



Behavioral Economics, Libertarian Paternalism and Rent-to-Own



here is a move afoot in this country to change how people behave. It is less a frontal assault on the various behaviors that some deem not in the best interests of the greater good than it is, for the moment at least, a subtle attack on the flank of individual freedom. This development, if unchecked, could set its sights eventually on rent-to-own. If it does, the results for rental dealers will not be pretty.

The movement has not been generated from popular sentiment. Rather, it derives from the febrile brains of economic theorists, most of whom work for universities and think for a living. In the second half of the 20th century and with increasing vigor in the 21st, some of this thinking has given birth to the new theory of “Behavioral Economics,” which has, over time, sought not to amplify, but rather to replace classical neo-economic theory upon which the laws and capitalistic economic system of this country were founded and still rest. The tenets of behavioral economics were outlined in APRO’s magazine in 2007 (“Rent-to-Own and Behavioral Economics,” *Progressive Rentals*, October–November 2007, page 30; available online at www.rtohq.org/rent-to-own/files/behavior_prono7.pdf).

Classical economic theory proposes that the best way to allocate scarce resources is by the “invisible hand” of the marketplace. The theory presupposes rational actors, buyers and sellers, with perfect knowledge of all relevant information to the decision, making decisions in their own best interests in order to maximize their individual situations. By doing so, everybody benefits. Behavioral economics, relying as it does on the insights gained from the social sciences of psychology and sociology, maintains that people are not rational, not fully informed and do not, in fact, act in their own best interests very often. Moreover, behavioral economics maintains that the errors people make are at once “uniform, pervasive and predictable,” that they can be studied and used in economic modeling.

By Ed Winn III

Homo Economicus

All economic theory has been developed in order to explain what happens in the marketplace and make predictions about the future. No one ever maintained that the neo-classic economic principle of the perfectly rational actor—*homo economicus*—was necessarily true. In 1898, the economist Thorstein Veblen described *homo economicus* as “a lightning calculator of pleasure and pain, who oscillates like a homogeneous globule of desire for happiness under the impulse of stimuli.”

Even if its premise is admittedly flawed, neo-classic economic theory, based on uniform rationality, is useful because it allows economists to build models that are able to predict human behavior quite well, albeit, not perfectly, and because it is a relatively easy construct to apply. The theory has never been perfect in its predictive power; it did not predict the Great Depression, for example. (It should be noted, however, that behavioral economics, the ascendant theory at the time, failed to predict the financial meltdown of 2008. In fact, no economic theory saw that one coming.) Until lately, however, neo-classic economic theory has been deemed superior to the alternatives.

Today, behavioral economics insists that there is a better way to analyze economic behavior and predict the future. If neo-classical theory assumes, incorrectly, that there is perfectly rational behavior in the marketplace, behavioral economics assumes, equally erroneously, perfectly irrational behavior. According to two of its proponents, “These cognitive illusions—sometimes referred to as ‘biases’—are not limited to the uneducated or unintelligent and they are not readily capable of being unlearned. Instead, they affect us all with uncanny consistency and unflappable persistence.” (Hanson and Kysan, “Taking Behavioralism Seriously: The Problem of Market Manipulation,” *New York University Law Review*, volume 74, published in 1999).

If humans do behave irrationally, both through ignorance and their own biases, critics of the theory argue that the mistakes that are made are not at all uniform. How people make economic decisions will vary considerably among individuals and will depend upon their education, training, cognitive capacity, cultural background, sex, age, emotional state, judgment, social context and the timing of the decision, to name several of the variables. It would be complicated to work all of these variables into a coherent economic theory and so behavioral economists ignore them, preferring to err at the opposite end of the rational/irrational spectrum from Adam Smith’s and Milton Friedman’s theory by declaring that everybody makes irrational economic decisions—and they make them uniformly and, therefore, predictably.

Take the optimism bias, one of the several labeled examples of faulty thinking in behavioral economics that maintains people are overly and unreasonably optimistic about aspects of their personal economics than the evidence sup-

ports. Most readers, when they open their credit card bill, will find an amount due greater than they thought. However, some will underestimate the amount by \$10; some by \$100, some by \$1,000; some by even more. In addition, the size of the error will vary from month to month. And so, while most people may indeed have an optimism bias about their credit card debt, the degree of the bias varies considerably among individuals, a fact denied by behavioral economists.

As long as economic theory remains in the classroom, business people can safely ignore the theory of the day and get on with life. But when theory makes its way into the prevailing public policy and, ultimately, the law of the land, it is time to worry. That time is now for most business people, including rent-to-own dealers, because behavioral economics is making just such an advance.

