

RICCARDO REBONATO

TAKING LIBERTIES

A CRITICAL EXAMINATION OF
LIBERTARIAN PATERNALISM

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A Critical Examination of Libertarian Paternalism

Riccardo Rebonato

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Taking Liberties

*To my father, who taught me how to think
To my son, whom I am trying to teach how to think
To my wife, who sets for me an example of how to think
To the memory of my mother, who believed in thinking straight,
and about whom I always think*

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I am, of course, responsible for all the errors that remain.

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Chapter 1

Introduction

The last temptation is the greatest treason:

To do the *wrong* thing for the *right* reason

Adapted from T. S. Eliot, *Murder in the Cathedral*

1.1 What this book is about

Libertarian paternalists claim to have managed to reconcile libertarianism and paternalism. In this book I discuss whether this claim is valid.

As libertarians and paternalists look at the individual as decision-maker from radically different perspectives, the libertarian paternalists have set their sights very high. Indeed, the proponents of libertarian paternalism are self-consciously aware both of the logical feat they are trying to pull off (one of their flagship articles is called ‘Libertarian Paternalism Is Not an Oxymoron’), and of the importance of what they are attempting to achieve: ‘The twentieth century is pervaded by a great deal of artificial talk about the possibility of a “Third Way”. We are hopeful that libertarian paternalism offers a real Third Way – one that can break through some of the least tractable debates in contemporary democracies’.¹

Discussing the merits of libertarian paternalism is not an exercise in arm-chair political philosophy. With little exaggeration one can say that it has taken the political and cultural landscape by storm. Heavyweights on both sides of the traditional right–left divide (David Cameron, George Osborne

¹ Thaler and Sunstein (2008a), p. 252.

Note to the reader: footnotes are referred to by superscript Arabic numerals. Endnotes are arranged by chapter and referenced by superscript Roman numerals. They are collected at the end of book.

and Barack Obama, to mention only a few) have shown a keen interest in it,¹ libertarian paternalistic techniques are already being widely used in the political domain, and the libertarian paternalists have the ears of the most influential policy-makers. Understanding what this programme really entails (both logically and pragmatically) is therefore not only intrinsically interesting but politically topical.

What makes the approach so interesting? Traditional paternalists have always emphasized the inability of the individual to choose what is *instrumentally* good either for herself or for society (the ‘inefficient-means’ paternalistic justification),² or *intrinsically* good in the light of some idea of the proper goals a society or an individual should pursue (the ‘undesirable-ends’ justification).³ From this premise, libertarian paternalists conclude that in certain contexts it is therefore permissible and desirable for the government to limit the freedom of action of individuals so as to promote either their welfare (in the ‘inefficient-means’ version), or the attainment of some higher good (in the ‘undesirable-ends’ version).⁴

In the twentieth century, however, paternalists have found themselves on the defensive. As far as the undesirable-ends justification is concerned, contemporary Western society is probably more ill at ease than it has ever been with the idea of a universally acknowledged superior good imposed on the citizenship by a mandarin class. And the inefficient-means justification of paternalism has come under attack from the impressive analytical framework that goes under the generic rubric of decision theory (often as adopted by the neoclassical economics consensus) that has been built throughout the twentieth century. In a nutshell, the mainstream line of economic reasoning as to why paternalism is ineffective proceeds along the following lines. First, some postulates are given about how individuals make their

² A note on the use of personal pronouns: like every modern writer I have had to make a choice as to whether I should keep the prose lighter, and use exclusively either the masculine or feminine pronouns; or whether I should make the reading a bit more heavy-going by cluttering the sentences with he/she, him/her. I have decided to follow Frydman and Goldberg (2007), and I have arbitrarily chosen to use the masculine pronouns when referring to choice architects and libertarian paternalists and the feminine pronouns when referring to the individuals making the choices. Nothing deep should be read into this convention. However, when referring to *Homo Economicus*, I have always used the masculine pronoun.

