note 99, at 133 (noting that irrationality will "often increase the costs of government decision-making relative to private decision-making because consumers have better incentives to overcome errors than government decision-makers").

A second source of the behavioralist tendency to assume the costs of intervention are less than the benefits of error reduction is the assumption that regulators are rational. Judge Posner asked the pertinent question in arguing against the CFPB; that is, while "behavioral economists are right to point to the limitations of human cognition," if they have the same cognitive limitations as consumers, should they be designing systems of consumer protection?"[134] As we have emphasized, the complexity of distinguishing rational from irrational behavior and, further, of designing a behavioral intervention in a manner that minimizes the costs imposed upon rational actors, requires careful interpretation of significant amounts of reliable data. Even where the data are available and yield robust and reliable findings, behavioral policy interventions contemplate human decisions plagued by the same biases, while behavioral cost-benefit analysis generally assumes the cost of irrational intervention is negligible and need not be accounted for.

Thaler, responding to Judge Posner's critique in the context of consumer protection law, has offered a defense of behavioral interventions implemented by irrational and error-prone regulators. He argues that regulators being, like everybody else, boundedly rational says little about whether and how we should regulate individual behavior:

[134] Richard A. Posner, *Treating Financial Consumers as Consenting Adults*, WALL STREET JOURNAL (July 22, 2009), *available at* http://online.wsj.com/article/SB10001424052970203946904574302213213148166.html.

> The premise of behavioral economics is that humans are not perfect decision-making machines. … Even Judge Posner is human, and given the number of books he has written, he must have made a few mistakes in print. But our legal system needs judges, and one of the reasons we have a layered judicial system is so that mistakes by one judge can be corrected by others. Should we abolish our legal system because judges are known to make mistakes? No government agency (or judge) will be error-free. The goal of the Nudge agenda sketched out in my co-authored book of that title was to create decision-making environments in which it is easier for error-prone human decision makers to choose well. The Agency proposed by the administration is a good example of this kind of thinking. Even imperfect experts can help us achieve better outcomes, just as imperfect judges can help us enforce the law fairly. Until we invent the perfect human (or computer decision-making devise), we have no good alternatives.[135]

Thaler's response misses the critical point. The question is not whether governments or private individuals are irrational, or whether we can expect a government agency led by a group of behaviorally-biased individuals to implement error-free policy. The question is, as it always is when analyzing the relative economic merits of different institutional arrangements, "compared to what?" How costly will government policy errors be if government actors suffer from hyperbolic discounting, or status quo bias, or are sensitive to framing effects? What will be the frequency and magnitude of those errors relative to relying upon private decision makers to correct their own errors? Can we trust behavioral regulators suffering from confirmation bias reliably to identify the

[135] *See* Richard Thaler, *Thaler Responds to Posner on Consumer Protection*, THE BUSINESS DESK, July 28, 2009, *available at* http://www.pbs.org/newshour/businessdesk/2009/07/thaler-responds-to-posner-on-c.html.

true preferences of individuals in order to implement behavioral polices?[136] By casting the issue as whether people err — which no one could dispute — Thaler ignores the more subtle and fundamental points about the consequences of the choice to rely upon the government *rather than* private decision makers to correct errors.[137] The assumption that regulators are rational, or alternatively, that their irrationality is irrelevant to the welfare consequences of their interventions, is misguided and biases cost-benefit analyses of those interventions.

The behavioralist tendency to expect regulators to have access to the information required to identify true preferences, and even superior information relative to private economic agents, is a third, related source of bias involving the behavioralist's treatment of government actors.[138] Rizzo and Whitman describe this obstacle to welfare-increasing behavioral intervention as "the knowledge problem" of behavioral law and

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[136] For a discussion of the confirmation bias in the context of behavioral law and economics and its proponents, *see* Gregory Mitchell, *Taking Behavioralism Too Seriously? The Unwarranted Pessismism of the New Behavioral Analysis of Law*, 43 WM. & MARY L. REV. 1907 (2002).

[137] Nor do Sunstein, Thaler, or other behavioralists appear to be especially concerned with a research program or policy agenda intended to "nudge" regulators and judges to more rational evaluation of data, or improved decision-making free from behavioral biases. For example, the behavioral literature does not appear to include cooling off periods for regulatory decisions made in haste, or a "plain vanilla" requirement for novel applications of behavioral intervention which would require the government decision-maker to be informed of the risks of policy error and the potential costs of unintended consequences. *But see* Josh Wright, Posting to Truth on the Market, *A "Plain Vanilla" Proposal for Behavioral Law and Economics* (July 16, 2010), *available at* http://truthonthemarket.com/2010/07/16/a-plain-vanilla-proposal-for-behavioral-law-and-economics/.

[138] *See generally* Rizzo & Whitman, *supra* note 53.

economics, derived from Hayek's well known critique of central planning.[139] As Rizzo and Whitman describe the dilemma facing behavioralists:

> If well-meaning policymakers possessed all of the relevant information about individuals' true preferences, their cognitive biases, and the choice contexts in which they manifested themselves, then policymakers could potentially implement paternalist policies that improve the welfare of individuals by their own standards. But lacking such information, we cannot conclude that actual paternalism will make their decisions better; under a wide range of circumstances, it will even make them worse. New paternalists have not taken the knowledge problems that are evident from the underlying behavioral economic research seriously enough.[140] Many of the issues raised by economists and legal scholars skeptical of the behavioral research program and policy agenda involve such knowledge problems.

The assumptions required to avoid the knowledge problem are heroic even when made individually, yet they *must* be made simultaneously. Behavioralists must assume regulators will be able to (1) identify the distribution of individuals' true preferences, (2) get access to reliable empirical data sufficient to identify deviations from rational choice, (3)interpret those data accurately, and (4) implement the policies so the reduction in errors increases welfare. This combination of simultaneous assumptions poses an heroic challenge. The assumptions also bias downward, even unto zero, the perceived cost of behavioral intervention and thus can be seen as another form of the

[139] F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).
[140] Rizzo & Whitman, *supra* note 80, at 910.

Nirvana Fallacy. Further, the tendency to discount the knowledge problem facing behavioral regulators further biases cost-benefit analysis in favor of intervention.

An important corollary of the knowledge problem is that because behavioral economics generates indeterminate predictions in many settings, it encourages the central planner to substitute his own preferences, or those of special interests, when identifying true preferences. The indeterminate predictions are a necessary result of behavioral economics, as it lacks a coherent theory of errors that can predict the conditions under which behavioral biases influence decisions and when they do not. Further, the behavioral literature does not offer clear predictions when multiple cognitive biases infect decision making simultaneously, or in different contexts. The effect of the interaction of these biases is not well understood, even in the laboratory, much less in field and market settings. Behavioral economics produces a remarkably wide range of possibilities open to a regulator considering a proposed intervention. This property of behavioral economics entails a much greater risk of policy error than would reliance upon the typically clear predictions of price theory.[141] Any rigorous evaluation of the costs and benefits of behavioral intervention must account for the potential abuse or plain misuse of behavioral economics by regulators.

[141] *See* Ginsburg & Moore, *supra* note 48, at 96-97 (observing that "[behavioral economics] is almost the opposite of price theory, which narrows significantly the range of outcomes a court may reach;" instead it "increases the degrees of freedom with which a court may pursue personal, idiosyncratic goals.").

Each of these three general classes of objections to the welfare-based case for behavioral law and economics poses a serious challenge. The theoretical infirmities in the behavioralist's attempts to bridge the gap between mistake and welfare, including the adoption of an arbitrary welfare criterion by which to evaluate the consequences of context-dependent choices, warrant significant skepticism regarding the libertarian paternalist's claimed ability to make individuals better off by each individual's own lights. The empirical weaknesses in the behavioral literature are also significant, calling into question whether the existing body of knowledge is nearly enough to implement any behavioral intervention without running an unreasonable risk of error. The empirical problems exist both in the laboratory and in market settings, and go to the very core of the behavioral research agenda, including the robustness of that most frequently relied upon behavioral finding, the endowment effect. Finally, the behavioralists appear to be especially prone to errors of omission involving cost-benefit analysis of their proposed interventions, at times excluding from consideration entire categories of policy-relevant social costs, such as dynamic inefficiencies, cognitive moral hazard and the relative inefficiency of feasible institutional arrangements designed to reduce errors.

