

Decisional Defaults: Does Regulation Have Them Backwards?

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Read the book *Nudge*, by Richard H. Thaler and Cass R. Sunstein (Yale University Press, 2008). Its contribution to regulation is potentially profound. In a section entitled “Defaults: Padding the Path of Least Resistance” (pp. 83-91), the authors assert:

1. “[I]nertia, status quo bias, and the ‘yeah, whatever’ heuristic are pervasive.”
2. “All these forces imply that if, for a given choice, there is a default option—an option that will obtain if the chooser does nothing—then we can expect a large number of people to end up with that option, whether or not it is good for them.”
3. “Defaults are ubiquitous and powerful. They are also unavoidable in the sense that for any node of a choice architecture system, there must be an associated rule that determines what happens to the decision maker if she does nothing.”
4. “Of course, usually the answer is that if I do nothing, nothing changes; whatever is happening continues to happen. But not always.”

Their illustration is organ donation. Germany and Austria have different defaults. Germany’s is “opt in”: a citizen’s consent to donation must be explicit. Austria’s is “opt out”: the law presumes a citizen’s consent unless he declines explicitly. In these two adjacent nations, what portion of the population consents? Germany, 12 percent; Austria, 99 percent. Difference in lives saved? Thousands.

The authors argue for an apparent paradox: “libertarian paternalism.” They want public policy to give people choices (libertarianism) but guide them toward the “right” choices (paternalism). Public policy need neither ignore people’s foibles nor coerce their choices; it can “nudge.” Nudging requires policymakers to design the right defaults.

In our field, what happens when a regulatory choice is necessary but no choice occurs? Do our defaults make sense? Five examples follow.

Energy Efficiency

Consumers under-invest in energy efficiency. They overvalue upfront costs and undervalue long-term benefits; they require too short a payback period; they will passively pay 18% interest on a credit card balance but not act to save 10% on their electric bill. Inertia is powerful—and it makes consumers and our environment worse off.

Yet for most energy-efficiency policies, the default—the “choice” if the consumer makes no choice—is to do nothing, i.e., to continue inefficiency, to make us worse off. True, programs are available. But to trigger their benefits, the consumer must act: find, hire, and pay an energy auditor; choose among multiple thermostats, hot water heater covers, insulation types, window replacements; do the advanced math necessary to learn that paying now produces benefits later; find a bank and fill out loan papers; write a big check. Who on earth does any of these things, when there is soccer to play and SpongeBob to watch? Opt-in is our default; as an energy efficiency policy, it fails.

Why is the default not “opt-out”? Opt-out means that unless you say otherwise, a commission-selected, independent auditor will visit your home, determine the cost-effective investments, procure the contractors and the financing, and arrange matters so that the stream of savings exceeds the stream of costs, leaving the resident’s wallet untouched but the residence’s efficiency increased. Why is our default backwards?

Retail Competition

Ten years ago, some states passed statutes introducing retail electricity competition. The goal was to have multiple retail suppliers competing on price, customer service, and product innovation. These experiments had to scale two interdependent obstacles: incumbent dominance and customer inertia.

In most states, the default had it backwards. If a customer selected no supplier, her supplier would be the incumbent. Since most residential customers made no selection (inertia), incumbent dominance continued. The default undermined the entire statutory purpose. This failure was unnecessary. Without eliminating the incumbent option (libertarianism), we could have designed a default that advanced the statutory purpose (paternalism). Why not default non-choosing customers not to the incumbent but to the new entrants: (a) in proportion to the new entrants’ market share; (b) randomly; (c) in proportion to benefits offered by the new entrants, such as payments into a low-income fund; (d) according to merit criteria determined and applied by the regulator?

Each of these options has its problems, but so did the default to the incumbent, whose dominant market share was the problem motivating the legislation to begin with. Retail electricity competition, as a means of diversifying the market for residential customers, failed in most jurisdictions. This default-to-the-incumbent approach, requiring opt-in rather than opt-out, was one reason why.

