The Precarious Case of the True Preferences

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Abstract

Empirical demonstrations that people's behavior often deviates from predictions of models based on the assumption of coherent preferences highlight the possibility that people's choices systematically misrepresent what they genuinely want. Thus, the concept of welfare as preference satisfaction becomes more questionable than ever. The essay addresses the alternative to neoclassical welfare economics proposed by the libertarian paternalists. It shows the centrality of the idea of 'true preferences' for the libertarian paternalist program. However, the existing proposals on how to uncover true preferences are found lacking. This effectively undercuts the idea that the government could intervene in a transparent, non-arbitrary fashion to correct 'behavioral market failures.' The essay concludes with a plea to the benevolent policy-makers to retain a humble, skeptical attitude towards the use of tools of psychological manipulation which is legitimized by vague welfare criteria.

Keywords Behavioral market failure · Libertarian paternalism · Revealed preference theory · True preferences · Welfare economics

What do people want? That is a million-dollar question that has been examined by philosophers, psychologists, and marketing experts since the dawn of their respective vocations. In economics, this question seems no less important as far as it deals with human behavior, which is driven by needs, desires, and values. The mainstream approach in modern economics is both subjectivist and individualist. What people want is based on how they subjectively value alternatives (alternative bundles of goods, or, more broadly, alternative states of the world) relative to each other, i.e., on their individual preferences. Preferences, in turn, are assumed to be coherent, which means internally consistent, stable in time, and independent of the objectively irrelevant context in which alternatives are presented (McQuillin and Sugden 2011). Under these conditions, the question after people's wants has a straightforward answer, although one might not find it very profound at first sight: *What people want is revealed by the choices they make.*

This baseline approach is called a theory of revealed preference (RP from now on). It originates in the writings of Paul Samuelson (1938, 1948). The theory has gradually evolved into a basic framework of neoclassical economics, still much in vogue today. Within the RP framework, an individual is considered a black box – the reconstruction of preferences from choices has nothing to do with stating hypotheses about her mental states and the like. It is an exercise whose sole purpose is to connect the observed input, i.e., a set of available alternatives, with the observed output, i.e., an alternative chosen, via a mathematically tractable utility function which ranks any alternatives in order of preference. The theory has two different uses: a positive and a normative one. On the positive side, it can be employed in the effort to predict the future choices. On the normative side, it is used to deal with the elusive concept of welfare, which is crucial for practical applications of economics.

Over the years, some formidable theoretical objections have been raised against the RP approach (notably Sen 1977 or Simon 1978). Nevertheless, these did little to change the economic practice and the nature of the policy recommendations. It is the relatively recent debate, connected with the advances in behavioral economics, which has been having a significant practical impact. Contrary to the expectations of the baseline model of *homo economicus*, the experimental evidence strongly suggests that people are prone to nonstandard beliefs, nonstandard preferences, and nonstandard decision-making (DellaVigna 2009). In other words, if we look at people through the lens of the *homo economicus* model, they misbehave (Thaler 2015).

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If it is no longer possible to assume that what people choose reveals what they truly want, at least on average, the RP approach loses its normative appeal. The essay examines an alternative to neoclassical welfare economics proposed by the libertarian paternalists. After an illustration of the problems that the RP adherents face on the issue of welfare ("The Normative Issue" section), I will show the centrality of the concept of 'true preferences' for the libertarian paternalist account ("Libertarian Paternalist Answer" section). "In Search of the True Preferences" section points out the challenges encountered by the effort reconstruct the true preferences as well as the pitfalls of the use of underdeveloped and vague welfare criteria in policy-making. The concluding section appeals to benevolent policy-makers to retain a humble, skeptical attitude towards the tools of psychological manipulation.

The Normative Issue

A convenient starting point for any critique of the application of the RP framework in the normative analysis is self-control problems. These are often treated as paradigmatic cases, for example by Richard Thaler (2015, chap. 3) in the following scenario:

> Some friends come over for dinner. We are having drinks and waiting for something roasting in the oven to be finished so we can sit down to eat. I bring out a large bowl of cashew nuts for us to nibble on. We eat half the bowl in five minutes, and our appetite is in danger. I remove the bowl and hide it in the kitchen. Everyone is happy.

The story certainly bears a close resemblance to many a real-world situation everyone has experienced. It also illustrates how the RP approach fails to account for self-control problems and why this is imminently relevant to the concept of welfare. From the RP point of view, it is impossible to make anyone better off by taking away their most preferred alternative. The people in the vignette have revealed their preference for eating cashews over not eating cashews by *choosing* to eat them. There is no other proof of preference than the actual choice.