Any of these three classes of objections, and even specific objections within these categories, might be sufficient to undermine dramatically or to reject altogether any welfare-based case for behavioral law and economics. Even if we assume the

behavioral economics research and policy programs can avoid all these problems, and would be justified on pure economic welfare grounds, such a calculation ignores the equally significant, but underappreciated, threat to individual liberty posed by these programs.

IV. Beyond Welfare: Behavioral Economics and Liberty

In the brave new world contemplated by the advocates of government policies informed by behavioral law and economics, many more aspects of each individual's life will be regulated, or more stringently regulated, than at present. This would be true even if the behavioralists' agenda were limited to matters of health and money, the two major subdivisions of Thaler and Sunstein's book,[142] each of which they define capaciously; the former, for example, includes smoking, nutrition, and insurance,[143] while the latter includes credit cards, investing, and saving for retirement.[144]

Assuming, again, the behavioral law and economics regulatory agenda can be implemented in a manner that avoids the problems discussed in Part III, or even in a manner that increases economic welfare, the agenda would still present a substantial threat to the liberty of every individual. Perhaps because both sides of the debate over behavioral law and economics have been conducted primarily by academic economists

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[142] *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE (2008).
[143] *Id.* at 161–98.
[144] *Id.* at 104–58.

and lawyers, and academics are notoriously risk averse and government preferring,[145] the literature is rather barren when it comes to thinking about the implications of behavioral law and economics for individual autonomy and the social significance of its further diminution. It is to those concerns that we now turn.

A. Autonomy

John Stuart Mill was probably not the first, and surely not last, to note the value of autonomy in its own right, that is, apart from what one does with one's autonomy or the consequences of its exercise. His point was that a fully realized human being is one who makes the important decisions in his own life:

> If a person possesses any tolerable amount of common sense and experience, his own mode of laying out his existence is the best, not because it is the best in itself, but because it is his own mode. Human beings are not like sheep; even sheep are not undistinguishably alike. . . . If it were only that people have diversities of taste, that is reason enough for not attempting to shape them all after one model. But different persons also require different conditions for their spiritual development.[146]

On the related topic of unthinking conformity to a tradition or custom, which he acknowledges may embody the teachings of experience, Mill's observation is a

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[145] *See* Daniel B. Klein & Charlotta Stern, Professors *and Their Politics: The Policy View of Social Scientists*, 17 CRITICAL REV. 257 (2005) (providing evidence that social scientists are government preferring); John O. McGinnis, Matthew A. Schwartz & Benjamin Tisdell, *The Patterns and Implications of Political Contributions by Elite Law School Faculty*, 93 GEO. L. J. 1167, 1186 (2005) (finding over 80 percent of faculty campaign contributions from the top 21 law schools are directed toward Democratic / Liberal candidates).

[146] MILL, *supra* note 130, at 132–33 (Penguin ed. 1985) (1859); *see also* JAMES GRIFFIN, WELL-BEING 67 (1986) ("One component of agency is deciding for oneself. Even if I constantly made a mess of my life, even if you could do better if you took charge, I would not let you do it. Autonomy has a value of its own.").

cautionary note with equal application for those who would relieve the citizen of the need to decide things for himself:

> [T]o conform to custom, merely *as* custom, does not educate or develop in him any of the qualities which are the distinctive endowment of a human being. The human faculties of perception, judgment, discriminative feeling, mental activity, and even moral preference, are exercised only in making a choice.[147]

And finally, in words that fortuitously seem to anticipate Thaler and Sunstein's ideas on manipulating the default rule for enrolling employees in payroll savings (Sec. 401) plans,[148] Mill wrote:

> He who chooses his plan for himself employs all his faculties. He must use observation to see, reasoning and judgement to foresee, activity to gather materials for decision, discrimination to decide, and when he has decided, firmness and self-control to hold to his deliberate decision. [149]

More than a century later Friedrich Hayek, in *The Constitution of Liberty*, made a slightly different point about the value of having more rather than fewer choices: "[T]he importance of our being free to do a particular thing has nothing to do with the question of whether we or the majority are ever likely to make use of that possibility. … The less likely the opportunity, the more serious will it be to miss it when it arises, for the experience it offers will be nearly unique."[150] As Amartya Sen would later point out, this consideration relates to "the process aspect of freedom," which includes

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[147] MILL, *supra* note 130, at 122.
[148] *See* THALER & SUNSTEIN, *supra* note 14, at 105–19.
[149] MILL, *supra* note 130, at 123.
[150] F.A. HAYEK, THE CONSTITUTION OF LIBERTY 31 (1960).

considerations that may not figure in the accounting of the opportunity aspect [of freedom]."[151] In particular, he identifies

> (i) decisional autonomy of the choices to be made, and (ii) immunity from interference by others. The former is concerned with the operative role that a person has in the process of choice, and the crucial issue here is self-decision, e.g., whether the choices are being made by the person herself – not (on her behalf) by other individuals or institutions.[152]

Behavioralists in general do not place any value upon the "the process aspect of freedom" or "decisional autonomy."[153] Thaler and Sunstein in particular claim to preserve the choices now open to people by, for example, merely altering default rules without preventing the determined individual from opting out; as we have seen, however, that is not always the case and it is never without cost to the person whose preference is different from theirs. Indeed, the proposals advanced by Thaler and Sunstein are libertarian only in the limited sense that they "do not block choice" altogether.[154] As Mozaffar Qizilbash observes, however, Thaler and Sunstein do not address the deeper anti-paternalist objection that their proposals deny the inherent

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[151] Amartya Sen, *Markets and Freedoms: Achievements and Limitations of the Market Mechanism in Promoting Individual Freedoms*, 45 OXFORD ECON. PAPERS 519, 522, 524 (1993).

[152] *Id.* at 524. "The process aspect of freedom" is about more than "myopic selfishness. It is whatever it is that interests the participants, whatever they value, whatever goals they pursue," including their altruistic goals. MILTON FRIEDMAN & ROSE D. FRIEDMAN, FREE TO CHOOSE: A PERSONAL STATEMENT 27 (1980).

[153] Sunstein & Thaler, *supra* note 1, would assign zero weight to decisional autonomy unless it was linked with a welfare-based preference for decision making ("freedom of choice is itself an ingredient in welfare. In some situations people derive welfare from the very act of choosing. . . . But much of the time, especially in technical areas, people do not particularly enjoy the process of choice"). *Id*. at 1198-99.

[154] Mozaffar Qizilbash, *Well-Being, Preference Formation and the Danger of Paternalism*, Max Planck Institute of Economics Papers on Economics and Evolution No. 0918, at 23 (draft 2009), *available at* ftp://papers.econ.mpg.de/evo/discussionpapers/2009-18.pdf.

value individuals place upon autonomy. The process value of autonomy — "deciding for oneself" — has value that "run[s] contrary to even the weak form of paternalism" favored by Thaler and Sunstein, rendering "the idea of 'libertarian paternalism' as they define it [] potentially incoherent."[155]

Sometimes Thaler and Sunstein obscure the coercive element from view, as in the example with which they begin their recent book, *Nudge* (2008). There they instance the "director of food services for a large city school system" who has "formal training in nutrition."[156] She can arrange for food to be presented in the school cafeterias in any sequence and must choose from an array of several possibilities, including what is best for the children and what will maximize profits.[157] Their point is about the inevitability of her making some choice. Note the comforting nature of the setting, however; ultimately, the ones whose choices are being influenced are children, who have less autonomy than do adults — which is why most of them are in school when they would rather be outside playing. The "choice architect" works for a public school system, not a for-profit enterprise, the mission of which school system is to educate children, perhaps even on the subject of nutrition. So, yes, the nutritionist must make a choice,

[155] *Id.*
[156] THALER & SUNSTEIN, *supra* note 14, at 1.
[157] *Id.* at 1–3.

but what the inevitability of this choice has to do with the case for a public agency manipulating adults, who are sovereign in the marketplace, remains obscure.[158]

Limiting the range of decisions to be made by individuals, or burdening those who would make an officially disfavored choice — not saving enough, eating unhealthful foods, etc. — tends to infantilize the public. Effective decision making is a skill that is acquired through experience. To the extent individuals are deprived of that experience, they do not develop the skill.

