

# The new paternalism: over-indebtedness and non-rational borrowing from a behavioural economics perspective

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## AIM OF THE PAPER

Our paper discusses the idea of the new paternalism, including its development over recent years, its characteristics and the tools which it provides for governments to steer decisions. The idea of the new paternalism is based on the claim that, to achieve our own true preferences, there is a need for relatively modest adjustments to decision-making. Certain core neoclassical values have also been retained - for example, freedom of choice is acknowledged as an important safeguard against government error.

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## METHODOLOGY

In respect of methodology, we undertook a serious review of the literature. Further, the basic psychological phenomena which characterise our decision-making processes and the theoretical debate on the new paternalistic approach are also interpreted - arguments in favour of its wide implementation, as well as concerns over its legitimacy.

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## MOST IMPORTANT RESULTS

The main result of our review is that this new economic policy approach, which is based on behavioural economics-related findings, should be discussed as widely as possible. It is, nevertheless, also important to underline the critical thoughts of the new light or libertarian paternalism. Here we concentrate mainly on two streams of criticism: the discoverability of people's true preferences and the rationality of politicians.

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## RECOMMENDATIONS

We focus on the possible fields of application of the new paternalistic approach: over-indebtedness and non-rational borrowing. Several ways of how libertarian paternalistic tools can be applied to these issues are listed, but, more significantly, the limits of these application possibilities are emphasised.

*Keywords: Libertarian paternalism, over-indebtedness, over-borrowing*

## INTRODUCTION

The development of behavioural economics is a consequence of the application of psychological approaches, methods and results in the field of economics. It became a popular research area as it was able to explain phenomena which were inconsistent with the expected outcomes predicted by standard economic models. Interpreting the findings and conclusions of behavioural economics, however, requires caution, since accepting results which support the unrealistic features of *homo oeconomicus* is not the same as abandoning the basic values of neoclassical economics. In fact, a misinterpretation of the findings of behavioural economics is frequently found in paternalism – that is, in restricting the autonomous endorsement of preferences and claiming that this is in the best interests of the individual. Classical paternalism, which has a more authoritarian character, is neither compatible with the values of neoclassical economics nor with the values of behavioural economics. The new paternalism is based on a need for relatively modest corrections which help us to achieve our true preferences by inhibiting restrictive rational decisions. Certain core neoclassical values have been retained, although, for example, freedom of choice is acknowledged as an important safeguard against government error - which appears to mitigate the antipathy towards its heavier paternalistic features.

More specifically, this study provides some new perspectives which contribute to the formulation of more complex conclusions about one of the most crucial consequences of the crisis of 2008: the everyday problem of the level of indebtedness in foreign currency of households in Hungary. One aim of the study is to paint a clearer picture of this topic, since not only does public opinion have a somewhat arbitrary view of the situation, but related political communication is also weak and rather too populist in character. It is, therefore, important to provide another perspective, since the Hungarian govern-

ment is currently more concerned with exonerating itself from the responsibility and with the (certainly complex) ways of handling the problem *ex post*. Although we have a rather sceptical opinion of the new paternalistic views, we believe that, if the *ex ante* approaches of the new and classic paternalists in problem-solving were in the focus of the argument, the current situation would be significantly improved.

The paper comprises two main chapters. The first describes the theory and tools of the New Paternalism together with a critical review, whilst the second focuses on one important feature of Hungarian household debt other than the tendency to borrow foreign currency: basic over-indebtedness. The crisis resulting from over-borrowing in foreign currency can be regarded as one manifestation of this phenomenon. Following a (deliberately) brief review of the literature relating to this problem as far as the starting point of the foreign currency loan crisis, we conclude that non-rational borrowing behaviour and its possible consequences should have been foreseen by both the organisations involved in government finance regulation and by the banks. After suggesting some answers to the new paternalistic approach, we leave some questions open, since our aim in this paper is not to provide clear unequivocal answers, but to share our opinion and provoke further thoughts on the topic.