³ The distinction between means-paternalism and ends-paternalism is clearly discussed in New and Le Grand (forthcoming, p. 48 and *passim*): ‘A distinction [...] of great importance is that between paternalism directed at the decisions people make in order to achieve certain goals or ends, and paternalism directed at the goals themselves...’ As New and Le Grand point out, this important distinction is not commonly made in the literature about paternalism. As we shall see, it is of great importance to our discussion of libertarian paternalism.

⁴ I must stress that libertarian paternalists would probably claim to be firmly at the ‘means’ end of the spectrum. In this book I intend to show that what they propose is far more tilted towards ‘ends-paternalism’ than they would like to admit.

choices (this goes under the name of choice theory and theory of consumer choice).⁵ This is where the axiomatization of choice behaviour and its representation in terms of a utility function are typically introduced. Building on these foundations, the concept of partial equilibrium is introduced (how supply and demand for one good results in the equilibrium price for that good). By bringing together the markets for all the goods in the economy, the concept of general equilibrium then follows: it is the allocation of resources that results in the maximization of expected utility for all the agents in the economy. Finally, a Pareto-efficient allocation of resources is defined as an allocation such that it is not possible to make anyone better off (i.e., increase anyone's utility) without making someone else worse off (i.e., decreasing someone else's utility). From this, under some conditions of 'market perfection', the two Welfare Theorems are derived.⁶ The first states that every general equilibrium corresponds to a Pareto-efficient allocation. The second states that, conversely, every Pareto-efficient allocation can be supported by a general equilibrium, at least as long as we are willing to redistribute the initial wealth (the endowments) of the agents in the economy.

These results are very important, because they allow the separation of distributional goals from efficiency maximization: in this conceptual framework, if a given equilibrium is perceived to be, in some ethical sense, unfair, then the 'solution' is simply to change the initial endowments, not to meddle with the price mechanism.⁷ Another corollary of this impressive conceptual edifice is that the only justification for interfering with the choice of the (rational) agents in the economy (the *Homines Economi* par excellence that the model posits) is the presence of market imperfections ('failures'). And when the existence of market failures such as externalities is recognized welfare theory suggests that the 'neat' solution is simply to introduce the 'missing market', and then set individuals free again to choose without hindrance.⁸

⁵ See the discussion in Section 6.3 about the 'rationality' of the postulates, and the justification (or lack thereof) for a normative status of the results derived from these axioms.

⁶ For two clear derivations at undergraduate and graduate level, respectively, see McConnell, Brue and Flynn (2008) and Kreps (1990). For a discursive critical discussion that focuses on the conceptual implications of Pareto efficiency, of the two Welfare Theorems and of the conditions under which they obtain, see, e.g., Marglin (2008, Appendix A).

⁷ One has to be careful here: if endowments are changed through taxes, this introduces distortions, markets are no longer perfects, and the two Welfare Theorems no longer necessarily hold true. For this reason economists like to think in terms of a one-off initial redistribution of wealth ('lump-sum transfers'). These transfers, of course, are every bit as theoretically appealing as practically and politically unrealistic.

⁸ This, for instance, has been the route taken by the carbon-trading proposals to fix the externalities that come from carbon pollution. For a discussion of externalities in the context of libertarian paternalism see Sections 4.4.1 to 4.4.3 and 11.2.

This analytical framework has given concrete and solid theoretical underpinnings to the intuition first put forth by Adam Smith and some of his contemporaries about the benefits for society of leaving the choices of individuals (reasonably) unfettered. In short: for the economic liberalist, the unhindered choices of individuals bring about outcomes that are good for the individual and good for society.