Rate Structure

Embedded cost rates do not send accurate price signals; time-of-use rates do. Accurate price signals produce efficient behavior, conserving resources for all citizens. Some states do have optional time-of-use rates, but inertia remains powerful. If the embedded cost rate is the wrong rate and the time-of-use rate the right rate, which is the better default?

Commission Staffing

How do we staff our state commissions? The default structure is positions designed 20 to 30 years ago, when markets and transactions were different. When new issue challenges arise, the default is shaped by civil service rules and budget limits: We tend to shift people to new areas without sufficient education, rather than bring in new people expert in the new issues. The default should not be a static, reactive structure but anticipatory analysis: What are the new challenges? What skill sets will best meet those challenges? Should we retrain our existing people or must we find new people? Hiring procedures should be as flexible as industry change requires.

Statutory Authority

Competitive business and nonprofit organizations assess their opportunities continuously, restructuring their priorities, staffing, and resources to be at their best. The default is alertness, assessment, adjustment, and re-invention—aligning decisions with demands.

A commission's statutory authority needs the same constant attention. Legislatures and commissions, combining their comparative advantages (see essay, "Legislatures and Commissions: How Well Do They Work Together?"), must identify industry structures to encourage, standards of excellence to establish, economic risks to manage, innovations to induce. But that's not our default. The default is a century-old statute, changed only when some political urgency or interest group pressure moves a legislature to amend it—usually adding responsibilities without resources. These episodic interventions do not always produce a coherent whole.

A better default would be a legislative requirement that every two years, commission and legislature produce a joint charter and plan. These documents would describe the challenges faced by each regulated industry, then assess the fit between industry structure and industry performance, between commission responsibility and commission authority, and between commission obligations and commission staffing. Accompanying the document would be a statutory change that reflected all these needs. Is there a better default for adjusting commission authority to ensure public-interest achievement?

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Last month's essay, "The 'Public Interest': Who Has A Definition?" sought to define the "public interest" phrase ubiquitous in regulatory statutes. I argued that the public interest includes economic efficiency; replication of competitive outcomes; alignment of shareholder and customer interests; and respect for legitimate expectations. To these four conventional concepts, I add diversity—sociological diversity among each utility's employees to reflect each utility's customer base.

In response, I received the three thoughtful comments below. Each focuses on environmental values. Of course I agree with them. And I view such goals as already included within the value of economic efficiency. But I understand why they felt it necessary to comment. For the last 20 years, opponents of environmental responsibility have treated that value as somehow in conflict with economic efficiency. That political strategy then caused those who seek environmental responsibility to feel a need to identify environmental concerns as somehow separate from economic efficiency. Real conservatives—those who decline to disfigure the term—understand that economic efficiency exists only if each of us bear all the costs we cause.

So, thanking again my correspondents, here are their thoughts:

I would add environmental stewardship to the public interest, not only from a climate change perspective, but also environmental justice - the health impacts and societal costs of living near a fossil fuel plant which largely impacts low-income communities and those of color through more trips to the hospital and higher absenteeism from school and work, for example. Fossil fuel generating plants are a chief source of all sorts of harmful pollutants that affect climate, air and water.

You leave out a lot. Most importantly, there is sustainability and impacts of climate change in particular. Markets will not solve those issues and standard economic efficiency guidelines are useless also. Markets cannot solve the issue because there are no current markets for sustainability plus the future generations that must live with the results of our decisions do not have the opportunity to participate in today's decision making. In electricity we don't want the biggest output. We want an output that is safe and reliable and sustainable. We want to reduce output of electricity by using the most efficient end-user equipment and by insisting that the standards for end-user equipment are constantly increasing. We want to switch to renewable resources to produce the electricity we generate. We must nurture the earth and be good stewards of the earth for ourselves and future generations.

Any definition of public interest has to somehow explicitly require the internalization of all costs. We can't keep dumping externalized costs on the environment and future. This is not just an "old" issue like asbestos or lead paint, it is still a very current one, like child labor or that obscure substance that goes into cellphones that is polluting Africa today.