Consider the possibility that Thaler and his friends *say* they would like to stop eating cashews, yet they continue eating them. Should the verbally stated preference count for anything? The RP approach denies it. Speaking that does not cost anything ('cheap talk') bears no information on "real" preference regarding eating cashews. It reveals a preference for "eating cashews while complaining about it" over, say, "eating cashews while chatting about the weather," but that is about it.

What about welfare then? Welfare is a notoriously elusive concept for economists and philosophers alike. However, as long as one believes that the agents' preferences are coherent, the precise meaning of welfare can be left unspecified. This is essentially the stance of neoclassical welfare economics incorporated in the principle of consumer sovereignty, which states that people know best what is good for them and they ought to be left to their own devices to choose accordingly. Welfare is individually subjective, and a definitive account of what counts as welfare is neither necessary nor possible. I will call this an 'open' view of welfare.

The open view of welfare can be illustrated with the help of the most pervasive normative criterion economists use, i.e., the Pareto efficiency. As its standard definition has it, an economy is Pareto efficient if and only if the resource allocation is such that no one's welfare can be further increased without diminishing someone else's welfare. In a Pareto efficient situation, there is no free lunch in terms of welfare to be had anywhere. It is important in our context that voluntary exchange is considered the prime example of a Pareto improvement. Whenever two parties agree on a deal, e.g., a cup of coffee for $1.50, a welfare gain has been realized. Such view is uncontroversial as long as we accept several assumptions like that the participants are informed about the nature of the transaction, or that there are no spillover effects (externalities) that would afflict third parties. Crucially, however, the voluntary exchange example of a Pareto improvement also relies on the RP assumption *that the individuals possess coherent preferences revealed through their choice to accept the transaction.*

In situations where we have strong reasons to doubt the validity of the RP assumption, for example due to an apparent intertemporal inconsistency in the preferences, the original intuition regarding the welfare gains of trade forfeits much of its power. Consider a case of an alcohol addict who tries in vain to resist the temptation to purchase a bottle of vodka. The advocates of the RP approach may find it difficult to defend here that only the choice matters from the perspective of welfare. One may be tempted to subscribe to some form of a multiple selves view (Thaler and Shefrin 1981; Kahneman 2011). E.g., that the person's myopic self prefers vodka over no vodka (which is the revealed preference), his long-run self has a contrary preference to stay sober, which is no less "real" or "true," and should also be considered, if not taken as decisive. It is situations like these that call for a closer examination of what should be counted as welfare, as the open view provides us with no answers.

As McQuillin and Sugden (2011, 555) argue, if preferences are believed to be coherent, there is not much sense in distinguishing whether we understand welfare as happiness, as preference satisfaction, or as a realization of freedom of choice, because it makes no practically meaningful difference which of these views we emphasize. However, if we give up

coherence and thus abandon the RP assumption, different views of welfare may mean differences in optimal policy approach. The happiness view arguably leads in a more interventionist direction than the freedom of choice view, and the preference satisfaction view does not provide any clear guidelines without further specification.

Libertarian Paternalist Answer

The extent to which incoherencies in people's revealed preferences justify a third-party intervention has been one of the prime causes of controversy in normative economics over the last two decades. In response to experimental findings that document instances of misbehaving, there has been a widespread revival of interest in paternalism. The most successful attempt to contest the position of the neoclassical approach in welfare economics is 'libertarian paternalism' proposed by Richard Thaler and Cass Sunstein (Thaler and Sunstein 2003, 2008; Sunstein and Thaler 2003).

In the neoclassical view, the government cannot increase people's welfare by meddling with their choices unless they have uncompensated effect on others. Libertarian paternalists argue that neoclassical welfare economics is based on a flawed view of economic agents. It ignores the human reality where choices take place under conditions of limited will-power, limited memory, and limited cognitive ability. Instead of humans, it pictures 'econs,' who are, in essence, perfectly rational, emotionless supercomputers (Thaler and Sunstein 2008). Thus it disregards the inherent weaknesses of human cognition which frequently lead people to choices that undermine their own well-being. Contrary to econs, we humans often act against our best interest: we save too little for retirement, we gorge on junk food, we do not exercise as much as we would like to, we waste resources, we procrastinate.