Decision making requires an individual to proceed through four steps: setting a goal; compiling options for reaching that goal; rank-ordering those options; and selecting the highest-ranked option.[159] Skill in making decisions is acquired by trial and error, that is, by making a decision and getting either verbal feedback about, or directly observing the success or failure of, one's decision as a means of reaching one's goal.[160] The experimental literature shows that observing the outcome of one's decision is the more influential type of feedback; subsequent decisions are more likely to be improved

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[158] Sunstein clarified the connection in an earlier work, instancing "the cafeteria at some organization" and rather lamely suggesting that if the cafeteria's goal is profit maximization, then "even those cafeterias that face competition will find that some of the time, market success will come not from tacking people's preferences, but from providing goods and services that turn out, in practice, to promote their welfare, all things considered. Consumers might be surprised by what they end up liking." CASS R. SUNSTEIN, LAWS OF FEAR 179 (2005). Clearly Thaler and Sunstein have little to offer when they move from a bureaucratic to a market environment, where consumers are sovereign.

[159] James P. Byrnes et al., *Learning to Make Good Decisions: A Self-regulation Perspective*, 70 CHILD DEV. 1121, 1121 (1999); *see also* JAMES P. BYRNES, THE NATURE AND DEVELOPMENT OF DECISION-MAKING: A SELF-REGULATION MODEL 27–28 (1998) (relying on the approach used by scholars in the field of artificial intelligence in formulating the self-regulation model for rational task analysis and observing "[n]o one would disagree with ... my claim that decision making requires the[se] four processes").

[160] Byrnes et al., *supra* note 159, at 1122.

by experiencing success or failure than by being told one's decision was a success or a failure and why. Not surprisingly, adolescents exhibit less decision making competence and are less likely to learn from feedback than are adults.[161] Experimental studies suggest that "adults could progressively learn to make better decisions if they received relatively clear feedback from outcomes."[162]

Relatedly, a body of studies in experimental psychology shows that individuals better remember and more closely analyze unfavorable feedback than they do favorable feedback.[163] Moreover, "when people are motivated to be accurate, they expend more cognitive effort on issue-related reasoning, attend to relevant information more carefully, and process it more deeply, often using more complex rules."[164]

The lesson seems clear: Experience teaches, and the more palpable the consequences, the more likely the lesson is to be learned.[165] Moreover, there is reason to

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[161] James P. Byrnes, *The Development of Decision-Making*, 31 J. ADOLESCENT HEALTH 208, 208, 214 (2002).
[162] Byrnes et al., *supra* note 159, at 1125, 1137 (citing two studies in support of the general proposition adults will make better decisions as a result of clear feedback and two studies that conclude older children are more likely to exhibit improved decision-making as a result of feedback than are young children). Klick and Mitchell have expanded somewhat upon Byrnes's findings, concluding that, because feedback is obtained "[t]hrough education, experimentation, experience, and observation," increased activity or opportunity in these areas will likewise lead individuals to "select the option that will lead to the most favorable outcomes." *See* Klick & Mitchell, *supra* note 20, at 1629.
[163] *See* Peter H. Ditto et al., *Motivated Sensitivity to Preference-Inconsistent Information*, 75 J. PERSONALITY & SOC. PSYCHOL. 53, 65 (1998).
[164] Ziva Kunda, *The Case for Motivated Reasoning*, 108 PSYCHOL. BULL. 480, 481 (1990).
[165] Consistent with this inference, Vernon Smith and James Walker's review of the experimental literature on the effect of incentives on decision making finds that "[s]ome studies report observations that fail to support the predictions of rational models, but as reward level is increased the data shift toward these predictions." Smith & Walker, supra note 98, at 246-250, 251-259. Consequences need not be serious, however, for the effect of a choice to provide valuable feedback; studies show the repetition of feedback that accompanies making similar decisions may be useful to the decision-making process. *See* Vernon L. Smith, *Economics in the Laboratory*, 8 J. ECON. PERSP. 113, 118 (1994) (rational behavior tends to emerge "in

think experimental results such as these, although indicative, tend to understate significantly actual behavior outside the confines of the experiment. As Glaeser has pointed out, the subjects enrolled in the experiment face limited incentives, which would be "much stronger in the real world than in the laboratory. In experiments, individuals have few tools with which to improve their reasoning, and their only real method of responding to incentives is to think harder. Outside the lab, people have access to advisers, books, the Internet, and more time. Their willingness to spend time and money to use these resources will surely depend on the stakes involved in the decision."[166]

It is precisely because individuals invest more effort when making more important decisions that paternalistic policies relieving them of responsibility for those decisions will have the most corrosive effect upon their decision making ability.[167] Nor is it reasonable to think the adverse effect will be felt with respect only to a narrow class of similar decisions; a muscle that has atrophied is rendered incapable of any strenuous activity.

If individuals are to realize their full potential as participants in the economic and political life of society, then they must be free to fail in large ways as well as small. The fatal flaw of libertarian paternalism is to ignore the value of this freedom to err.

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the context of a repetitive market institution"); John A. List, *Does Market Experience Eliminate Market Anomalies?*, 118 Q.J. ECON. 41, 70 (2003) (there is "strong evidence that individual behavior converges to the neoclassical prediction as trading experience intensifies").

[166] Glaeser, supra note 99, at 140.

[167] *See* Klick & Mitchell, *supra* note 20, at 1635–36.

Interestingly, Hayek said as much in making the inherently anti-paternalistic case for *The Constitution of Liberty*: "Man learns by the disappointment of expectations."[168] "Liberty not only means that the individual has both the opportunity and the burden of choice; it also means that he must bear the consequences of his actions and will receive praise or blame for them. Liberty and responsibility are inseparable."[169] In a passage that, if heeded, would have saved the behavioralists a great deal of effort, he wrote:

> The justification for assigning responsibility is thus the presumed effect of this practice on future action; it aims at teaching people what they ought to consider in comparable future situations. . . . This does not mean that a man will always be assumed to be the best judge of his interests; it means merely that we can never be sure who knows them better than he.[170]

Thinking about the implications of paternalism — soft or hard, libertarian or totalitarian — both for individuals and for the society they make up, yields some testable hypotheses. For one, we would expect people who were raised in a paternalistic state, having been relieved of the need to make many important decisions for themselves, to have less well-developed decision making skills and to be more risk-averse. As it happens, there is a body of literature in cognitive psychology that tends to confirm that hypothesis. It proceeds from an understanding of the characteristics associated with entrepreneurship.

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[168] HAYEK, *supra* note 150, at 30.
[169] *Id.* at 71.
[170] *Id.* at 76.

