



Rent-to-own and behavioral economics

There is a new movement in microeconomic theory that challenges the assumptions underlying neoclassical economic thought. If this new movement continues to gain adherents as it has been doing of late and finally becomes the preferred, accepted theory for modeling economic behavior, there could be profound repercussions for rent-to-own as well as any number of other industries in America. • The most complete analysis of behavioral economic theory as it applies to RTO to date can be found in a recently published article by Jim Hawkins, “Renting the Good Life” (www.utexas.edu/law/academics/centers/clbe/papers.html). • While Hawkins does, indeed, conclude that some paternalistic intervention vis-à-vis RTO would improve the marketplace, he argues for a milder form of paternalism than hard-core consumer advocate critics demand. He eschews APR disclosures for the industry, for example, for many of the same reasons that the Federal Trade Commission found the disclosure to be largely irrelevant and possibly even misleading for the transaction in its 2000 study of rent-to-own.

By Ed Winn III

Hawkins would allow price controls as long as they are set high enough not to drive RTO dealers out of the market. He notes that the four states that have price controls on both cash prices and total RTO prices seem to have competitive rent-to-own markets. He favors government-mandated lifetime reinstatement rights as a feasible provision in all RTO agreements, since many companies offer such rights voluntarily already, and it would be a definite boon to consumers who suffer procrastination and other biases that keep them from taking full advantage of the ownership provisions of the transaction.

He recommends caps on all “other charges,” ideally at the level of the cost to the company for the service provided. (This is already the law in Illinois, New York, Texas and California.)

He favors a three-day cool-off period on all RTO transactions to prevent stores from taking advantage of the close personal relationship that often develops between customers and store personnel and loading up customers with too much merchandise.

He favors requiring rent-to-own dealers to offer monthly transactions first to customers as opposed to weekly agreements, and would like to see monthly RTO transactions as the default and predominant transactions in the industry.

Finally, again like the FTC, he recommends government regulation to require price tags on all merchandise in the stores disclosing the rental rate, the length of the agreement and the total rent-to-own price.

Many of Hawkins’ recommendations can be traced to the application of this new school of behavioral economic thought.

A LESSON IN TRADITIONAL MICROECONOMIC THOUGHT

For more than 100 years, neoclassical microeconomic theory has maintained that rational self-interest does and should dominate the marketplace. The premise is that both buyers and sellers apply reason in order to achieve their own maximum personal satisfaction from the marketplace. The theory goes on to postulate that this rational self-interest not only benefits the party who is looking out for himself, but the public interest as well by facilitating the most efficient allocation of scarce re-

sources possible. This is Adam Smith’s “invisible hand” at work: “He [the actor in the marketplace, either buyer or seller] generally neither intends to promote the public interest, nor knows how much he is promoting it...[H]e intends only his own gain and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.” (A. Smith, *The Wealth of Nations*)

In its purest form, this is classical free-market economics, the foundation of our capitalist economy. Proponents have always known that individuals are not, in fact, always perfectly rational actors in the marketplace, but the working hypothesis of rational self-interest has allowed for remarkably accurate predictions and explanations of human economic behavior. Milton Friedman, one of the chief economists promoting this classical view, acknowledged that perfect rationality was an unrealistic assumption and descriptively inaccurate, but endorsed it anyway as a useful tool for economic analysis, because the predictions derived from the theory are more accurate than predictions from other theories. (M. Friedman, *Essays in Positive Economics*, 1953)

This economic view has prevailed in America and has been responsible for the country’s phenomenal growth. It favors leaving market decisions to the individuals involved and rejects the view that any kind of collectivist policies would produce superior results. The other end of the economic theory spectrum maintains that the best way to allocate finite resources is for a central authority to take control and ownership of all resources—“from each according to his abilities”—and to parcel them out—“to each according to his needs”—i.e., communism.

This classical view of microeconomics has been taken to task in recent years, due in part to advances in psychology and the study of human behavior. The new school of thought is generally known as behavioral law and economics and rejects the classical view and particularly the rational behavior assumption upon which the classical view is founded.

The behavioral movement maintains that all individuals, in fact, act irrationally in the marketplace and elsewhere, but that they do so consistently, systematically, predictably, pervasively and uniformly to such an extent that the irrationality can be put into behavioral models and used for economic predictions and policies that are more accurate than those derived from the classical view with its false assumptions concerning how humans behave.

HEURISTICS: THE DECISION-MAKING PROCESS

This new view was identified in the 1950s, began to take root in academic circles in the early 1980s and has gained ground ever since. The movement seeks to apply psychological insights to economics. The theory rests on cognitive experiments, field data, computer simulations and, lately, even brain scans that demonstrate that an individual’s decisions are not made unemotionally and rationally, but rather are made by using mental shortcuts or rules of thumb—heuristics in the literature—that can lead to faulty conclusions. Heuristics are both good and bad. A good heuristic offers fast, reasonably accurate answers to situations. But a heuristic also violates logical principles and can lead to serious judgment errors.

