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Nudge: Improving Decisions about Health, Wealth, and Happiness

By Richard H. Thaler and Cass R. Sunstein, 2008. Yale University Press, Pp. 304, $26.00, hardcover.

As of January of this year, U.S. employers can automatically enroll their employees in 401(k) plans with diversified portfolios— without fear of lawsuits and without certain regulatory burdens. Automatic enrollment should increase participation by about one-third, and diversification should produce larger and safer returns, although employees are able to opt out of both decisions. In the future, roughly one of every two 401(k) enrollees is likely to be so enrolled.

This opportunity was created by the Pension Protection Act of 2006, which reflected the joint efforts of the National Center for Policy Analysis (NCPA) and the Brookings Institution, including Capitol Hill briefings, publications, speeches, editorials, etc. Yet the real intellectual groundwork came from University of Chicago Professors Richard Thaler and Cass Sunstein. They call the theory behind this effort "libertarian paternalism," and they have written a book about it called *Nudge*.

Here is how they describe the 401(k) problem: far too many people fail to enroll—even when there is an employer match. Some do not enroll even when the employer is paying 100 percent of the contribution and they need not invest even a dime of their own money. Once in a plan, people tend to make two more mistakes. They invest either in what they know (their employer's stock) or in what they think is safe (money market funds). The first mistake puts all of their investment eggs in one (very risky) basket. The second generates an inadequate rate of return.

The solution to this problem: automatic enrollment in diversified portfolios, leaving employees free to opt out if they choose. Thaler and Sunstein concede that, for homo economicus, a default would matter not one whit. But in a world of ordinary people, it matters a great deal. Amazingly, most people have a very strong tendency to stay wherever the default puts them.

The authors also diverge from textbook economics in other ways. Theoretically, more choices are always better than less. Yet they argue convincingly that senior citizens forced to choose among 50 different Medicare drug plans faced a decision-making nightmare and often made bad choices. Similarly, unsophisticated employees faced with myriad portfolio choices are often poor managers of their 401(k) money.

There is a pattern here. People tend to "make good choices in contexts in which they have experience, good information and prompt feedback," such as choosing among ice cream flavors. They often make poor choices in contexts in which "they are inexperienced and poorly informed and in which feedback is slow or infrequent." Choosing an investment portfolio is one example. Choosing a drug plan is another.

So why can't markets solve these problems? They can and sometimes do. But often it is profitable for the sophisticated and unscrupulous to cater to peoples' frailties and exploit them. So what can be done? Since Thaler and Sunstein are libertarians, they are not calling for big-brother government solutions. They are perceptive enough to realize that regulations often do more harm than the problems they are designed to correct. But since they are paternalists, they are intensely interested in how to get people to make good choices. Fortunately, coercion is rarely needed anyway. Often a simple nudge will do. They call the general approach that establishes the nudges "choice architecture." According to Thaler and Sunstein, a great many social problems could be solved with simple nudges. Here are some examples from the health-care field:

- For the problem of too few organ donors, why not assume that people want to be donors and leave them free to opt out of that presumption if they choose?
- For our wasteful, inefficient medical malpractice system, why not assume that people prefer a no-fault alternative and allow them to pay more to secure their common law litigation rights if they prefer?
- Why not default seniors on Medicare into plans that minimize out-of-pocket costs and maximize coverage for their current drug needs—at least for chronically ill, poor seniors for whom government is paying almost the entire bill anyway?

As it turns out, people are surprisingly nudgeable. Buyers of new cell phones have numerous options— from the ring sound to the decibel level to the number of rings before automatic transfer to voice mail. Yet they tend to stick with whatever default choices they are given. If renewal is automatic, people will subscribe for a long time to magazines they do not even read. People who download a new piece of software tend to accept default choices as well. These are all examples of what the authors call "status quo bias."

Another factor is "collective conservatism," the tendency of people to conform to group norms. For example, a light eater tends to eat more in a group of heavy eaters. A heavy eater tends to eat less in a group of light eaters. This principle can be used to change behavior. Informing college students that most of their peers drink moderately, if at all, reduces binge drinking. Informing teenagers that most teens are tobacco-free reduces teen smoking. An unhappy emoticon message (indicating above average energy use) causes households to reduce their electricity consumption. However, a happy emoticon message (indicating below average use) causes them to increase their power consumption.

In one experiment, simply telling Minnesotans that 90 percent of their fellow citizens complied in full with tax law produced a greater increase in compliance than threats, pleas, or any other type of communication. (By implication, if you want to turn out more voters, don't lament the fact that so few people vote.)

Temptation and mindlessness are other factors that affect the lives of ordinary humans—particularly with respect to such activities as binge eating, binge drinking, smoking, and gambling. Homo economicus would never voluntarily put his name on a list of people who are banned from casinos. Problem gamblers sometimes do. Smokers may choose to work in a smoke-free office—to discourage their own smoking. People who want to quit smoking or lose weight may make bets with each other on the outcome of their quests, with the loser paying a hefty sum. (Interestingly, "losing something makes you twice as miserable as gaining the same thing makes you happy.")

Perhaps the most interesting observation in Nudge is the conclusion that it is impossible not to nudge. We are always encouraging one behavior over another, even if unintentionally. In one experiment, the lunchtime food choices of students could be altered by as much as 25 percent by rearranging the way the food is displayed. However, there is no such thing as a neutral cafeteria display. One food choice or another is always being encouraged.

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