In general, "entrepreneurs ... exhibit a particular mode of information processing, or cognitive style. "[171] They are more alert to opportunities that require linking previously unrelated information.[172] Indeed, the experimental literature tends strongly to validate Kirzner's description of the Austrian tradition, which "postulates a tendency for profit opportunities to be *discovered* and *grasped* by routine-resisting entrepreneurial market participants."[173] In a socialist state, however, resistance is futile.[174] Uncritical acceptance of the party line is essential to advancement or even survival. Of course, there are choices to be made: Shall I read Pravda or Izvestia? But the choice set has been limited by the state in a way that serves the state's ends, not those of the individual.[175] As Milan Simecka so graphically recounted from his personal experience after the "Prague Spring" of 1968, the communist party in Czeckoslovakia controlled the citizenry by depriving individuals of their decisional autonomy in only three respects: The state determined their housing, their occupation, and their children's education. That is why this professor of mathematics made a mid-life change of career

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[171] Amir N. Licht, *The Entrepreneurial Spirit and What the Law Can Do About It*, 28 COMP. LAB. L. & POL'Y J. 817, 819 (2007).
[172] *Id.* at 824–25; Connie Marie Gaglio & Jerome A. Katz, *The Psychological Basis of Opportunity Identification: Entrepreneurial Alertness*, 16 SMALL BUS. ECON. 95, 96–98 (2001).
[173] Israel M. Kirzner, *Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach*, 35 J. ECON. LIT. 60, 71 (1997).
[174] *See* STAR TREK THE NEXT GENERATION (saying of Borg).
[175] *See* KATHERINE VERDERY, WHAT WAS SOCIALISM, AND WHAT COMES NEXT? 26 (1996) (asserting purpose of socialism was "to accumulate means of production" in order "to redirect resources to a goal greater than satisfying the population's needs").

and became an operator of construction equipment. Perhaps coincidentally, his book was published in 1984.[176]

The end of the Soviet era in Russia and the eastern European states it dominated, and the very substantial movement in China toward a market economy, provide an opportunity to make some useful comparisons. The Soviet experience was unique in that it spanned the lives of three generations over a period of 74 years.[177] The experience of eastern Europe with communism lasted about 45 years and in most places did not entail as comprehensive a form of state control over the economy.[178] At the end of the communist era, therefore, there were many small business owners as well as people with pre-communist business experience who could rekindle the entrepreneurial spirit. China began to shift to a more privatized economy even in the late 1970s, after only 30 years of economic totalitarianism.[179]

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[176] MILAN SIMECKA, RESTORATION OF ORDER: THE NORMALIZATION OF CZECHOSLOVAKIA (1984).

[177] Ruta Aidis, et al., *Institutions and Entrepreneurship Development in Russia: A Comparative Perspective*, 23 J. BUS. VENTURING 656, 657 (2008).

[178] *See, e.g.*, TONY JUDT, POSTWAR: A HISTORY OF EUROPE SINCE 1945, at 428 (2005) (Hungary under Janos Kadar implemented economic reforms in 1968 to promote a "mixed economy" with some local autonomy and private ownership); David Lipton & Jeffrey Sachs, *Creating a Market Economy in Eastern Europe: The Case of Poland*, 1990 BROOKINGS PAPERS ON ECON. ACTIVITY 75, 80–82 (1990) (farmers in Poland "retained their private land after World War II," and a larger though still restricted "private sector ha[d] been allowed to operate under the reforms in Hungary and Poland" during communism).

[179] Louis Putterman, *The Role of Ownership and Property Rights in China's Economic Transition*, *in* ANDREW G. WALDER, CHINA'S TRANSITIONAL ECONOMY 86 (1996) (Between 1978 and the early 1990s, China's economy shifted with "significant new participation by foreign and domestic private firms"); *see also* Hon. Richard D. Cudahy, *From Socialism to Capitalism: A Winding Road*, 11 CHI. J. INT'L L. 39 (2010) (noting "[t]he flexibility of the Chinese in economic matters seemed to far exceed the Soviets" and discussing China's cautious shift toward privatization); Jonas Alsen, *An Introduction to Chinese Property Law*, 20 MD. J. INT'L L. & TRADE 1, 20–21 (1996) (detailing shift to more private ownership beginning in 1978).

Transnational comparisons using data from the Global Entrepreneurship Monitor[180] produce "strong evidence" that, even after controlling for relevant variables, all countries with a communist past have a lower rate of entrepreneurship activity than do other countries.[181] A recent study concludes that even now those unfortunate countries have "low levels of entrepreneurial human capital that have been engendered by decades of existence under a central planning system that tended to blunt individual incentives."[182] At the same time, as one would expect, the level of entrepreneurship is "significantly lower in Russia."[183] A study conducted jointly by Russian and U.S. scholars concludes that "[t]he absence of freedom of decision-making in the most important resource — the workforce — and the 'no-choice' employment situation were two fundamental obstacles to the development of entrepreneurship" during the communist era.[184] And Russian entrepreneurs tend to be younger than is typical elsewhere;[185] only the young were unscathed by their nation's history.

B. A slippery slope

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[180] Global Entrepreneurship Monitor, http://www.gemconsortium.org (last visited Sept. 7, 2010).
[181] *See e.g.*, Aidis et al., *supra* note 177, at 657.
[182] Martin Robson, *Explaining Cross-National Variations in Entrepreneurship: The Role of Social Protection and Political Culture*, 28 COMP. LAB. L. & POL'Y J. 863, 890 (2007).
[183] Aidis et al., *supra* note 177, at 657, 670 (attributing difference in part to weak institutions to support entrepreneurial development).
[184] Alexander I. Ageev, Mikhail V. Gratchev, & Robert D. Hisrich, *Entrepreneurship in the Soviet Union and Post-Socialist Russia*, 7 SMALL BUS. ECON. 365, 369 (1994).
[185] *Id.* at 371, 374 (finding entrepreneurs in Poland and Hungary are older than their counterparts in Russia).

Of course, no proponent of regulation based upon the findings of behavioral economists espouses a regime remotely as encompassing and restrictive as even the least oppressive of the late, unlamented communist regimes. They would, however, move our societies in that direction and there is reason to believe they would put us on a slippery slope[186] — or push us that much further down the slope than we have already slid.

Paternalistic policies are particularly prone to be slippery.[187] Such policies are expressed in regulations specifically adopted, at least initially, for the benefit of those regulated. The federal law requiring manufacturers to install seatbelts in all automobiles provides a familiar example.[188] When seatbelt usage proved disappointingly low, federal regulators experimented with requiring various passive restraints, including airbags, automatic seat belts, and even an "ignition interlock" device that prevented a car from starting if an occupant had not fastened his seatbelt.[189] Then the regulators threatened the states with further regulation if they did not adopt

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[186] *See* Douglas Glen Whitman & Mario J. Rizzo, *Paternalistic Slopes*, 2 N.Y.U. J.L. & LIBERTY 411, 412 (2007) ("A slippery slope argument is one suggesting that a proposed policy or course of action that might appear desirable now, when taken in isolation, is in fact undesirable (or less desirable) because it increases the likelihood of undesirable policies being adopted in the future").

[187] Rizzo & Whitman, *supra* note 80, at 691-705 ("slippery slopes flourish in the presence of a gradient or continuum," and "[t]he new paternalist paradigm ... relies on discarding sharp distinctions in favor of gradients").

[188] *See* Barry L. Huntington, *Welcome to the Mount Rushmore State! Keep Your Arms and Legs Inside the Vehicle at All Times and Buckle Up*, 47 S.D. L. REV. 99, 101–04 (2002) (providing history of federal seat belt laws).

[189] *See Geier v. American Honda Motor Co., Inc.*, 529 U.S. 861, 875–77 (2000) (discussing history of federal regulations requiring passive restraints).

laws requiring that seat belts be used.[190] Each of these mandates imposed a cost upon the manufacturers and the purchasers of automobiles, but not upon the government officials who formulate them. On the contrary, regulators stand to be criticized if their initial measures are insufficient to prevent all harms of the sort they are tasked — or have tasked themselves — with preventing; they will not be rewarded until they have accomplished their mission to the fullest.

Also, missions have a tendency to expand;[191] mission creep assures that the government agency will need more "resources," meaning money and staff, and forestalls the danger of its actually accomplishing its mission and becoming redundant.[192] Just as the invention of a vaccine for polio threatened to put the March of Dimes charity out of business[193] (and caused it to adopt a mission that could never be fully achieved, namely, "improv[ing] the health of babies" worldwide[194]**),** government agencies are always on the lookout for conduct that needs to be regulated. Mission

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[190] Huntington, *supra* note 188, at 101. States without mandatory seatbelt laws also receive reduced federal funding for highway maintenance. *Id.* at 102.