## ECONOMIC POLICY FROM THE BEHAVIOURAL ECONOMICS PERSPECTIVE: THE NEW PATERNALISM

Most decisions by economic actors are based on forming expectations about uncertain future events, and behavioural economics focuses on these decisions. More narrowly, it examines the features, functioning and consequences of main decision-influencing factors such as the presence of heuristics, cognitive bias, inconsistent time-preferences or the appearance of feelings and other visceral factors in judgments. The literature

in the field of behavioural economics is very broad, and so the aim of this section is only to offer a few assertions about the relationship of the neoclassical models and psychological findings.

Based on our findings, the behaviour of economic actors can only be characterized by bounded rationality (e.g. Simon, 1955). It is safe to claim that humans cannot always follow self-interest and that their preferences are often contradictory. Despite these non-rational features, human behaviour is not considered as irrational or unpredictable. The aim of behavioural economics is to reveal and to get to know the *systematic* errors of people's thinking or activities. Then, taking these 'failures' into account, a more realistic human being could be defined and cast as central actor in economic models (Rabin, 1998, 2002; Kahneman, 2003; Camerer and Loewenstein, 2004).

As for the purposes of Economic Policy, revealing the non-rational features of human behaviour and thinking has always been an interesting topic for policy-makers and politicians. Rhetoric has always had a central role – which is why scientific results concerning the effects of framing on the acceptance of new programmes or on understanding the importance of taxation gained constantly increasing attention (McCaffery and Slemrod, 2006). Advances in the field of behavioural law and economics have made it possible to measure the expected impact of different policies and actions (Jolls et al., 1998).

Although the new paternalism is not based on pure authority but on intentions to counter the anomalies and bias of decision-making, the logical conclusion seems to be problematic: is any form of paternalism really *necessary* to enable us to follow our preferences consequently?

## THE MAIN CHARACTERISTICS OF THE NEW PATERNALISM

In the case of classical or hard paternalism, restricting the autonomous implementation of individual preferences is based on

the values of each society. Neoclassical economics is not suitable to provide normative arguments for classic paternalism, apart from some cases of people who are restrained from decision-making. In these cases people can be restricted either because they have bounded decision-making abilities (intellectually challenged people, the younger generation and people with mental disorders) or due to social sanctions such as imprisonment.

The theory of bounded rationality and behaviour-related research has brought about a change in the theoretical argumentation about paternalism. This argument says that, given the presence of cognitive barriers, individuals are not able to be consequential in their preferences and so the task of the government is to ensure that individuals act according to their real preferences. In the last fifteen years new approaches to paternalism have emerged. These are based on behavioural economics arguments and have called different names such as asymmetric, light, behavioural or libertarian paternalism. Differences in naming already show clear demarcation from traditional forms of paternalism.

The best known approach is *libertarian* paternalism, which is characterized by the attention paid to libertarian values and principles whilst increasing welfare by applying paternalistic interventions by the government (Sunstein and Thaler, 2003; Thaler and Sunstein, 2003, 2008). The major authors in the field lay great emphasis on intervention by consciously creating default rules. For example, participation in a company's savings programme is much higher if an employee is automatically enrolled (still having the right to opt out) than if enrolment is not automatic (although he can opt in at any time) (Madrian and Shea, 2001). The default in this case was the option of automatic enrolment and the company has to define a default whilst preserving an employee's right to change at any time.

Another form of new paternalism is *asymmetric* paternalism (Camerer et al.,

2003). The name refers to the feature of new paternalism which, whilst it provides support to non-rational individuals, rational decision-makers are not put at a disadvantage. Applying the example of automatic enrolment in savings programmes, thanks to intervention, the savings of non-rational employees increase, while rational individuals are not affected at all.

An interesting version of the new paternalism is *paternalistic information telling*. This aims to apply behavioural economics results so that they can have a clear impact on decisions. In the opinion of relevant authors, as bias in decision-making stems from the non-rationality of human thinking, it is legitimate to use these non-rational characteristics to help people to obtain a clear picture of, for example, the real risks related to their activity (Jolls et al., 1998).