For example, you might think that Dell makes the best computers or that the cheapest gas is at the Texaco down the street. You persist with these opinions even though further analysis and research might



prove you wrong. If you were entirely rational about where to buy gas, you would study the issue, find the cheapest gas stations, compute whether the distance to such stations would, in fact, save you money and, if so, how much and then go get gas. So, your trip down the street to the Texaco is an example of a heuristic at work and possibly a cognitive error that decreases the efficiency of the marketplace.

Behavioral economics maintains that all individuals are subject to “bounded rationality.” For example, consumers typically spend only a limited amount of time and effort to educate themselves about a future purchase. The theory suggests that they accumulate a “satisfactory” amount of information about their choices and then make a decision. This is a time-saving strategy adopted to avoid sensory overload and to simplify complex decision-making. How many cars did you research before you bought your last one? Some looked at a few; some looked at many. None looked at all of the choices because the result would have resulted in information overload.

The phenomenon of cognitive heuristics can lead to biases, errors and illusions, i.e., deviations from the normative conclusion that would be reached through pure reason. They are different from motivational biases, which individuals use intentionally to protect self-image, standing, existing beliefs or goals. According to this theory, individuals make economic decisions based on these cognitive biases without necessarily being aware of them. Individuals are aware of motivational biases.

NEW ECONOMIC THEORIES AND HOW THEY APPLY TO RENT-TO-OWN

The conclusion of behavioral economists is that because the irrationality of everyone is predictable, clever sellers and marketers can and do take advantage of buyers’ cognitive errors and biases, thus rendering the marketplace inefficient and unfair. The only solution is for the government to step in to keep the playing field level. While a few behavioral economists favor an aggressive form of intervention, most argue for weak, minimalist intervention. The government must step in, so the argument goes, to help individuals make better decisions and come closer to behaving in their own best interests because such conduct is good for the individuals and for everyone else.

These cognitive biases or errors in reasoning have been labeled and characterized by behavioral economic theorists. Several are pertinent to decision-making in the RTO context are discussed below. While the labels may be useful, it should be noted that the various types

of biases that have been identified are not discrete separate behaviors. They overlap and several may apply to any one economic decision. They represent attempts by economists to apply principles from psychological experiments to explain and predict human economic behavior. This branch of economics is fairly new and is still in its developmental stages. However, in the world of economics, long known as the dismal science, it is new and exciting, and it is challenging assumptions that have been the bedrock of economic theory for decades.

Rental dealers will want at least passing familiarity with the concepts of behavioral economics because some of the theories may be used against the industry by critics and legislators and because some of the insights concerning individuals' economic behaviors may influence how dealers position and run their businesses.

FRAMING AND THE ENDOWMENT EFFECT

Individuals can have different responses to the same choices depending upon how the choices are presented. In a well-known experiment involving a coffee mug, the subjects were divided into two groups. One group was given a mug and asked how much they would charge to give it up. The other group was shown the same mug and asked how much they would pay for it. The first group consistently priced the mug higher—over two times higher in repeated experiments—than the second due to how the issue was framed and also to an “endowment effect.” The value of a good seems to change when it becomes part of one's possessions or endowment. Psychology shows that people react to losses more strongly than gains and so advertising meat as being 80 percent lean is more powerful and preferred over advertising that it is 20 percent fat.

“Everyday low pricing” is not perceived by consumers to be as valuable as sales events, because “everyday low pricing” presents price as an expenditure, while a sales event frames the transaction as saving the consumer money.

The endowment effect in behavioral science means that an individual values goods that he owns more than the goods of others. This is so because people feel the pain of loss more acutely

than the joy of gain. The endowment effect is a reaction to loss aversion and regret avoidance.

ANCHORING

This is the tendency of individuals to focus on an obvious, convenient number or event. It is why retail prices are set at \$3.99, \$44.99 or \$999.99. The mind anchors on \$3, when in fact the price is really \$4.

Researchers assert that branding makes use of this phenomenon. When branding succeeds, consumers anchor their attention on the brand without further inquiry. In the rent-to-own context, rental dealers have long maintained that customers are most interested in the rental rate per week or per month—the convenient number—and base their decision to rent or not on that number, without becoming overly concerned with the other financial aspects of the transaction.

THE OPTIMISM BIAS

When polled, 82 percent of college students asserted that they were above average. This bias means that people are overly and unrealistically overconfident about their own economic futures. They overestimate how much they will earn in the future and they underestimate the likelihood of bad things happening to them—job loss, extended illness, divorce, etc. Health club members overestimate their future use of the facility by more than 100 percent.

The recent debacle in the sub-prime housing market is proof of the existence of this bias as work. Consumers purchased homes far more expensive than they could have afforded with traditional financing and in accordance with traditional underwriting guidelines. They paid little or nothing down and got interest-only loans with payback amounts scheduled to rise in the future. Consumers overestimated their future incomes and underestimated the risk of rising interest rates. Purely rational consumers would not have bought those houses.