As the name of their movement makes plain, the libertarian paternalists deviate from the neoclassical perspective in two key aspects. First, in their view it is not just the old-school changes in "hard" costs and benefits of alternatives, e.g., in the form of taxes or subsidies, that can be used to move people around. Soft interventions like unobtrusive changes in the environment of choice, that is, in the 'choice architecture,' are often enough to alter people's choices. These subtle changes in the choice architecture have earned their place in public consciousness as 'nudges.'[1] As long as one tries to influence people's choices with nudges instead of the hard incentives, freedom of choice is not violated in Thaler's and Sunstein's view. Tampering with choice architecture does not change the

availability of alternatives, only the way they are arranged and presented. That is why the nudge-based approach is supposed to be libertarian. Notwithstanding whether the label of libertarianism is justified,[2] the question of the effectivity of nudges in influencing choices is ultimately an empirical one. At present, there are few reasons to doubt that nudges exercise at least some influence and may be more cost-effective than other measures (Benartzi et al. 2017).

Second, and more importantly, the findings that compromise the RP approach are supposed to legitimize paternalism at the normative level. According to its arguably most famous definition, formulated by Gerald Dworkin (1972, 65), paternalism is an "interference with a person's liberty of action justified by reasons referring exclusively to the welfare, good, happiness, needs, interests or values of the person being coerced." Although the definition is perhaps too narrow as it connects paternalism directly with coercion and thereby precludes any possibility for it to be libertarian, it is valuable for the present discussion because it highlights the interest of paternalists in the welfare of the persons in their paternal care. After all, the libertarian paternalists' most important principle, which they draw much legitimacy from, states that the aim of their interventions is "to influence choices in a way that will make choosers better off, *as judged by themselves*." (Thaler and Sunstein 2008, 5).

Here, it is important to stress the difference between paternalism and 'perfectionism' (Conly 2012, chap. 4). Paternalism aims at helping the agent, through "hard" or "soft" means, to realize his true preferences that may not be revealed in his choices due to mistakes. In other words, people's ability to choose the right means to satisfy their preferences is doubtful for the paternalist, but these preferences are ultimately respected as a normative benchmark. Perfectionism, on the other hand, implies substituting the agent's preferences with the preferences of a third party who claims that these are, in some way, objectively good. In a perfectionist's eyes, people are hopelessly misguided and need to be coerced or manipulated not just regarding the means they choose but concerning their ends as well.[3] Thus, although both the paternalist and the perfectionist may be benevolent, it is only the former one who is in any way bounded by people's own preferences and requires their consent at some point.

Thus, the conundrum of the 'true preferences' pushes itself to the center of the stage of the critical discussion enveloping the libertarian paternalist program. Essentially, libertarian paternalists want to keep the open view of welfare, but in their commitment to nudge people for their own good, they identify

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[1] Today, there is a growing literature that tries to achieve more precise conceptual distinctions regarding different aspects of choice architecture (e.g., Mongin and Cozic 2018). In our context, however, referring generally to just 'nudges' will suffice, because our focus lies elsewhere.

[2] Unsurprisingly, critics find the subtle manipulation via nudges no less in conflict with liberty than outright coercion is (see Grüne-Yanoff 2012).

[3] A distinction between means-paternalism and ends-paternalism is used more frequently than the paternalism-perfectionism distinction (e.g., Sunstein 2014). Such terminology is misleading, though. If not just the agent's choice of means but also his choice of ends is to be doubted, it seems impossible to adhere to the "as judged by themselves" standard.

welfare with the satisfaction of the true preferences, instead of whatever preferences get revealed in choices.

The true preferences do not pose a problem for either neoclassical welfare economics or perfectionism. Due to its reliance on the RP approach, neoclassical welfare economics is implicitly anti-paternalist. It makes little sense to help agents with coherent preferences with what they already do best themselves. Perfectionism, on the other hand, follows "the Good," or a particular objective list of goods, regardless of whether the people come to appreciate what the perfectionist is making them choose.

Libertarian paternalism cannot take refuge in any of these two safe havens: neither denial of the normative significance of people's errors, nor supplanting their preferences with a list of objective values will work for it. The first escape route means surrendering to neoclassical welfare economics; the second one is manifestly irreconcilable both with the liberal values and with the subjectivist and individualist methodology of economics. Therefore, libertarian paternalists need to design a way, how it could be established what preferences count as true.[4]

In Search of the True Preferences

The libertarian paternalists' playfield can be staked out in the following fashion: People do make choices, that much is obvious. However, many of these choices do not reveal people's true preferences but are caused by systematic mistakes that we can attribute to the inherent weaknesses of human will-power, cognition, and so on. Therefore, an opportunity exists to increase people's welfare by helping them to make choices that more closely correspond with whatever it is they want to achieve. 'Behavioral market failures' (Sunstein 2014) are supposed to provide legitimacy for government intervention in the same way the (neo)classical market failures do. It is crucial that this legitimacy stems from the ultimate approval of the interventions by the target population.