These results, stylized as they may be, explain why means-paternalism in the twentieth century has been intrinsically ‘on the defensive’: if the microeconomic foundations sketched above are accepted, then paternalistic intervention appears to be at best a patch or an afterthought to deal with some regrettable ‘imperfections’; at worst, wasteful meddling. So, for instance, Arrow writes:

The best developed part of the theory [of externalities] relates to only a single question: the statement of a set of conditions, as weak as possible, which insure that a competitive equilibrium exists and is Pareto efficient. Then the denial of any of these hypotheses is presumably a sufficient condition for considering resort to non-market channels of resource allocation – usually thought of as Government expenditures, taxes, and subsidies ...⁹

In this view, the only *raison d’être* for paternalism are therefore those imperfections of the system that, for one reason or another, cannot be tackled with the ‘best’, price-based approach.

If a programme of paternalistic inefficient-means-based intervention is still advocated, there are therefore three main logical routes open to twenty-first-century paternalists: either they must claim that real-life conditions are too far removed from the idealized requirement of the theorems for the results to apply; or they must limit the scope of paternalistic intervention to those rather special situations (such as externalities or strategic interactions with ‘inefficient’ Nash equilibria¹⁰) where unfettered choices of rational, well-informed individuals do not bring about optimal results; or they have to ‘go for broke’ and try to strike a fatal blow to the very foundations of rational decision theory.

The latter is indeed the route implicitly taken by the libertarian paternalists: in a sense, they go for broke. They refuse, in fact, even to start the intellectual journey built on the rational features of *Homo Economicus*. They do so by denying the validity – either as useful approximations or in an *as-if* sense – of the most basic axioms as to how individuals make

⁹ Arrow (1969), p. 1.

¹⁰ See the discussion in Section 7.4.

choices. Indeed, given the importance accorded by libertarian paternalists to status quo bias and framing in general, even transitivity of preferences is not guaranteed,¹¹ and the whole edifice that builds up to expected utility maximization falls to pieces. And if *that* falls, nothing else follows: partial and general equilibria are meaningless, Pareto efficiency cannot be derived and neither cornerstone of welfare economics (the two Welfare Theorems) makes sense.

As a consequence, modern red-blooded inefficient-ends paternalists do not allow themselves to be hemmed in as the *faute-de-mieux* fixers of left-over special cases or market imperfections. Rather, they tend to go for the jugular, asserting that the rationality of the decision-maker is fundamentally the wrong starting point to address society's inefficiencies.

Libertarian paternalists then go one step further. They claim that what individuals freely choose is not always good, not only for society, *but even for them*. Libertarian paternalists are, in this respect, the reddest of red-blooded paternalists.

So much for what the libertarian paternalists do *not* accept. But how do libertarian paternalists go about building the positive part of their programme? Giving a simple, clear-cut answer is not easy, because libertarian paternalism is a proteiform beast. For instance, helping a consenting adult to overcome her addiction (e.g., to gambling); inducing a child or an adult to choose a healthier diet; influencing the saving behaviour of the working population; altering, by switching a default option, the fraction of adults who consent to organ donation – these are all applications where the libertarian paternalistic nudging approach claims to be (and probably is) very effective. But surely they are not just different instances of ‘more of the same’. As I argue in Chapter 3, there are among these applications such fundamental differences that they cannot all be taken to be bona fide instances of libertarian-paternalism-inspired choice architecture. Discussing all of them in the same breath as if they were a coherent set of proposals is not very productive. And indeed, whenever one raises a concrete objection to a specific application, there is always the escape route of being told that this is not a ‘real’ case of libertarian paternalism. In order to

¹¹ Roughly speaking, transitivity of choices means that if *A* is preferred to *B* and *B* is preferred to *C*, then *A* is preferred to *C*. It is one of the least controversial axioms of choice. See Gilboa (2010) for a clear and precise, yet non-technical, discussion, or Appendix B of the same work for a simple mathematical treatment (available at <http://mitpress.edu/rationalchoice>). For an example of the libertarian paternalistic assertion that transitivity of choice is often violated, see, e.g., Thaler and Sunstein (2003), p. 176: ‘People do not exhibit rational expectations, fail to make forecasts that are consistent with Bayes’ rule, [...], *exhibit preference reversals* (that is they prefer *A* to *B* and *B* to *A*) and make different choices depending on the wording of the problem ...’; emphasis added.

avoid confusion, let me offer a narrow, yet reasonably precise, definition of libertarian paternalism as follows.

