THE WALL STREET JOURNAL.
WSJ.com

JUNE 23, 2009

A Personal-Finance Workout

By SUDEEP REDDY

The central idea behind the Obama administration's effort to protect the personal finances of Americans boils down to this: put laziness to work.

Tell people to set aside part of their paychecks every month and they'll usually ignore the advice. But start the saving process for them -- automatically siphoning off a raise from a paycheck into a bank account -- and perhaps that will help them avoid the financial trauma that has affected millions of Americans in this recession.

As part of its financial-regulation overhaul, the Obama team is encouraging more responsible use of credit cards, savings and even mortgages. Using tactics ranging from a light nudge to a hard shove, officials are turning theories about behavioral economics into practice to reshape how Americans make personal-finance decisions.

Some of them may prove controversial as the government brings a heavier hand to personal finance. To help people who don't save, for instance, the government would create accounts -- unless they opt out -- to redirect part of their salary or tax refund into savings.

The fundamental premise behind the approach: design lending policies and government programs based on how consumers actually behave.

"Very strong market incentives exist in the system to take advantage of human failing," said Michael Barr, an assistant Treasury secretary and one of the leading proponents of behaviorally informed regulation. "We're trying to figure out the right regulatory tools to realign the incentives and make abuse in the marketplace less likely."

The financial regulation plan unveiled by the Obama administration last week entrusts a new regulator, the Consumer Financial Protection Agency, with implementing simpler rules and standardized options for consumer loans.

One key reason for the heavy dose of behavioral economics: Senior administration officials -- from Mr. Barr at Treasury to White House economist Austan Goolsbee to Peter Orszag, Cass Sunstein and others in the Office of Management and Budget -- all spent years studying how to tweak regulations to force consumers to consider their decisions more carefully.

Opponents of greater government involvement in personal finance call it a slippery slope toward paternalism. Behavioral economists "assume that market participants make systematic errors all the time but bureaucrats don't," said Mark Calabria, director of financial-regulation studies at the Cato Institute, the libertarian think tank.

Behaviorally informed regulation, as opposed to the perennial calls for more disclosures, starts with presenting information and choices to get consumers to make decisions that the government thinks are in their interest.

The Obama budget proposal includes plans to require employers who don't offer a 401(k) or similar retirement savings account to automatically enroll workers in individual retirement accounts, siphoning deposits directly from their paychecks. The program is aimed at the half of all working Americans -- roughly 75 million people -- who don't have a retirement plan other than Social Security.

Workers would be allowed to opt out of the auto-IRAs. But that would force them to make a clear decision not to save this way, perhaps driving them to think more about their retirement needs. When the government this decade changed the law to encourage employers to automatically enroll their workers in 401(k) accounts, unless they opted out, employee participation shot up.

The Treasury is now considering proposals to direct tax refunds into a bank account automatically -- rather than sending refunds through checks -- to encourage people without a savings account to save more. Taxpayers would have the right to opt out if they decided the current approach worked better for them.

On the housing front, behavioral economists have a solution to keep home buyers from taking on risky mortgages they don't understand: Offer a plain-vanilla loan -- a 30-year fixed mortgage -- thereby forcing consumers to act if they want a more creative mortgage instead.

The credit-card legislation that sailed through Congress last month became behavioral economists' first major win in the Obama administration. When the law takes effect next year, it will give borrowers a wake-up call: plain-English warnings and a prominent warning of how long cardholders would take to pay off their debt by sending only the minimum payment each month, and how much interest they'd rack up.

Critics such as Mr. Calabria say the administration is simply banning practices it can get away with, and in instances where it can't ban them, it is stacking the deck of choices. Case in point: The credit-card law prohibits card issuers from offering plastic to some people under 21, even if they are adults who can make their own decisions. "It just seems like a weakened authoritarianism," he said.

Behavioral economists say they simply want to flip the current approach to regulation.

"Anywhere you look, the government is setting up a lot of defaults for people who don't do anything. If I fail to write my will, there is a default set of laws that go into effect about my children's inheritance," said Eldar Shafir, a Princeton University professor of psychology and public affairs who studies behavioral economics.

The key concern for opponents of the changes will be maintaining the element of choice in financial decision making, and ensuring consumers aren't nudged too far in one direction. Even proponents say any changes must be easily reversible.

Write to Sudeep Reddy at sudeep.reddy@wsj.com

Printed in The Wall Street Journal, page A11