As already explained above, paternalism is not preference-independent. *Some* preferences must be taken seriously and considered normatively binding, or simply 'true.' Otherwise, the concept of a mistake as such is meaningless because there is no benchmark against which hits and misses could be told apart. Therefore, the most fundamental question is: *How can we determine, given a set of preferences that are revealed in choices or verbally stated, which of these can be discounted or even disregarded and which need to be taken at face value?* Beshears et al. (2008) and Allcott and Sunstein (2015) can be taken as typical examples of the attempts to answer this question.

Beshears et al. (2008) present a list of "red flags," i.e., of circumstances that cast in doubt whether the preferences revealed in them are indeed true enough to be considered normatively binding. They consider choices suspect if they are passive (choosing the default), complex, intertemporal, made with limited personal experience, or influenced by third-party marketing.

Although these red flags are intuitively appealing, and empirical studies can be enlisted to support each of them, one is left to wonder how many choices would pass the test, if such filter was strictly applied. There is also a pressing issue of vagueness because complexity or personal experience are not binary variables but come in many shades of grey. It is somewhat difficult to imagine a nonarbitrary cut-off level at which a person qualifies to be experienced enough to make a choice that counts, or a choice qualifies simple enough that even unsophisticated decision-makers can be trusted with it.

In a similar vein, Allcott and Sunstein (2015, 702) enumerate rules the choice architects should follow to identify the true preferences:

1. Use well-informed choices.
2. Use considered choices. Here, "considered" means choices where the individual evaluates all relevant facets of a product or activity.
3. Use active choices. Such choices reflect the agent's own values and tastes, whereas passive choices (such as failing to opt in or opt out of a default setting) may not.
4. If individuals are present-biased, use long-run instead of present-biased (impulsive) choices. The objection of vagueness can be raised again regarding the first two rules – it should also be emphasized that ambiguity does not bear well for the transparency of the filtering procedure.

Moreover, an underlying assumption is that individual welfare can be increased if we rely more on expert judgment. Such may indeed be the case for experientially simple, one-dimensional choices. As far as I want to maximize the return on my investment, mimicking the more informed and more considered choices may indeed be the best way to go. In many situations, however, growing expertise changes the nature of the subjective experience. A connoisseur will rank wines systematically differently from someone, who can barely tell red from white by taste, not just because of his expertise, but also because he experiences the taste very differently. On the top of that, the connoisseur is not 'just like me but with more information,' she is a *different person* – people are not homogeneous, they can be endowed with different talents and tastes, i.e., both their preferences and the constraints they face are individualized. Use of well-informed choices presumes a large degree of homogeneity.

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[4] These are also sometimes called 'rational', 'informed', 'normative', or 'laundered' preferences.

The fourth rule introduces a value judgment that long-run preferences should be prioritized over short-run ("present-biased") preferences if a clash occurs between the two. Such a value judgment is problematic in itself (Whitman and Rizzo 2015), but there is one specific concern that deserves closer attention. It is true that reasonability has long been identified with the choices that we make in a "cool" state rather than under the influence of momentary emotions (Elster 2008). Such is, in all likelihood, also the basis of our intuitive uneasiness regarding the validity of the RP approach in cases introduced in "The Normative Issue" section. However, this intuition should not disguise a pressing issue that the "reasonable" long-run preferences, especially as far as we rely on people's explicit confirmation of their existence, may well be shaped more by social desirability considerations than by any actual wants. In other words, the authenticity and strength of many of the long-run preferences that people claim to have (e.g., to live an industrious, healthy, and moral life), while often failing to act upon them, can be easily overstated. After all, the view that 'reasonable self' is not a disinterested observer, but, above all, a weaver of a narrative of our life whose purpose is to present us in a favorable light to our prospective allies and mates, has been growing increasingly influential (Sperber and Mercier 2017; Simler and Hanson 2018). Ultimately, prioritizing the long-run preferences may be equal to giving the embellished, if not fake, public persona the sole normative bearing. It is far from clear that nudging people to live the narrative they tell others would represent a welfare-increasing move and bring us any closer to solving the problem of true preferences. Moreover, all this seems to assume that those "selves" that we want to endow with a normative authority do possess coherent preferences that could be uncovered given the right procedure.