Libertarian paternalism is the set of interventions aimed at overcoming the unavoidable cognitive biases and decisional inadequacies of an individual by exploiting them in such a way as to influence her decisions (in an easily reversible manner) towards choices that she herself would make if she had at her disposal unlimited time and information, and the analytic abilities of a rational decision-maker (more precisely, of *Homo Economicus*).

Of course, the fair thing to do here would be to present the libertarian paternalists' own definition of what their programme is about, rather than mine. The problem is that it is difficult to find in their literature a single concise definition that addresses all the important aspects (the 'necessary and sufficient conditions') of libertarian paternalism. Its logical building blocks (such as, for instance, the easy reversibility, the appeal to the true preferences of the individual, the preference for her 'System-II' deliberations) tend to be scattered in the writings of libertarian paternalists and are often presented by means of examples, building an 'ostensive' rather than 'axiomatic' definition of libertarian paternalism. This is, in itself, perfectly valid, but it is not very helpful to the reader who is not familiar with the extensive literature. The matter is then further complicated by the tendency of libertarian paternalists (who almost always have real-world policy-oriented applications in mind) to present in the same literature a number of loosely related ideas and measures to improve the lot of mankind. Since these proposals are put forth by libertarian paternalists in libertarian paternalistic literature, they have often been regarded as libertarian paternalistic ideas. However, it would be more precise to describe them as (interesting) ideas put forth by people who happen to be libertarian paternalists.

For all these reasons I have taken the liberty of providing a distillation of what I understand the necessary and sufficient conditions have to be in order for a proposal to be libertarian paternalistic. This is a subset of what the literature and commentators refer to as libertarian paternalism. I will argue, however, that this is the *only* truly original part of the programme – the only part, that is, that can stake a reasonable claim to being 'the new Third Way'. This is the libertarian paternalism I deal with in this book.

The definition above clearly shows that libertarian paternalism is made up of two distinct logical components: an 'engineering' part – how to influence behaviour without coercion; and a justification of why, how and under which circumstances it may be admissible, or, indeed, desirable, to employ these techniques. The 'why' is because human beings are boundedly rational; the 'how' is via the exploitation of their cognitive biases; the desirable

circumstances are encountered when the individual is nudged in the direction 'she would have herself chosen'; and the admissibility criterion is (supposedly) met because of the easy reversibility of the paternalistic measures.

The two components (the 'plumbing' and the justification) are often conflated, but the distinction is essential. In this book I barely discuss the plumbing part of the programme (that goes under the name of choice architecture.) I simply assume that it works as well as its proponents claim it does. Indeed, the evidence provided does appear convincing – if, at times, somewhat overstated.

The main concern of this book is instead with the justifications put forth by the libertarian paternalists for the means of persuasion they intend to use – or, to be more precise, for their means of behaviour modification. I believe that this area has received far less attention than it deserves, given how deceptively innocuous, yet insidious and deeply manipulative, these means of behaviour modification can be.

I also intend to show that libertarian paternalists, despite their recurrent and pervasive reservations about the rational abilities of individuals, ultimately put forth a hyper-rationalistic programme. Indeed, to be logically coherent libertarian paternalism requires an important variation (and a starkly rationalistic one) on the theme of standard neoclassical economic libertarian thought: instead of maintaining that the unfettered choices of *individuals* will bring about the best outcome for themselves and for society, libertarian paternalists must assume that the unfettered choices of *the rational part* of individual decision-makers will bring about the best outcome for them and for society. I intend to argue in this book that this apparently innocuous variation introduced in their programme brings about unwarranted, worrying and possibly faulty results.