[191] *See* MILTON FRIEDMAN, WHY GOVERNMENT IS THE PROBLEM 9 (1993) ("The general rule is that government undertakes activity that seems desirable at the time. Once the activity begins, whether it proves desirable or not, people in both the government and the private sector acquire a vested interest in it. If the initial reason for undertaking the activity disappears, they have a strong incentive to find another justification for its continued existence."); *see also* Rizzo & Whitman, *supra* note 80, at 717–23 (noting the adoption of a moderate paternalist policy makes the adoption of further policies more likely because the proponent can argue the now-accepted justification for the first policy also provides a foundation for the new policy).

[192] See Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101 (1987); HERNANDO DE SOTO, THE OTHER PATH (1990); Simeon Djankov et al., *The Regulation of Entry*, 117 Q.J. Econ. 1, 3, (2002).

[193] DAVID L. SILLS, THE VOLUNTEERS: MEANS AND ENDS IN A NATIONAL ORGANIZATION 253–54 (1957); HOWARD P. GREENWALD, ORGANIZATIONS: MANAGEMENT WITHOUT CONTROL 369 (2008).

[194] http://www.marchofdimes.com/787.asp.

creep is a concern regardless whether an agency's purpose is paternalistic, but with a mandate to regulate conduct for the benefit of the regulated individuals, there is no end to the good an agency may attempt to do.[195]

Once a regulation is in place it may come to be accepted as the new norm, so that an extension of the regulation seems like a modest and logical next step.[196] Smoking bans are a case in point.[197] The government first determined that cigarette smoking is bad for one's health and so advised the public. When the public did not respond adequately, i.e. , not everyone quit smoking, warnings were required on every pack of cigarettes, "sin" taxes were put on cigarettes so as to raise the price and thereby reduce the quantity consumed, and tobacco advertisements were banned from television.[198] Notwithstanding the government's paternal concern for their health, millions of people continued to smoke cigarettes. The government then publicized the hazard smoking posed to non-smokers, which provided a new rationale for banning smoking, namely,

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[195] *See* Olmstead v. United States, 277 U.S. 438, 479 (1928) (Brandeis, J., dissenting) ("Experience should teach us to be most on our guard to protect liberty when the government's purposes are beneficial. Men born to freedom are naturally alert to repel invasion of their liberty by evil-minded rulers. The greater dangers to liberty lurk in insidious encroachment by men of zeal, well-meaning but without understanding.").

[196] Whitman & Rizzo, *supra* note 186, at 441; *Cf,* Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 964 (1996) ("Many laws have an expressive function. They "make a statement" about how much, and how, a good or bad should be valued. They are an effort to constitute and to affect social meanings, social norms, and social roles. Most simply, they are designed to change existing norms and to influence behavior in that fashion."); Larry Lessig, *The New Chicago School*, 27 J. LEGAL STUD. 661, 666-72 (1998) (describing work by scholars concluding law can regulate social norms).

[197] *See* Rizzo & Whitman, *supra* note 80, at 720–23.

[198] *Id.* at 720.

the externality it imposed upon others.[199] The rationale was flawed, of course, because there was no gap in the relevant property rights: Patrons of restaurants and bars who did not want to be exposed to second-hand smoke could take their custom elsewhere; the expressed concern for employees of those establishments was similarly flawed in that, unlike the unfortunate subjects of the Soviet system, they were free to change their place of employment. Eventually, the ban on smoking in bars and restaurants was generalized to all indoor spaces and recently has spawned proposals to ban smoking even out of doors in some localities,[200] notwithstanding the lack of any reason to be concerned with third parties.

As the assault on smoking proceeded down the slope, the justification for each new step zigged and zagged between paternalistic and erroneous externality rationales. In fact, once smoking was deemed unhealthful to smokers and bystanders alike, the actual rationale for each next step became unimportant.[201] The previous step had established the new normal and the next step was but a small effort to perfect the norm. It is in this way, too, that the concept of "public health" evolved from a concern with

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[199] *Id.*

[200] *See, e.g.*, Sewell Chan, *New York Eyes 'No Smoking' Outdoors, Too*, N.Y. TIMES, Sept. 14, 2009, http://www.nytimes.com/2009/09/15/nyregion/15smoking.html (discussing the New York City Health Commissioner's proposal to ban smoking at city parks and beaches).

[201] *See* Rizzo & Whitman, *supra* note 80, at 722 (many recent "restriction[s] on public smoking became acceptable with little or no evidence of significant harm to bystanders").

contagious disease[202] into a paternalistic concern with the health of the public.[203] If smoking is unhealthful, that is now enough to deem it a matter of public health. So, too, with obesity[204] and other self-determined and non-contagious harms — if harms they be in the eyes of the individual who smokes or overeats.

V. Why this, why now?

Behavioral law and economics is a product produced primarily by law professors. As we have seen in Table 1, the number of articles on behavioral law and economics appearing in law reviews has grown exponentially over the last ten years.[205]

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[202] BERNARD J. TURNOCK, ESSENTIALS OF PUBLIC HEALTH 3–4 (2007) (noting the "clear intent" of creating state public health agencies in the late nineteenth century was that their "powers be used to battle the epidemics of infectious diseases").

[203] For example, the Office of the Assistance Secretary for Health — formerly the Office of Public Health and Science, 75 Fed. Reg. 53,304 (Aug. 31, 2010) — currently comprises 19 offices with missions ranging from the general "protect[ion] and advance[ment] [of] the health of the nation" to the promotion of "physical activity, fitness, and sports in America." http://www.hhs.gov/ophs/. The World Health Organization, the objective of which is "the attainment by all peoples of the highest possible level of health," defines "health" as "a state of complete physical, mental and social well-being and not merely the absence of disease or infirmity." http://www.who.int/governance/eb/who_constitution_en.pdf. Similarly, the mission of the U.S. National Institutes of Health is "to enhance health, lengthen life, and reduce the burdens of illness and disability."

[204] The effort to promote more healthful eating started in 1990 with the enactment of the Nutrition Labeling and Education Act, which authorized the Food and Drug Administration to issue rules requiring that food bear nutrition labels Pub. L. 101-535, 104 Stat. 2353 (1990); *see also* 21 C.F.R. 101 (implementing regulations), and has evolved into outright bans on the use of trans fats in restaurants, *see, e.g.*, N.Y.C. Admin. Code § 81.08. The Centers for Disease Control refers to obesity as an "epidemic." Centers for Disease Control & Prevention, *Obesity: Halting the Epidemic by Making Health Easier* (2009) ("American society has become 'obesogenic,' characterized by environments that promote increased food intake, nonhealthful foods, and physical inactivity. Public health approaches that affect large numbers of different populations in multiple settings—communities, schools, work sites, and health care facilities—are needed."), *available at* http://www.cdc.gov/chronicdisease/resources/publications/AAG/pdf/obesity.pdf.

[205] *See also* Ginsburg & Moore, *supra* note 48, at 94 (cataloging the number of law-review articles discussing behavioral economics).

What, we now ask, accounts for the great and increasing attraction of the subject to legal academics?

For at least the last 40 years, academic legal writing has been highly prone to the vicissitudes of fashion. Starting around 1970 the fashion turned to economic analysis of law; particularly after Richard Posner published his treatise on that subject in 1973,[206] scores of articles presenting an economic analysis of a particular legal doctrine appeared in the law journals every year.[207] Articles and books in this genre continue to be published[208] but they no longer have as large a share of the market.

In something of a reaction to the growing interest in economic analysis, a smaller but prolific cadre of law professors created the Critical Legal Studies (CLS) movement,[209] which in turn inspired cognate schools such as Critical Race Theory,[210]

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[206] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (1973).