Libertarian Paternalism

One of the chief theorists of behavioral economics is Cass Sunstein, a former professor at the University of Chicago. Recently, President Obama appointed him director of the Office of Information and Regulatory Affairs, a division of the Office of Management and Budget. OIRA has the authority to review every regulation proposed by any branch of the federal government with the charge to review and do a cost-benefit analysis of the regulation. Prior to this appointment, Sunstein, along with co-author Richard Thaler, wrote a book titled *Nudge: Improving Decisions about Health, Wealth and Happiness* (Yale University Press, 2008). The book’s aim is in its title. The way to improve how people behave is by implementing the oxymoronic “libertarian paternalism,” which, the authors assure, is just what is needed for people “to make their lives longer, healthier and better.” The idea is to empower the government to “nudge” citizens to make better decisions—“better,” like beauty, being in the eyes of the beholder and ultimately defined by policy makers in power. The authors of this book note that decisions are always being made according to how the choices are presented—which choice is offered first, for example. There is a context for every choice. Since that is so, why not optimize how choices are presented by empowering “choice architects” to structure the choices?

The distinction between the traditional liberal notions of ever more government regulation and merely “nudging” people to do the right thing is a subtle one. The authors define nudging as “any aspect of the choice architecture that alters people’s behavior in a predictable way without forbidding options or significantly changing their economic incentives.” Instead of legislating how people must behave, this new model suggests that the government merely offer people carefully structured choices so that they will, quite naturally


and without any coercion, choose the right thing—eating better, saving more, drinking less, gambling less (unless via state-sanctioned lotteries), driving less and just generally becoming better, happier citizens.

A shop-worn example is the school cafeteria. According to the nudgers, it would be better, both for them and for the rest of us, if students ate more fruits and vegetables and fewer cheeseburgers and pies. Why not, then, display the fruits and vegetables first in the line, at eye level, and make the other, less nutritious foods less visible and not as easy to


just end up being healthier, wealthier and happier, without realizing why. For critics, that is exactly what makes the system so pernicious.

Another word for nudging is manipulation and, if the central government is doing it, it means a loss of freedom for the citizenry. Proponents, including the current administration, insist that the modest loss of freedom is more than offset by the benefits of better living through this new and clever iteration of central planning.

Then there is the issue of the slippery slope. What if



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reach. Then students, so the theory goes, will instinctively make the correct, “better” choice and eat the apple instead of the apple pie.

In the business world, the example involves 401(k) retirement plans. The nudgers have decided that it would be better for employees and the country as a whole if more employees signed up for their employers’ 401(k) plans. The employee is essentially getting free money from the employer and Americans do not save enough for old age. The nudgers would change the law so that employees, instead of having to sign up for the plan, would instead automatically be enrolled when hired, with the choice of opting out. Banking on people’s inertia and the status quo bias, the nudgers are persuaded that reversing the choice that currently exists would yield more 401(k) enrollments and the country would save more money for retirement.

Yet another proposal by the nudgers is to offer consumers the choice of a government-drafted “plain vanilla” contract for most consumer transactions. The merchant and the consumer would negotiate the specific terms of the deal—e.g., price, interest rate, repayment terms, etc.—but the consumer would have the choice of putting the terms into the framework of a simple, easy-to-read, government-drafted agreement with no fine print, instead of using the merchant’s form. This proposal actually made its way into the initial drafts of the U.S. Treasury’s bill to create the Consumer Financial Protection Agency, but did not survive early congressional scrutiny.

The beauty of nudging, according to the nudgers, is that people will not even know that they are being nudged. So light will be the touch of government in their lives, they will

students pass on the apples and insist on eating the cheeseburgers and pies, no matter how well hidden or hard to attain? What is the next step? Ban the cheeseburgers from the lunch line, like the mayor of San Francisco has just done to soft drinks in city hall? The nudgers insist that there is no next step and that people remain free to make mistakes even unto ruination. Libertarian paternalism is all about choices and guiding people to make better ones and that is where it stops, according to its champions. Critics, however, point to any number of instances where the grasp of government has gotten progressively tighter around whatever policy it was advocating. Take cigarettes. The government began by banning smoking on airplanes. Today, there are towns that have banned smoking in people’s homes and even outdoors.

Critics argue persuasively that those with a tendency to nudge are never really content until everybody is doing things their way. That raises the question whether their way is necessarily the *right* way. In matters of health, there may well be right and wrong decisions based on hard science. In economic matters, however, there is no hard science. Most of the findings of behavioral economists have come from classroom experiments with college students bargaining for coffee cups or playing negotiating games. The results of these experiments, often self-fulfilling, have become the foundation of behavioral economics. It has become accepted as behavioral gospel that the results of these experiments with students yield a better understanding of behavior in the marketplace than does neo-classical economic theory.