1.2 How can one possibly worry?

In contemporary political and philosophical debate, it matters a lot whether a programme of interventions is paternalistic or not. If it is, then the proponent of the paternalistic measure usually feels obliged to provide lengthy explanations as to why the intervention or programme in question can be justified.¹² The reason for this is clear: if a set of proposals is indeed

¹² There exists a large literature, for instance, discussing whether Sen's capability approach should be defined as paternalistic: see, e.g., Layard (2005) and Sen (2009). The robustness of Sen's rebuttal of Sugden's 'accusation' of latent paternalism (as discussed in Qizilbash, 2011) is a testament to the importance attached in philosophical and political discourse to this label. Similar contemporary concerns about the need to justify paternalism are shown by the lengths to which Nussbaum (2000) feels she has to go to construct an 'argument from paternalism' in order to defend her own version of the capability approach.

deemed to be paternalistic, the onus is immediately placed on its proponent to explain when and why it should be admissible to interfere with an individual's autonomy of choice. This has never been an easy task, and it is even less so today than, say, before Mill.

Libertarian paternalists seem to dismiss with an impatient wave of the hand most of these exculpatory concerns. Indeed, they appear to adopt a philosophically 'muscular' and no-nonsense attitude when, for example, they state that '[t]he first misconception is that there are viable alternatives to paternalism',¹³ and they urge us to 'abandon the less interesting question of whether to be paternalistic or not, and turn to the more constructive question of how to choose among the possible choice-influencing options'.¹⁴ The reason for their failure to engage seriously with the question of how paternalism should be justified can be found in the special version of their paternalism. Recall that in my definition of libertarian paternalism I have emphasized that its interventions must be *easily reversible*. If they truly are, the argument goes, why should one be overly concerned with the question of whether we label them as paternalistic? And, labels aside, if we accept that easy reversibility 'justifies' paternalism without the need for further discussion, shouldn't the examination of the acceptability of a libertarian paternalistic intervention be very easy indeed, and limited to checking that the choices are indeed easily reversible?

In the body of the book I explain why I think that the 'case for the defence' based on the reversibility argument is not as open-and-shut as it seems, but an example can already highlight some of my concerns. Here is the first.

Almost 100 per cent of Austrians have agreed to being organ donors, as against 12 per cent of Germans.¹⁵ Trying to account for this enormous difference by looking, say, at cultural, social or medical-institutional differences between the two countries would be an almost complete waste of time. The simple explanation is that 'Germans must opt in, whereas the Austrians are asked whether they do *not* want to become organ donors'.¹⁶ Here we have an example of a cheap, effective and, in principle, *easily reversible* nudge: the choice of a default option. Now, nobody can deny that, if an Austrian citizen objected to being a potential organ donor, the cost associated with reversing the default would be very low. Conversely, I can imagine that it must be easy for a German to put her name on an organ-donor register. Both Germans and Austrians can therefore exercise their *nominal*

¹³ Thaler and Sunstein (2003), p. 175.

¹⁴ *Ibid.*

¹⁵ Friedson (2010). See also the discussion in Section 5.4.

¹⁶ *Ibid.*, p. 99; emphasis in the original.

freedom of choice at very little cost. In practice, however, the figures above suggest that they do not. And they do not exactly for the cognitive reasons (say, status quo bias, decisional inertia) that the libertarians paternalists are so good at identifying and exploiting for their programme. What has become, then, of their ‘freedom of choice’? I will discuss the issue of nominal versus real freedom of choice at length in this book, but this example already suggests that looking at effective, rather than nominal, freedom of choice might be a better indication of whether a measure can be called ‘libertarian’ or not. It is not obvious, in sum, whether the foundations of easy (theoretical) reversibility are strong enough to support the libertarian edifice built upon them. As the libertarian paternalists want to accomplish no less a feat than reconciling paternalism with liberalism, this observation is worrying.