[207] *E.g.*, Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979); Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978); George L. Priest, *Breach and Remedy for the Tender of Nonconforming Goods Under the Uniform Commercial Code: An Economic Approach*, 91 HARV. L. REV. 960 (1978); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977); Richard A. Posner, *Gratuitous Promises in Economics and Law*, 6 J. LEGAL STUD. 411 (1977); Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J. L. & ECON. 293 (1975); William Breit, *Antitrust Penalties and Attitudes Toward Risk: An Economic Analysis*, 86 HARV. L. REV. 693 (1973).

[208] *E.g.*, Ann-Sophie Vandenberghe, ECONOMIC ANALYSIS OF EMPLOYMENT LAW (2d ed. 2010); Judy A. Temple et al., *Cost-Effective Crime Prevention: Economic Analysis of the Chicago Child-Parent Centers Early Education Program*, 15 PUB. INT. L. REP. 181 (2010).

[209] *See* MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 1 (1987) ("the first annual Conference on Critical Legal Studies in 1977 gave little hint as to what the organizers thought 'critical legal studies' was to become ... the organizers were simply seeking to *locate* those people working either at law schools or in closely related academic settings" who were "something akin to New Leftists").

[210] *See* CRITICAL RACE THEORY: THE CUTTING EDGE xi (Richard Delgado & Jean Stefancic eds., 2d ed. 2001) (Critical Race Theory "has predecessors—Critical Legal Studies, to which it owes a great debt").

Critical Feminism,[211] and Queer Theory.[212] CLS, which had a significant following, particularly among faculty at the most elite law schools, advanced the idea that all law, including court made law, is indistinguishable from politics, particularly class politics.[213] As recounted by Duncan Kennedy, a leading figure in the movement, one of its early projects was to "produce[] a critique of mainstream economic analysis of law."[214]

Overtly a leftist movement, CLS turned out to be little more than a species of Marxism, as it had evolved in the hothouse of radical European social theorists such as

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[211] *See generally* Deborah L. Rhode, *Feminist Critical Theories*, 42 STAN. L. REV. 617 (1990) (charting the relationship between CLS and feminist theories, identifying "crosscutting objectives, methodologies, and concerns" between the two fields and observing a "growing body of feminist and critical race scholarship [] developed along lines that paralleled, intersected, and challenged critical legal theory").

[212] *See* Francisco Valdes, *Queers, Sissies, Dykes and Tomboys: Deconstructing the Conflation of "Sex," "Gender," and "Sexual Orientation" in Euro-American law and Society*, 83 CALIF. L. REV. 1, 29–30 (1995) ("endeavor[ing] to enlist critical legal theories and theorists in an effort to create a space and a framework for holistic and contextual critiques of sex, gender, and sexual orientation as legal (and social) concepts"); *see also* Minna J. Kotkin, *Creating True Believers: Putting Macro Theory into Practice*, 5 CLINICAL L. REV. 95, 101–102 (1999) ("Critical jurisprudence also finds expression in feminist legal theory, critical race theory, and queer theory. These movements are alternatively viewed as off-shoots of CLS or independent schools of legal thought that changed the focus of CLS. In either case, by the 1980s, critical scholarship had shifted to some degree from exclusively economic analysis to the exploration of how issues of race, gender, and sexuality determine legal outcomes.").

[213] *See* MORTON HORWITZ, THE TRANSFORMATION OF AMERICAN LAW: 1780–1860 (1977); KELMAN, *supra* note 209; ROBERTO UNGER, KNOWLEDGE AND POLITICS (1975); Mark Kelman, *Misunderstanding Social Life: A Critique of the Core Premises of Law and Economics*, 33 J. LEGAL. EDUC. 274 (1983); Mark Kelman, *Consumption theory, Production Theory, and Ideology in the Coase Theorem*, 52 S. CAL. L. REV. 669 (1974); Duncan Kennedy, *The Critique of Rights in Critical Legal Studies*, *in* LEFT LEGALISM/LEFT CRITIQUE 178 (Wendy Brown & Janet Halley eds. 2002); Duncan Kennedy, *Legal Education as Training for Hierarchy, in* THE POLITICS OF LAW: A PROGRESSIVE CRITIQUE 54 (David Kairys, 3d ed. 1998); Duncan Kennedy *Toward a Critical Phenomenology of Judging*, *in* THE RULE OF LAW: IDEAL OR IDEOLOGY (Allan C. Hutchinson & Patrick Monahan eds. 1987); Duncan Kennedy, *Psycho-Social CLS: A Comment on the Cardozo Symposium*, 6 CARDOZO L. REV. 1013 (1985); Duncan Kennedy, *How the Law School Fails: A Polemic*, 1 YALE REV. L. & SOC. ACTION 71 (1970).); For a more complete bibliography of the CLS movement, see also Duncan Kennedy & Karl E. Klare, *A Bibliography of Critical Legal Studies*, 94 YALE L.J. 461 (1984) .

[214] Duncan Kennedy, *Law and Economics from the Perspective of Critical Legal Studies*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 465 (Peter Newman ed., 2d ed. 1998).

Michel Foccault, Jurgen Habermas and the Frankfurt School of neo-Marxist critical theorists, and Antonio Gramsci, a leader of the Communist Party in Italy. The self-declared purpose of the CLS movement was "to provide a critique of liberal legal and political philosophy," with adherents arguing the "liberal embrace of the rule of law is actually incompatible with other essential principles of liberal political thinking."[215]

Key to the CLS analysis was the notion of "false consciousness,"[216] the "holding of false or inaccurate beliefs that are contrary to one's own social interest and which thereby contribute to the maintenance of the disadvantaged position of the self or the group."[217] Driving a wedge between reality and what people — that is, other people — perceive, creates a space to be filled by some combination of re-education and, insofar as the public is not radicalized, a resort to paternalism.[218] The combination is nicely encapsulated, and given a Mao-ist tinge,[219] in Duncan Kennedy's proposal that

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[215] ANDREW ALTMAN, CRITICAL LEGAL STUDIES: A LIBERAL CRITIQUE 3 (1990); *see also* KELMAN, *supra* note 209, at 2–8.

[216] Although often attributed directly to Marx, *see* Joseph McCarney, Ideology and False Consciousness, Marx Myths and Legends (2005), *available at* http://marxmyths.org/joseph-mccarney/article.htm, the phrase "false consciousness" if not the concept, seems actually to derive from an early translation of a letter Friedrich Engels wrote to Franz Mehring. *See* MICHELE BARRETT, THE POLITICS OF TRUTH: FROM MARX TO FOCCAULT 5–6 (1991).

[217] John T. Jost, *Negative Illusions: Conceptual Clarification and Psychological Evidence Concerning False Consciousness*, 16 POL. PSYCHOL. 397, 400 (1995); *see also* Richard Delgado, *Rodrigo's Sixth Chronicle: Intersections, Essences, and the Dilemma of Social Reform*, 68 N.Y.U. L. Rev. 639, 653 n.57 (1993) (defining "false consciousness" as the ""phenomenon in which the oppressed come to identify with their oppressors, internalize their views, and appear to consent to their own subordination.").

[218] As one student of Kennedy's put it, the phrase "implies that all those who disagree with you are stupid." RICHARD D. KAHLENBERG, BROKEN CONTRACT: A MEMOIR OF HARVARD LAW SCHOOL 166 (1999).

[219] *See also* Michael Froomkin, *Habermas@Discourse.net: Toward a Critical Theory of Cyberspace*, 116 HARV. L. REV. 749, 768 (2003) (Under Habermas's theory of self deception, "[e]xplanation, education, discussion,

professors and janitors at the Harvard Law School be required to trade places for one month each year.[220] The ultimate goal of CLS, as stated by Kennedy was that of "building a left bourgeois intelligentsia that might one day join together with a mass movement for the radical transformation of American society."[221]

The end of the communist era in Russia and eastern Europe dealt a blow to CLS, as it did to all leftist movements. The worldwide triumph of socialism, which had long seemed inevitable to so many — and opposition to which had inspired formation of the Mont Pelerin Society — never seemed more improbable. That is not to say that CLS vanished or even went underground; the leading authors are still publishing, but new recruits seem to be scarce. Law students, few of whom were ever as interested in CLS as they were in preparing for the bar examination, are now largely ignorant of this recent episode in the intellectual history of their professoriate.