### TOOLS FOR 'STEERING' DECISIONS

The lack of practical experience means that the tools suggested by behavioural economists are supported mostly by theoretical considerations and laboratory experiments. As mentioned previously, their common feature is that they are created to influence the decisions of others and not to make decisions instead of them. In the next few paragraphs we offer a rough outline of the most important groups of tools.

Just as neoclassical theory claims, information is needed to make rational decisions. The new paternalism not only wants to lay more emphasis on gathering adequate information about a situation; it also supports the rephrasing of information so that people would understand the risks and opportunities more clearly. Rephrased information has to eliminate bias in perception and evaluation (Jolls et al., 1998; Tversky and Kahneman, 1981).

The use of framing can be helpful in, for example, countering health-impairing habits or gambling. As all humans are characterized by loss aversion, all that a 'choice architect'<sup>2</sup> has to do is to highlight the negative outcomes of former activities

rather than positive options. Paternalistic rephrasing can also use a heuristic approach as *availability* or *representativeness*, whilst human cognitive errors can be 'used' in both ways: they can be reduced or strengthened as the situation requires. For example, it is best to avoid suggesting anything which increases the feeling of a person being *above-average*, saying, rather, that 'road regulations are needed because of other, below-average drivers'. This helps to have these rules accepted by increasing the perception of the self as being an exception.

Applying defaults is inevitable (Thaler and Sunstein, 2003; Sunstein and Thaler, 2003) and results in a *status quo* bias. Samuelson and Zeckhauser (1988) show that most decision-makers do not change, but adhere to the default option – which makes the planning of defaults more serious. Madrian and Shea's (2001) research, quoted above, showed that one default can have most serious, long-lasting impacts – for example, in the field of savings. Also, the motivational system in a company can be based on similar effects, such as *commitment* (Thaler, 1980), that is where privileges owned are valued more highly than if one had to buy them.

The tool of the mandatory 'cooling off' period is aimed at removing decision-makers from situations where they would behave too intuitively (Loewenstein et al. 2001). Decisions made in an exaggerated state of mind can cause long-lasting negative effects. For example, with expensive purchases it is important to rethink consumer decisions (Camerer et al., 2003).

Internalities (Gruber and Köszegi, 2001) are negative effects related to non-rational consumer habits such as smoking or eating unhealthy food. 'Sin taxes' can be applied here which count as a slightly more intrusive tool. The aim of sin taxes is to bring consumers closer to the real costs which they are incurring for themselves. Due to a lack of self-control people tend to under-value future costs. Sin taxes highlight that problem for them.

## CRITICISM OF NEW PATERNALISM

Although the new paternalism does not have authoritarian intentions, it has some features similar to classical paternalism which generates similar arguments concerning criticism. This section comprises two main fields: the first is the over-riding concern of ascertaining one's *real* preferences, and the second is determining whether policy-makers or government are appropriate actors in consciously influencing our decisions.

### Is it possible to discover peoples' true preferences?

First of all, criticism relating to the new paternalism refers to theoretical and practical problems of gathering necessary information about true preferences (Rizzo and Whitman, 2009a). Although it is clear that human preferences are inconsistent in time<sup>3</sup>, there is no proof for them being cognizable (Waldfoegel, 2005; Rizzo and Whitman, 2009a). However, if new paternalists claim to act to help people follow their long-term goals, it has to be assumed that it is possible (at least, for them) to recognize and choose between one's true preferences (Loewenstein and Haisley, 2008). If we consider the decision-influencing effect of framing, choosing the *right* preference becomes more problematic: people change their choices as a consequence of different phrasing. How, then, would anyone be able to say something about their real preferences?

Most empirics in the fields of behavioural economics and new paternalism cover laboratory experiments. Nothing ensures that these experiments are appropriate to real life situations and that people really react in the expected way following external (e.g. government) intervention or default modifications. That is why arguments for asymmetric paternalism claim that choice architecture has to help 'boundedly rational' individuals *whilst* letting rational actors do what they think best for them (Camerer et al., 2003, Sunstein and Thaler, 2003). It is, however, hard to accept that interventions come at no cost to rational actors.