Then there is the matter of the rationality of the nudgers. If the classroom studies demonstrate that everybody is predictably misinformed and irrational about various economic

matters, “everybody” must include the professors and the bureaucrats. The system proposed by the behavioral economists seems merely to be substituting the cognitive biases and misjudgments of consumers for their own. Of course, as professors, they do deem themselves smarter, less biased and less irrational than common folk. They have the big desks and the diplomas, after all. If they did not know how to structure choices so as to maximize results, the nudges would be random and the theory that they are making things better would collapse. Behavioral economists are internally inconsistent—evidence of irrationality—when they argue that people are uniformly and predictably irrational and, yet, the economists themselves claim to know in which direction to nudge people to make life better.

The Implications for Rent-to-Own

What does behavioral economics and its implementation via libertarian paternalism bode for the rent-to-own industry? How might behavioral economists nudge RTO customers? A popular mechanism favored by the nudgers for all major consumer purchases is the choice of an optional “cool-off” period of three days. The cool-off option could be applied to rent-to-own transactions across the board. It is already a part of the law in California and New York that consumers have the right to take a completed rent-to-own agreement home with them for 24 hours, presumably to study the terms and talk it over with family and friends. It is unknown how many customers avail themselves of this choice, but no dealer has complained that this option is unwieldy or has caused the dealer to lose money. What if the option was extended to three days? What if the customer was given the choice of making the initial payment, having the property delivered and then having the choice for the next three days to cancel the deal, return the property and get all of his money back? This, of course, already is the rule for door-to-door sales and makes more sense as a valuable consumer-protection choice in an outright sale than it does in an rent-to-own transaction that the consumer can terminate after seven days anyway, with a minimal outlay of money—one weeks rent.

What if the nudge went a little further? What if the customer had to wait three days before signing the agreement, making the initial payment and getting the property? That kind of cool-off choice guts the notion of “getting it now” and would likely hurt the business. A customer wants to rent a big-screen television on Friday to watch the games over the weekend, but now the law will not allow the dealer to sign the deal and deliver the TV until Monday. Could the dealer do a rent-to-rent deal for the weekend? Probably. Would the customer still want to do the rent-to-own deal on Monday? Some would; some would not.

What other kinds of choices might the nudgers offer rent-to-own customers? They could offer a standardized rent-to-own agreement in plain English and, if that were an option, most rental dealers—but not their lawyers—would jump for joy. The nudgers could add to the disclosures that dealers make to consumers in their advertising and agreements. Rental dealers no longer fear making whatever financial disclosures appropriate to the transaction that have been called for. They have demurred at disclosing an APR, because the term itself implies a debt and finance charge and usury limits in many jurisdictions would alter the economics of the transaction by lowering rent-to-own pricing.

Might the nudgers require rent-to-own dealers to remind customers of their other choices? That is the law in a couple of states already, where dealers must state in their agreements that the customer may be able to find better terms elsewhere. Might dealers have to advise customers to visit Goodwill stores or Craigslist or yard sales before offering a rent-to-own deal? Might potential RTO customers be offered the choice of financial counseling before signing a rent-to-own agreement? In the brave new world of libertarian paternalism, no one yet knows exactly how RTO customers would be nudged, but one can rest assured that any nudging done will be away from—and not toward—the rent-to-own transaction.

Make no mistake, some behavioral economists would dispense with nudging altogether and just shove people into doing the right thing. Some of the consumer-advocate behavioralists would delight in declaring rent-to-own transactions to be abusive, defective transactions and simply outlaw them altogether in the interest of protecting consumers from themselves. This outright ban would stem from the conclusion that entering into a rent-to-own transaction is an irrational decision under all circumstances and consumers would be better off without the RTO choice. (That, not incidentally, is the conclusion reached by a number of state legislatures about payday loans.)

Behavioral economics is a flawed theory, but so was Prohibition. Behavioral economics, flawed though it be, is the operative economic theory driving the policies of the current administration. While the attention so far has been on big issues such as health care, the global economy, energy policy and environmental protection, that does not mean that in time the president’s attention will not turn to smaller issues. The government has just created the Consumer Financial Protection Bureau and, if rent-to-own transactions are not directly within this new bureau’s province, it is still the time for rental dealers to school themselves about the implications of behavioral economics and the dangers it may pose for the continued viability of the industry they hold so dear. ✧

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