Let’s put the issue of reversibility to one side. Perhaps we may reach the conclusion that the libertarian paternalists are not quite as libertarian as they would like to be. Perhaps they are just ‘neo-paternalists’. Still, their ‘softer’ version of paternalism may be more palatable than the ‘hard’ version. But is it? I argue that there are other important reasons to believe that their version of paternalism is, paradoxically, less desirable than the ‘hard’ variety. To outline my concerns I present just two examples in this Introduction and then analyse them in greater detail in the body of the book.

As Ralfe reports in the *Financial Times*, the Pension Accounts Delivery Authority (PADA) ‘was set up by the UK government to encourage pension saving for the 10 million lower paid workers who now save little or nothing for their pensions’.¹⁷ Starting from 2012, PADA will open personal pension accounts holding equities and bonds. Enrolment in the scheme will be automatic, with a right to opt out. This, as we shall see, is a classic example of a libertarian paternalistic measure: simple, non-coercive, cheap, easy to reverse and *very effective*.

There is another element of libertarian paternalistic predetermination in the scheme (and this element can also be reversed by opting out): the allocation of the fund between equities and bonds, which is set by default at 60 per cent for equities. Once a pension default is set, it is likely to be ‘sticky’, as there is a high degree of inertia: even if opting out is theoretically easy, most employees remain in whatever scheme has been selected for them.

Just at a time when the pension funds run by private companies are moving away from high equity allocations, the choice of 60 per cent for the ten million lowest-paid workers may seem high. How was this ratio arrived at? It would be pleasing to think that it was determined either by taking

¹⁷ Ralfe (2009), p. 11, FTfm section.

into account the preferences of the future pensioners, or by some objective determination of what is in the best interest of this particular socioeconomic cohort of future pensioners. The same article, however, suggests that such a high allocation was simply necessary ‘since any lower risk allocation [would have] fail[ed] to deliver the projected eventual pension *assumed by the government*’.¹⁸ And these projections are important, because only if the actual returns end up being in line with the government’s projections ‘would [they] significantly reduce government means-tested benefits’.

If this was indeed the motivation behind the choice of 60 per cent for the equity allocation, it would be an extraordinary coincidence if this precise allocation at the same time turned out to be the optimal one for the pensioner (what the pensioner would have ‘truly wanted’), and happened to coincide with what the government requires to ‘significantly reduce [the] means-tested benefits’. And unfortunately, if the returns from the equity component are not in line with expectations, ‘[t]he risk that investments do not do as well as expected lies with the saver’.¹⁹

Before explaining why I find this type of intervention worrying, let me present a second example. It has a similar flavour, but with an interesting twist. As Skypala (2010) explains, ‘[t]axpayers [...] have an interest [in long-term saving], as the more people save for retirement, the less dependent they will be on state benefits. Governments, however, often have a short-term interest in people spending [...] rather than saving. [...] Whose interests are paramount?’ To answer the question, three external ‘experts’ have been enlisted to consider the costs and benefits of ‘auto enrolling employees into pension schemes’ – as we shall see, another flagship libertarian paternalistic initiative. Now, who are the three ‘experts’? ‘The experts come from a think-tank (The Institute for Fiscal Studies), an employer organization (the EEF) and an insurer (Legal and General). *Individuals’ interests are not represented*’.²⁰

These two simple examples have a lot in common, and clearly show the origin of some of my worries.

First, exactly because the means employed by the libertarian paternalists to achieve their goals are not transparent (in both cases, default enrolment and asset allocation with the right to opt out), the accountability deficit of the libertarian paternalistic intervention is particularly pronounced.

Second, the first example makes clear the ‘naiveté’ implicit in the assumption that the users of choice architecture will always employ this technique in the best interests of the nudged individuals. A stronger (or, at

¹⁸ *Ibid.*; emphasis added.

¹⁹ *Ibid.*

²⁰ *Ibid.*; emphasis added.