With interest in CLS and other "critical' movements waning, legal scholars were in danger by the mid-1990s of being remitted to further work in economic analysis of

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and even therapy may serve to allow everyone except those suffering from the worst forms of self-delusion to understand (or, at least, better understand) their true interests.").

[220] *See* Duncan Kennedy, *Legal Education and the Reproduction of Hierarchy*, 32 J. LEGAL EDUC. 591, 615 (1982) (proposing legal education be reformed by "equaliz[ing] all salaries in the school (including secretaries and janitors), regardless of educational qualifications, 'difficulty' of job, or 'social contribution'" and encouraging every university employee or faculty member to "spend one month per year performing a job in a different part of the hierarchy from his normal job, [so that] over a period of years everyone [is] trained to do some jobs at each hierarchical level"). *See also* Randy Beck, *The Faith of the "Crits": Critical Legal Studies and Human Nature*, 11 HARV. J.L. & PUB. POL'Y 433, 447 (1988) ("Among [Kennedy's] more familiar proposals is his suggestion that law schools allocate positions in the starting class by lottery to all students possessing minimum qualifications and that janitors and law professors periodically switch jobs").

[221] Kennedy, *supra* note 220, at 610.

law and even more traditional doctrinal exegesis. The excitement and productive fervor of law and economic scholarship in the 1970s and 1980s could not be recovered, however. Whereas the pioneering work had been done by academic lawyers with only informal training in economics, such as Richard Posner, Robert Bork, Henry Manne, Gordon Tullock, and Guido Calabresi,[222] and by collaborations between those same academics and their economist colleagues,[223] by then all the leading law schools had appointed to their faculties one or more Ph.D economists, some of whom were also lawyers or had some legal education. In other words, the field had grown up; the creative and talented amateurs gave way to highly trained professionals using the formal tools of economics and statistics. An assistant professor without significant formal training in economics could not hope to distinguish himself in law and economics, let alone write something to warrant his promotion to a tenured position.[224]

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[222] *See, e.g.,* ROBERT BORK, THE ANTITRUST PARADOX (1978); GUIDO CALABRESI, THE COST OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS (1970); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (1973); Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961); Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies and Theft*, 5 WESTERN ECON. . 224 (1967).

[223] *See., e.g.,* Guido Calabresi & Alan K. Klevorick, *Four Tests for Liability in Torts*, 14 J. LEGAL STUD. 585 (1985); Richard A. Posner & William M. Landes, *Legal Precedent: A Theoretical and Empirical Analysis*, 19 J.L. & ECON. 249 (1976); Richard A. Posner & William M. Landes, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1 (1975). Pioneering examples include Robert H. Bork & Ward S. Bowman Jr., *The Crisis in Antitrust*, 65 COLUM. L. REV. 363 (1965), Aaron Director and Edward H. Levi, *Law and the Future: Trade Regulation*, 51 NW. U. L. REV. 281 (1956), and JAMES BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF A CONSTITUTIONAL DEMOCRACY (1962).

[224] *See generally* Henry G. Manne & Joshua D. Wright, The *Future of Law and Economics: A Discussion* (George Mason Law & Economics Research Paper No. 08-35, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1145421 (discussing the shift toward the modern, formal, mathematical approach to economics and its implication for law and economics and legal education).

Miraculously, as it were, behavioral law and economics came to the rescue. Just as the first wave of law and economic scholarship had provided hundreds of opportunities to revisit plowed ground and turn up new insights, behavior law and economics offered a reason to return to the same ground once again with confidence the new approach would yield new results. Much of the early law and economics work explored the hypothesis that a particular common law rule was efficient[225] or, in the public choice variation, that a particular statutory provision served some special interest and was inefficient.[226] In the new scholarship the author would almost inevitably conclude the prevailing rule should be reformed to take account of the

[225] *See, e.g.*, CALABRESI, THE COST OF ACCIDENTS, *supra* note 222; A. Mitchell Polinksy, *Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies*, 32 STAN. L. REV. 1075 (1980); Richard A. Posner & William M. Landes, *Joint and Multiple Tortfeasors: An Economic Analysis*, 9 J. LEGAL STUD. 367 (1980); *cf.* John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 62 A.B.A. J. 887 (1976) (arguing conventional investment practices of trusts are inadequate with the portfolio theory and therefore yielding inadequate returns).

[226] *See, e.g.*, Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q. J. ECON. 371 (1983); Frank H. Easterbrook, *The Court and the Economic System*, 98 HARV. L. REV. 4, 15–16 (1984) ("People demand laws just as they demand automobiles, and some people demand more effectively than others. Laws that benefit the people in common are hard to enact because no one can obtain very much of the benefit of lobbying for or preserving such laws. Smaller, more cohesive groups are more effective lobbyists. These groups can obtain a greater share of the benefits of laws targeted to assist people who have common characteristics, and so they will raise more money and campaign for legislation more effectively. The tobacco lobby is not large, but it is effective in obtaining subsidies. It also turns out that small, cohesive groups can get more for themselves by restricting competition and appropriating rents than by seeking rules that enhance the welfare of all. Thus we should expect regulatory programs and other statutes to benefit the regulated group—they need not 'capture' the programs, because they owned them all along. The burgeoning evidence showing that regulatory programs increase prices for consumers and profits for producers supports this understanding."); McChesney, *supra* note 192; George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. 3 (1971); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J. L. & ECON. 211 (1976).

cognitive biases of the individuals subject to the rule[227] or some as yet unregulated conduct should be regulated along certain lines in order to protect individuals from their tendency to err as they pursue their self-interest.[228]

Not only would the behavioral law and economic approach assure an author of reaching a meaningful conclusion — no one ever concludes that an existing rule perfectly corrects for the cognitive biases of those subject to it — it would also provide a rationale for greater government intervention in the marketplace and do so in the good cause of helping individuals accomplish their self-determined goals, such as eating more healthful foods or saving for retirement.[229]

Because behavioral law and economic scholarship yields proposals for law reform less radical than what CLS had produced, it appeals to a larger segment of the legal professoriate than CLS ever did. At the same time, behavioral law and economics shares with CLS the paternalistic premise that the poor wretches to be benefitted by the

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[227] *See, e.g.*, Michael S. Barr, et al., *Behaviorally Informed Home Mortgage Regulation*, in BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED 170 (Nicolas P. Retsinas & Eric S. Belsky eds., 2008) (arguing for a default option of "plain vanilla" mortgages).

[228] Nutrition labeling on menus exemplifies well the creeping nature of paternalism. Initially required by only a few cities and states — most notably, New York City, Philadelphia, and the state of California — the House of Representatives proposed nutrition labels be brought to restaurant menus nationwide in its first three drafts of the Health Care Bill. *See* Shirley S. Wang, *Menu Labeling to Go National, Thanks to Health Bill's Passage*, Wall ST. J. Health Blog (Mar. 22, 2010, 2:16 PM), http://blogs.wsj.com/health/2010/03/22/menu-labeling-to-go-national-thanks-to-health-bills-passage/; *see also* Affordable Health Care for America Act, H.R. 3962, 111th Cong. § 2572 (2009) (as introduced to the Senate on November 16, 2009). The labeling provision did not survive the Senate, Preservation of Access to Care for Medicare Beneficiaries and Pension relief Act of 2010, Pub. L. No. 111-192, 124 Stat. 1280 (2010), but it is unlikely we have seen the last of the nutrition-labeling proposal.

[229] *See* Rachlinksi, *supra* note 21, at 1166 ("virtually every scholar who has written on the application of psychological research on judgment and choice to law has concluded that cognitive psychology supports institutional constraint on individual choice").

insights of their governors suffer from a form of "false consciousness." Behavioral law and economics scholars never use that phrase but the concept is the foundation of their entire enterprise. Indeed, we doubt legal academics would have seen the appeal of appropriating the fruits of cognitive research had they not first been exposed to the idea that individuals routinely fail to act in their own best interest as they themselves express it.