Some actions such as a mandatory cooling-off period could cause a *welfare reduction* as consumers have to wait for goods they wanted immediately (Kivetz and Keinan, 2006). The same applies to 'sin taxes'. People who wish to put on a little weight have to pay the taxes for so-called 'unhealthy' foods, although those taxes were imposed basically for obese people (Rizzo and Whitman, 2009a).

Also, attention has to be paid to other human characteristics which can change people's thoughts about an earlier government intervention. Thanks to the *hindsight bias* (Fischhoff, 1975) and *self-attribution bias*, people may later interpret an event differently from when it happened. Understanding individual responsibility also changes as the context changes. This means that, even if a government were able to help people in difficulties and improve their situation, many would consider this as their own personal achievement.

### The rationality of politicians

To believe that policy-makers or politicians are led by altruism is naive. For decades, models in economics have already assumed that politicians act in their self-interest (e.g. Buchanan and Tullock, 1962). There are phenomena such as lobbying and interest-groups (Olson, 1965) or rent-seeking behaviour (Buchanan, 1980); and these warn of the possibility that the individual interests of politicians outweigh their public interests.

Considering the basic assumptions of people being boundedly rational, the rationality of policy makers can also not be ensured—and so how could the new paternalism even work effectively if neither the voters nor the politicians are rational. Non-rational voters can misjudge political actors and this leads to suboptimal results in elections. If we assume politicians who act in their own best interest together with non-rational voters, phenomena such as *political manipulation* (McCaffery and Slemrod, 2006) or *populism* (Glaeser, 2006) seem to be logical inferences.

Finally we must also cite the *slippery slope* argument. There is a threat to the whole of society if any kind of paternalism is legitimised. ‘Slippery’ refers to the fact that it is hard to stop in the middle if something has started. If people accept the application of light tools by the government with the aim of influencing their choice, there is a chance that government goes further and that, gradually, hard paternalism will evolve. Advancing gradually, applying harder and harder decision-steering tools will not provoke huge opposition from members of society (Rizzo and Whitman, 2009b).

### **NON-RATIONAL BORROWING**

#### **The behavioural economics basics of non-rational borrowing**

The neoclassical theory of borrowing behaviour is based on assumptions of rational decision-making, i.e. decisions are directed by long-term preferences and reflect time-consistent preferences, and costs and benefits discounted exponentially. There are two oppositional representations in the judgment of the experienced redemption problems. On the one hand there is the *rational* actor, who wants to make use of or take advantage of the opportunities provided by social solidarity; and together with this comes the striving to increase austerity in financial regulations. On the other hand, there is the borrower as the *victim* of the manipulations of the supply side of the financial market; together with this appear needs for strict market regulations and for the fair treatment of insolvent debtors. The aim of the behavioural economists’ investigation in recent years was to reveal the behavioural components of non-rational borrowing, to acquire deeper knowledge of its characteristics and, based on this, to develop *ex ante* solutions for the problem (Bar-Gill, 2004; Benton et al, 2007; Block-Lieb and Janger, 2006; Kilborn, 2005; Sunstein, 2006; Willis, 2006).

The behavioural economics approach to borrowing is based, instead of on the

assumption of rational behaviour, on non-rational behaviour. The determining elements of most analyses is extreme (self) confidence (Fischhoff, Slovic and Lichtenstein, 1977; Svenson, 1981; Moore and Healy, 2008) and over-optimism, unrealistic optimism (Weinstein, 1980). This means that people tend to assume a favourable future setting of both subjective and objective factors that will influence redemption and interest-paying. The insufficient processing and non-rational evaluation of the information-stream at times when people have to choose among credit-constructions is the consequence of their bounded cognitive capacities (Simon, 1955) and in some cases of their financial illiteracy (Block-Lieb and Janger, 2006; Willis, 2006). What drives the borrowers’ decision-making is the minimizing of cognitive expenditure and the related negative emotional effects (Willis, 2006). The applied heuristics can result in too simplified relationships and distorted estimations of risk – based, for example, on availability or anchoring (Tversky and Kahneman, 1974). Among the cognitive deficiencies of the individual, it is easy to see how we tend to neglect accumulating costs (Slovic, 2000), especially when using credit cards; how we solve cognitive dissonances; or how we do not realize the forming and the real extent of our debt (Ausubel, 1991).

