



An Apple or a Donut?

How Behavioral Economics Can Improve Our Understanding of Consumer Choices

By Carolina Reid

Generally, I wake up committed to the idea of eating healthy meals and I pack my gym bag for my afternoon workout. Then at the morning staff meeting I eat a donut, and at day's end I'm headed home on the train with my workout clothes still folded neatly in my bag. I would have gone to the gym, but Laura, the editor of *Community Investments* (and she can be tough!), was reminding me that this article was long overdue, and if I could just squeeze in one more hour of work . . .

Luckily, behavioral economists have developed a theory to explain why my actions are so at odds with my intentions: hyperbolic discounting. In more simple terms, I “undervalue” the future rewards of a better diet and exercise and “overvalue” the current gratification of a glazed old-fashioned. I'd rather take the smaller payoff now, rather than waiting for the larger payoff at a later time. While it's easy to scoff at a fancy name for what seems like a basic lack of willpower, hyperbolic discounting is in fact

a very important economic idea that can help to predict financial behavior. Financial decisions are highly susceptible to hyperbolic discounting, since consumers often value money differently in the present than in the future.¹ In fact, hyperbolic discounting can help us to explain why so many consumers carry high credit card balances for items they bought “on sale,” while not factoring in the cost of the interest payments. Or why homeowners took out high-priced, cash-out refinance loans that stripped them of the equity in their home. Or why most people say that they would like to improve their financial knowledge, yet nonprofits find it difficult to fill the seats in a free financial education class.

Understanding what drives these seemingly “poor” outcomes—as well as many others related to financial decision-making—is part of the growing field of behavioral economics. Behavioral economists focus on research that explains why people often make choices against their

best interests, even when they know better. This research is increasingly coming to the attention of policy-makers interested in influencing consumer choices in the financial marketplace, and many of the principles of behavioral economics are being used to inform everything from retirement savings programs to credit card and mortgage loan disclosures.

So what is behavioral economics, and how is it different from traditional economic theory? Simply stated, traditional economic theory generally assumes that individuals make rational decisions based on the information they have (e.g. knowledge about a financial product) and their situation and resources (e.g. income). This individual—*homo economicus*—makes rational, unbiased decisions that maximize his well-being, systematically evaluating risks and accurately assessing both short- and long-term costs and benefits.² If consumers make a poor financial choice—for example, by taking out a loan they can't afford—this approach would lead us to believe that they merely didn't have enough information to make a good decision. The appropriate policy response in this case would be to provide disclosures or additional information to ensure that *homo economicus* can make a better loan choice given his financial situation.

While financial knowledge is certainly important, it is also clear that it is not sufficient to ensure that consumers make good financial decisions. This is where behavioral economics steps in. Rather than assuming that people exhibit the perfect rationality of *homo economicus*, behavioral economists rely on insights from psychology to understand why people often make choices that do not align with a rational assessment of the decision's consequences. This is not to say that people are “irrational,” but rather that there are systematic and predictable ways that people behave differently from what we might expect.³ In the area of financial decisions, insights into these behavior patterns can help to craft more effective and efficient policies to encourage savings or protect consumers from predatory loan products.⁴

Hyperbolic discounting—making different decisions based on present versus future benefits—is just one of those insights. In a recent study, Stephen Meier and Charles Sprenger found that individuals who tended to value the future more than the present were much more likely to choose to participate in a credit counseling session to learn more about their credit score. In contrast, those with a bias to the present were less likely to participate in the course, despite the fact that hyperbolic discounters tend to borrow more (to spend in the present) than their more patient counterparts.⁵ This finding suggests that offering voluntary financial education courses may not reach those consumers who need them the most. Time horizons—such as the timing of financial information—may also influence

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consumer behavior. In a study of credit card use, researchers found that consumers who were subjected to a penalty fee (e.g. for a late payment) were more likely to pay their credit card on time, but that this response diminished over time. As the experience of the penalty fee receded into the past, consumers tended to revert to their past behaviors.⁶