Thus, as even this very brief examination suggests, there are formidable obstacles along the way towards a criterion, or a set of criteria, that would allow us to distinguish systematically between the true preferences and the errors:

a. *The problem of the 'informed desire' view of welfare*: The classification criteria may set standards that are very difficult or even impossible to fulfill in realistic situations. If we understand true preferences as such that people would have, if they had "complete information, unlimited cognitive abilities, and no lack of self-control" (Sunstein and Thaler 2003, 1162), they cannot be found because the criteria are too difficult for mere mortals to fulfill (Qizilbash 2012).

b. *The problem of arbitrariness*: It is easy to muster intuitive support for the claim that some choices are better qualified and have a lower probability to be mistaken than others. Nevertheless, we cannot ignore the much harder problem of how the competence criteria could be stated with any degree of precision and how a competence cut-off at which the revealed preferences become normatively binding (that is, considered "true enough") could be set in a nonarbitrary way. For example, if I decide to opt-out from a default choice, libertarian paternalists, instead of recognizing the preference thus expressed, may try a different nudge to make me stick to the "right" choice. It is, after all, a common feature of experimental studies to test which of the tweaks in the choice architecture works best, i.e., has the strongest influence upon the choosers. Is there *any* sufficient proof of true preference, whose sufficiency is not determined by an arbitrary decision of an external authority?

c. *The problem of transparency*: If the criteria are not very simple, the procedure will weaken the democratic control over government policies, giving the choice architects more freedom to follow whatever ends they desire. This, in turn, aggravates the principle-agent problem between the government and the public.

d. *The problem of the normative priority of the public self*: In practice, giving a normative priority to "reasonable" long-run preferences may frequently lead to nudging people towards doing things that they only claimed they wanted because they desired (perhaps subconsciously) to look good in front of the others. There is not only tension between a myopic self and a forward-looking self but also between a public self and a private self. The latter one tends to be neglected when searching for true preferences.

e. *The problem of coherence*: Last but not least, the quest to find the true preferences often presumes that people do have coherent preferences after all (Sugden 2018, chap. 4). It is just that these preferences are latent and occasionally fail to manifest themselves in actual choices. If we take the experimental evidence seriously, such an assumption may well be unwarranted. After all the situational, confounding factors are subtracted, there may be nothing coherent about people's choices left.

When facing this list of problems with the true preferences, which is hardly exhausting, it is not possible but to wonder if the haste to address behavioral market failures with policy tools, for example through the "Nudge Units" active in several countries (see, e.g., Halpern 2016), does not represent a dangerous case of expert overconfidence. The libertarian paternalists seem to believe that even though a persuasive general solution to the problem of the true preferences is lacking, they will still somehow succeed in concrete cases – thus, abstract criticism is not much appreciated (Sunstein 2014, 2018). However, it is not quite clear how to judge success if there are no general criteria for it. It is only certain that the scope of government intervention is expanding due to the lobbying of libertarian paternalists and that the normative legitimacy of this expansion rests on hunches about what might count as people's true preferences in some specific cases like retirement saving.

Conclusion

It is hardly possible to question the validity of the empirical evidence that documents anomalies in human behavior which shake confidence in the RP approach. The hypothesis that people's coherent preferences are revealed through their choices may well be untenable as a descriptive statement about the world. In response, libertarian paternalists count on the possibility to identify situations where people commit systematic mistakes. Subsequently, choice architects could improve the environment of choice in such a way that people achieve higher-quality decisions as judged by themselves.

However, as attractive as the libertarian paternalist program sounds, construction of a set of criteria that would allow us to identify what exactly the true preferences are has emerged as a formidable problem for it. The existing proposals suffer from multiple shortcomings including vagueness and arbitrariness of the criteria. As far as the true preferences are supposed to be coherent in the neoclassical sense, which provides the libertarian paternalist program with much of its edge, their very existence is questionable.

Thus, it seems appropriate to conclude this essay with a plea towards the benevolent policy-makers to take a humble stance towards the use of the shiny new tools of psychological manipulation that libertarian paternalism can offer. Not because these tools are ineffective in altering people's behavior, but because their use currently cannot be guided by a coherent set of criteria of evaluation that would discipline the regulator and shield her from her own overconfidence.

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