Another possible explanation for over-indebtedness is the inconsistency of the preference order. The ‘decision utility’ of a certain good (the utility which comes at the time of acquisition) exceeds the ‘experience utility’ which comes from the use or consumption of that particular good (Kahneman et al. 1997). The inconsistencies in time preferences (Frederick et al., 2002) lead to the overrating of current benefits and the underrating of future costs, and so to the lack of self-control, to impatience - which urges consumption (Laibson, 1997, O’Donoghue and Rabin, 1999), to procrastination in important decisions (Akerlof, 1991), to underestimation of small credits

(Green et al., 1997) and in total to excessive borrowing (Meier and Sprenger, 2007).

The slowness of the individual's adaptation to changes in income or in redemption conditions can be explained by the characteristics of the value function (Kahneman and Tversky, 1979; Block-Lieb and Janger, 2006). Even in the case of declining income, the reference point stays constant – which can lead to loss-aversion and risk taking (Bowman et al., 1999). The effects caused by bias relating to sunk-costs (Thaler, 1980), the endowment effect (Thaler, 1980; Kahneman, Knetsch and Thaler, 1990, 1991), the *status quo* bias i.e. overrating the present situation (Samuelson and Zeckhauser, 1988), or omission bias (Ritov and Baron, 1990) can be all responsible for unreasonable consumption choices and for retaining assets which cannot be financed.

### **The new paternalistic approach to the regulation of non-rational borrowing**

Credit-related costs are difficult to interpret and to compare; and, because of the asymmetric information and the moderately price-sensitivity of the consumers, there is a possibility of price discrimination. What is more, borrowing behaviour is not rational – which is why it can be easily manipulated, and financial knowledge is essentially a 'public good' – which effectively means that it is inadequate for this purpose. For all of these reasons, there is a basic consensus among economists that credit markets need regulation (Bar-Gill, 2004; Willis, 2006). At the same time all the relevant issues concerning regulation are the topic of professional and political argument. These issues are: (1) the primary reason for the need for regulation, which can be insufficient competition, unfair market behaviour or the non-rational borrowing behaviour; (2) the aims of potential regulation which can be to regulate competition, create clear market conditions, terminate unfair behaviour and protect non-rational actors; (3) the tools of regulation, which can be the classical tools of market regulation, providing uniform

information, excluding manipulative sales techniques or the paternalistic approach representing and protecting the interests of the borrower. The basis for differences between views is differing judgment of the real role of credit-market innovations and their effect on borrowers' behaviour (e.g., in respect of credit cards see Brown and Plache, 2006 vs. Bar-Gill, 2004).

In the paternalistic approach, the need for regulation originates in the non-rationality of borrowers and their easily manipulated behaviour. As for suggested solutions, we find – both in the related literature and in practice – the tools of classical paternalism, with some ideas coming from the new, 'light' paternalists.

In accordance with its basic principles, the aim of the new paternalistic approach is to find the solution which can handle the problem *ex ante* with the help of decision-influencing tools (Benton et al, 2007; Sunstein, 2006; Willis, 2006), first of all ensuring sufficient information for decision-makers. Transparent, clear and comparable credit options can be effective in the case of rational decision-makers (Bar-Gill, 2004, Block-Lieb and Janger, 2006, Sunstein, 2006, Willis, 2006). To help households to realise, understand and handle basic problems, it is vital to provide them with financial education, the opportunity to request professional help from experts and to create a central infrastructure for these services. These measures can already be effective in the case of non-rational borrowers. Also, in the case of sufficient commitment, an effective tool in both handling and preventing a high level of indebtedness appears to be the voluntary regulation of card-usage (e.g. using a debit-card instead of a credit-card, putting a daily limit on the card and limiting the total credit etc., Benton et al. 2007).