Another important insight from behavioral economics is default bias—what most of us might simply call laziness or inertia. Default bias suggests that people are much more likely to stick with the status quo than what we might expect given the benefits of switching to another option. In studies of retirement savings, for example, researchers have found that default bias plays a significant role in determining whether or not employees participate in a 401(K) plan. Until recently, the default option for most 401(K) plans was non-participation, meaning that employees had to actively choose to participate. Changing the default option to participation—with no other changes to the benefits—leads to significantly higher participation in the 401(K) plan.⁷ Michael Barr, Assistant Secretary for Financial Institutions at the Treasury Department, has proposed that these findings be applied to loan products as well: lenders would be required to offer borrowers a standard mortgage option (e.g. a fixed rate, self-amortizing 30 year mortgage loan), and borrowers would have to actively ‘opt-out’ to receive a more risky product such as an adjustable rate or interest-only mortgage.⁸

Behavioral economists have also focused on how choices and information are framed—for example through advertising or disclosures—and are beginning to understand how even small changes may influence consumer decisions about financial products. Studying disclosure laws, Michael Collins found that a simple, negatively framed message can prevent borrowers from taking on a risky loan, not unlike the health warning on a pack of cigarettes. States that required borrowers to sign a disclosure that simply read “You Could Lose Your Home” before taking out a high-cost subprime loan significantly increased the likelihood that a borrower would reject the loan offer, compared to the less dramatic standard HOEPA disclosure.⁹ In South Africa, a controlled experiment on loan offers found that those that contained a picture of an attractive woman increased loan uptake. In contrast, loan offers that displayed too many loan options decreased uptake, consistent with the hypothesis that presenting

consumers with more options can overwhelm them and lead them to delay in making a decision.¹⁰ The way prices are framed also matters. For example, “rent to own” stores promise low monthly payments, yet the interest rates are incredibly high, leading to very high product prices over time. More than 70 percent of consumers eventually buy the product they rent,¹¹ meaning that the sofa listed at \$25 a month actually ends up costing \$2,000. Requiring these companies to state the true cost of purchasing an item up front—imagine your reaction to a sign that read “Used Couch For Sale: \$2,000”—would ensure that consumers are aware of the financial consequences of buying the rent-to-own product.¹²



Through this type of research, we’re starting to understand the systematic and predictable ways that people exhibit irrational behavior, and these findings can inform the structure and delivery of financial education, as well as help to shape public policy. For example, Meier and Sprenger’s research cited above suggests that we need to develop new strategies to ensure financial education courses are structured in a way that ensures attendance by people most likely to face difficulties planning for the future. Incentives that build on their desire to maximize present benefits, for example, could work to make the course a current priority. Framing can also be used creatively, such as “pre-approving” someone for a financial education class or credit counseling session, which may make the consumer feel as though they’ve been specially selected to participate (as opposed to a ‘free’ course open to anyone).¹³ Linking a financial education course with a savings account opened ‘on-site’ (and a mandatory \$20 contribution) may also help to overcome the inertia of having to go to the bank “tomorrow,” and may make it more likely that the lessons learned stick. Financial education curriculum should also include lessons about these common pitfalls—awareness of our potential biases or how advertisers frame messages is an important tool that can help us be more informed about why we make the decisions we do.

In addition, these theories into financial decision-making can provide policymakers with a better understanding of how to develop programs and policies that will ensure that consumers don’t unintentionally make poor financial choices. While some view policies such as “opt out” defaults, strategically framed disclosures, and “cooling off” time periods to be paternalistic, these approaches do not limit consumer choice in the same way as banning a product would do. Consumers would still be able to make the decision to take on a subprime mortgage, for example, but presumably they would only do so after conducting an informed analysis of the costs and benefits of this product choice. Richard Thaler, a leading behavioral economist, has developed an idea for a program called Save More Tomorrow (or SMarT), which gives employees the option of committing themselves now to increasing their savings rate later, each time they get a raise.¹⁴ This program takes advantage of people’s good intentions for the future, as well as ensuring that their take-home pay doesn’t change (thus reducing the effect of loss aversion), since it is their raise that will go towards their saving. As Thaler points out, developing policies that keep in mind that we are all humans will do much to help households navigate today’s complex financial world, and ultimately help them towards the goal of financial stability over the life course.¹⁵

As for me, I’ll go to the gym tomorrow. **CI**