False consciousness, then, is a hearty perennial, much like the notion that that there is a "third way" of social organization that suffers from neither the arbitrary nature of government nor the unforgiving ways of the market. The staying power of the idea reflects the romantic notion that government can help individuals overcome their own frailties and conform their behavior to the stated goals.

B. The next big thing

Academic lawyers and economists who had studied regulation and the economic analysis of law had a profound impact upon the government in the United States starting with the Carter Administration. In those four years the Congress passed significant deregulatory legislation affecting energy, transportation, and other sectors of the economy. The Congress was less obliging during the Reagan Administration but the president's appointees did much administratively to deregulate telecommunications, finance, energy and other sectors. Reagan also appointed to the federal courts a number of law professors prominent in the economic analysis of law,

including the luminaries Richard Posner and Frank Easterbrook of the University of Chicago, Robert Bork and Ralph Winter of Yale, and Stephen F. Williams of the University of Colorado.

Now the Obama Administration has made behavioral law and economics the foundation for its re-regulatory program.[230] The president has appointed the leading proponent and popularizer of the behavioral approach, Cass Sunstein, to oversee the regulatory output of the Executive Branch. Whether this Administration will be able to work a substantial change in the government's approach to regulation will depend vitally upon whether the president is re-elected. Enduring changes of this magnitude cannot be made in a mere four years, in large part because a change in political leadership does not effect a change in the composition of the bureaucracy;[231] the Administration's challenge is to educate the staff so they initiate regulatory proposals based upon the new approach, to which they were not exposed in their school years.

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[230] *See* Ferguson, *supra* note 44; Grunwald, *supra* note 44; Mike Dorning, *Obama Adopts Behavioral Economics*, BUS. WK, June 24, 2010 ("the behavioralists could be influencing regulations long after Orszag leaves. Their ideas have been seeded in numerous initiatives, just as the regulatory state is poised for a dramatic comeback following decades of retrenchment. Other promoters include Michael S. Barr, the Assistant Treasury Secretary for Financial Institutions, who helped draft Obama's Wall Street reforms. National Economic Council Director Larry Summers and economic adviser Austan Goolsbee are sympathetic, though they don't consider themselves behavioral economists."). President Obama recently named Goolsbee to chair the White House Council of Economic Advisers. Lori Montgomery, *New Economic Face is Still Familiar*, WASH. POST., Sept. 11, 2010.

[231] Indeed the CFPB is perhaps the only major behavioral law and economics initiative that will be realized within the president's first term.

Regardless of the influence behavioral law and economics has upon governance, in due course there will be a new fashion coming to fore in the legal academy. Its outlines can already be discerned, and it goes by the name of "neuroeconomics."[232]

Research in genetics and in neuroscience is almost daily discovering new ways in which human behavior is affected, if not fully determined, by the biology of the individual. Certain genetic endowments are increasingly associated not only with predispositions to particular diseases but also with the individual's propensity to violence[233] and sexual preferences.[234] Neuroscientists mapping brain functions are discovering the individuals differ greatly in their capacity to deal with economic problems, [235] to internalize moral inhibitions,[236] and to control their impulse to violence.[237] These scientific developments will surely have an effect upon fundamental notions of legal responsibility, punishment, and rehabilitation. Even now drug addiction is increasingly understood by scientists as a disease and one that must

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[232] Michael Haederle, *The Best Fiscal Stimulus: Trust*, in Miller-McCune.com ("Neuroeconomics is sort of an extension of behavioral economics, in which the basic level of behavior you're trying to understand is not just psychological forces like emotion or mistakes but the actual neural machinery," quoting California Institute of Technology economist Colin Camerer.), at http://www.miller-mccune.com/business-economics/the-best-fiscal-stimulus-trust-20005/

[233] *See* Erica Beecher-Monas & Edgar Garcia-Rill, *Genetic Predictions of Future Dangerousness: Is There a Blueprint for Violence?*, 69 LAW & CONTEMP. PROBS. 301 (2006).

[234] Bert-Jaap Koops & Maurice Schellekens, *Forensic DNA Phenotyping: Regulatory Issues*, 9 COLUM. SCI. & TECH. L. REV. 158, at *44 (2008).

[235] *See* Terrence Chorvat, et al., *Law & Neuroeconomics*, 13 SUP. CT. ECON. REV. 35 (2005) ("until recently it was not possible to actually examine the brain mechanisms that individuals use to process the economic problems they face); Megan Faulkner, *Rational Jury Assessment of Damages Through Neuroeconomics*, 32 Law & Psychol. Rev. 163 (2008)

[236] O. Carter Snead, *Neuroimaging and the "Complexity" of Capital Pubishment*, 82 N.Y.U. L. Rev. 1265, 1273-76 (2007).

[237] Amanda C. Pustilnik, 44 WAKE FOREST L. REV. 183, 204–14 (2009) (collecting sources and expressing skepticism about relying on neuroscience in criminal cases).

be managed because it cannot be cured.[238] It is far too early to predict the particular effects this type of knowledge will have upon public attitudes and hence the legal system, but it is a fair surmise that law professors will soon be picking through the scientific journals in search of findings they can use in support of one or another law reform. The deterministic element in this science, which the lawyers will tend to exaggerate, will not be significantly different in their implications from what we once knew as "false consciousness" and now call "cognitive bias."

VI. Conclusion

The promise of behavioral law and economics lies in its potential to deliver on two central claims concerning government regulation of irrational behavior: (1) that the behavioral regulatory agenda, whether implemented in the form of manipulating the framing of choices facing consumers or banning products, will increase welfare as measured by individuals' own preferences; and (2) that a central planner can and will implement the behavioral law and economics policy program in a manner that respects individual liberty, autonomy, and at least, "does no harm" to the set of choices available to individuals. Lawyers and economists have focused intensely, though disparately, upon the behavioral economic welfare claims, offering critiques grounded in microeconomic theory, empiricism, and public choice. The crux of these critiques, with which we agree, is that the behavioral welfare claims are in some cases misspecified; in

[238] *See e.g.*, National Institute of Drug Abuse, *Drugs, Brains, and Behavior: The Science of Addiction*, National Institutes of Health Pub. No. 10-5605 (2010).

the others, their claims are not supported by robust data, the data are misinterpreted in support of a paternalist objective, or the cost-benefit analysis is woefully incomplete. While behavioral economics broadly, and behavioral law and economics in specific, are too new for anyone to offer bold predictions about what future laboratory and field evidence might demonstrate, the theoretical and empirical infirmities plaguing the behavioral welfare claims suggests that these faults will likely prove enduring. Further, the chasm between the aggressive policy interventions proposed in the behavioral law and economics literature and what, if any, interventions are warranted by existing theory and empirical evidence, is a warning sign of a discipline far overextended.

Our primary goal in this article has been to focus upon the second and less scrutinized behavioral claim: That behavioral law and economics pose no significant threat to liberty and individual autonomy. One need not await further evidence to conclude that this claim fails. The behavioral regulatory toolkit includes not only subtle methods of coercion, but also interventions that would directly or indirectly reduce the choices available to individuals or instead penalize individuals for expressing their own preferences rather than following the advice of a regulator. Despite adopting an overly restrictive conception of liberty consisting only of "choice preservation," the behavioral liberty claims fail on their own terms. The "process aspect of freedom," emphasized by Mill, Hayek, Friedman, and others -- the liberty interest in a public that is not infantilized, has an entrepreneurial spirit, and can learn effective decision making

through experience-- has no place in the behavioral regulatory calculus. So long as behavioral law and economics continues to ignore the value to economic welfare and individual liberty deriving from individuals' freedom to err in their decisions , "libertarian paternalism" will not only fail to fulfill its promise of increasing welfare while doing no harm to liberty, but will pose a significant risk of reducing both.