In the RTO context, customers may take on more products over time than they can realistically afford to rent. This can result in breakdowns far more serious than merely picking up merchandise and losing a customer. The facts in recent New Jersey litigation

showed the optimism bias at work and resulted in that state's Supreme Court ruling that rent-to-own transactions, however formulated, are credit sales for all purposes and subject to the criminal usury statute's interest rate cap of 30 percent. Over a period of 14 months, the plaintiff in the case, a part-time cook, entered into five separate RTO agreements calling for total payments of \$172 per week and a total RTO price of more than \$18,000. The results of this customer's optimism bias were ruinous for the entire industry in the state.

THE BIAS AGAINST DELAYED GRATIFICATION

A perfectly rational consumer would carefully balance present consumption against future well-being when making current purchase decisions. The difference in value between get-

ting it now and waiting for it until later is the consumer's discount rate. Classical economic theory assumes a constant discount rate for decision-making. In fact, most consumers do not make such a rigorous analysis and are far more likely to seek immediate gratification by any means available and often at almost any cost. Rather than behaving rationally, individuals are impatient and myopic in the marketplace. Consumers demonstrate several biases in order to achieve immediate gratification, including hyperbolic discounting. No one can calculate present values in his head with much accuracy and an individual's instinctive calculation of the discount rate varies with time and with the size of the amount in question. The shorter the time, the higher the discount rate and the higher the reward, the lower the rate.

When individuals were asked what the equivalent value of \$15 would be for them at different intervals in the future—in one month, in one year and in 10 years, the responses were \$20, \$50 and \$100, yielding discount rates of 345 percent, 120 percent and 9 percent. (R. Thaler, “Some Empirical Evidence on Dynamic Inconsistency”, *Economics Letters*, Volume 8, Issue 3, 1981). This phenomenon may be why consumers are willing to take out payday loans with APRs of 400 percent—because the loan amounts are relatively small and the loan period short, usually two weeks.

SUNK-COSTS BIAS

Individuals have been shown to be slow to walk away from sunk costs in a possession, even when the rational economic response would dictate that they do so. This bias manifests itself in the car business. Consumers who are far into a car deal tend to hang onto the car when, rationally, the consumer should default on the contract and let the car go. Large numbers of consumers have been shown to hang onto their homes right into bankruptcy when the rational economic decision would be to sell the house, pay off the debts and acquire a smaller house and avoid bankruptcy altogether.

In the rent-to-own context, industry critics argue that the sunk-cost bias keeps people in their rental agreements far longer than the other variables in their economic situations would dictate.

OTHER BIASES

These are by no means the only cognitive errors and biases that behavioral researchers have identified. There is also the procrastination bias. Individuals with money in the bank will often delay paying bills until late charges accrue, when the rational bill payer would pay the bills on time and avoid the extra expense. There is the bias of “miswanting,” which is the irrational desire to obtain goods that will not, in fact, add to the individual's quality of life, but rather is merely the object of an obsession, fetish, desire for status, etc. There is the biased assimilation of new evidence or the status quo bias. People prefer “dancing with who brung 'em.” They resist accepting new information that would cause them to change their minds even when doing so would improve their circumstances and the cost of change is minimal.

THE IMPLICATIONS FOR THE RTO INDUSTRY ARE SIGNIFICANT. FINITE RESOURCES, IF THEY ARE BEING ALLOCATED IRRATIONALLY, ARE NOT BEING ALLOCATED IN THE MOST EFFICIENT MANNER POSSIBLE AND, IF THAT IS THE CASE, THEN THE GOVERNMENT MAY HAVE AN INTEREST IN HELPING PEOPLE AVOID THEIR OWN INCONSISTENCIES AND EVEN IN FORCING THEM TO MAKE BETTER DECISIONS, NOT JUST FOR THEMSELVES, BUT FOR THE SOCIETY AS A WHOLE.

There is also the explanation bias, the self-serving bias, hindsight bias and the cumulative-cost-neglect bias that have all been identified in psychological experiments with test subjects. There are new biases and cognitive errors being identified and written about all the time that parse the economic decision-making process into smaller and smaller increments. The stated goal of all of this psychological experimentation is to yield more accurate behavioral models that describe and predict human actions in the marketplace.

The implications for the RTO industry are significant. If individuals act irrationally when spending their money, then the decisions they are making may not be yielding the greatest benefit either for themselves or for others. Finite resources, if they are being allocated irrationally, are not being allocated in the most efficient manner possible and, if that is the case, then the government may have an interest in helping people avoid their own inconsistencies and even in forcing them to make better decisions, not just for themselves, but for the society as a whole. Taken to its extreme, some critics have argued that RTO is never a good idea for consumers and the transaction should simply be banned. This is not far from the approach Senator Charles Schumer of New York has taken with his bill that is currently pending in Congress.

The Hawkins' recommendations attempt to strike some middle regulatory ground for rent to own. However, rental dealers may argue against some of these proposals because they find them cumbersome or impractical for their businesses. A more complete understanding of behavioral economics—why people do what they do in the marketplace—may help dealers frame these arguments. It may also give them insights into consumer behavior and help them rent more TVs. ■

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