Besides providing neutral information for those with the rational information processing, there is a striving to exploit the characteristics of the non-rational ways of thinking in serving the interests of decision-

makers. Risk perception can be enforced with the help of tools based on the use of framing effects and availability heuristics (Tversky and Kahneman 1974, 1981, 1986), and with the help of any tools which aim to *debias* (Bar-Gill, 2004; Block-Lieb and Janger, 2006; Sunstein, 2006). In respect of large credits, the cooling-off period can be applied, considering the long-term effects of that one-time decision (for more about cooling-off periods see Benton et al, 2007; and Block-Lieb – Janger, 2006; for ‘chilling out’, see Willis, 2006).

### **In lieu of a conclusion – open questions**

By way of a summary of this short study, we list a few problems which we have concerning the theories of the new paternalism in general – and why these provisions can be inefficient in the case of non-rational borrowing. We will show that it is still safer not to give more power to government.

Behavioural economics and theories of the new paternalism mostly ignore problems and questions related to the *background* of anomalies. There are no results which could provide biological or cognitive reasons for our judgment and decision-making failures (Grüne-Yanoff, 2011). However, changes with age and developments in decision-making were investigated. Here, researchers found that not only cognitive values develop with age, but cognitive bias will be used more frequently by individuals (Jacobs and Narloch, 2001). Atypical mistakes are decreased and diminished by age, but heuristics and bias similar to that in adult decision-making are more and more common among adolescents (Klaczynski, 2001). Does growing up mean learning how to commit the same mistakes in decision-making as our parents?

Rejecting the new paternalism is rooted not only in differences in the basic values of economic or philosophical perspectives, but also in the questionable effectiveness of providing solutions in handling internalities. In studies by even the most committed

followers of the new paternalism (Sunstein, 2006), one can detect an obvious scepticism since ‘because the problems of non-rational (borrowing) behaviour are too deep and the set of tools too limited’. Among the suggested regulations of credit markets, tools of a hard paternalistic character emerge. Some marketing methods, such as introducing ‘teaser’ rates, are forbidden; some credit constructions, e.g. basic conditions and cost-calculations, are standardized; interest rates are maximized, usury is forbidden; and loan contracts can be revised *ex post* and are penal (Bar-Gill, 2004; Block-Lieb and Janger, 2006).

Acknowledging the limitations of *ex ante* regulation, expectations towards *ex post* measures, such as personal bankruptcy, are strengthening (Kilborn, 2005). These expectations are not really justified. Bounded rationality does not exclude the rational option to make use of the quibbles provided by the institution of personal bankruptcy – which is why adequate regulation can only be based on a compromise between effectiveness and a fair approach. However, we have to be cautious in respect of fair regulation, as people are characterized by hindsight bias (Fischhoff, 1975) - which results in the arbitrary understanding of one’s own historical responsibility.

Neither do we have a clear picture of the real economic effects of (in)sufficient self-control – something which would be most important in hindering the negative long-term effects of, for example, ‘spur of the moment’ purchasing decisions. We also lack empirics about useful tools to strengthen self-control, although we note that the related literature is constantly growing (Heath and Soll, 1996; Rizzo and Whitman, 2009a, 2009b). As long as we have no more scientific results for this topic, it is always safer to focus on solutions at the individual level than allow governments to solve problems.

One last important note is that research into self-control has concluded that there is a substitution effect between external con-



trol and self-control (Fishbach and Trope, 2005; Carlin et al., 2013). Increasing external control reduces internal self-control. In conclusion, we probably have to be cautious in both cases: if we consult others - as well as if goodwill is extended towards us.

## NOTES

- 1 The author acknowledges the financial support of SROP-4.2.2.C-11/1/KONV-2012-0005, "Well-being in the Information Society".
- 2 Thaler and Sunstein (2008) introduce the notion of *choice architecture*. Decision-making situations are planned (by a third person) in a way which makes it easier for humans to make rational decisions (e.g. by applying defaults).
- 3 Inconsistencies in preferences are further explained in the next section.

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