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ECONOMIC VIEW

How About a Stimulus for Financial Advice?

By **ROBERT J. SHILLER**

IN evaluating the causes of the [financial crisis](#), don't forget the countless fundamental mistakes made by millions of people who were caught up in the excitement of the real estate bubble, taking on debt they could ill afford.

Many errors in personal finance can be prevented. But first, people need to understand what they ought to do. The government's various bailout plans need to take this into account — by starting a major program to subsidize personal financial advice for everyone.

A number of government agencies already have begun small-scale financial literacy programs. For example, the Treasury announced the creation of an Office of Financial Education in 2002, and President Bush started an Advisory Council on Financial Literacy a year ago. These initiatives are involved in outreach to schools with suggested curriculums, and online financial tips. But a much more ambitious effort is needed.

The government programs that are already under way are akin to distributing computer manuals. But when something goes wrong with a computer, most people need to talk to a real person who can zero in on the problem. They need an expert to guide them through the repair process, in a way that conveys patience and confidence that the problem can be solved. The same is certainly true for issues of personal finance.

The significance of this was clear at the annual meeting of the American Economic Association this month in San Francisco, where several new research papers showed the seriousness of consumer financial errors and the exploitation of them by sophisticated financial service providers.

A [paper](#) by Kris Gerardi of the Federal Reserve Bank of Atlanta, Lorenz Goette of the University of Geneva and Stephan Meier of [Columbia University](#) asked a battery of simple financial literacy questions of recent homebuyers. Many of the respondents could not correctly answer even simple questions, like this one: What will a \$300 item cost after it goes on a "50 percent off" sale? (The answer is \$150.) They found that people who scored poorly

on the financial literacy test also tended to make serious investment mistakes, like borrowing too much, and failing to collect information and shop for a mortgage.

A [paper](#) by Liran Einav and Jonathan Levin, both of Stanford, reporting on work with William Adams of [Citigroup](#), shows how sophisticated automobile lenders can be in their loan technology. They use complicated statistical models not only to approve people for credit, but also to fine-tune the down payment and even to suggest what kind of car individuals can buy. This suggests to me that many borrowers can't match the expertise of lenders.

And another [paper](#), by Paige Marta Skiba of [Vanderbilt University](#) and Jeremy Tobacman of the [University of Pennsylvania](#), showed that payday loans — advanced to people who run out of cash before their next paycheck — exploit people's overoptimism and typically succeed in charging annual rates of interest that may amount to more than 7,000 percent.

One wishes that all this financial cleverness could be focused a bit more on improving the customers' welfare!

The theory of capitalism, going back to Adam Smith over 200 years ago, sees an alignment of interest between consumers and businesses. Only those companies that produce what consumers really need will succeed. Those that do not will be beaten in the marketplace as consumers shop elsewhere. This puts pressure on providers to innovate and to better satisfy consumer needs.

This theory assumes, however, that consumers are rational in their choices, and to a large extent they are. But in some areas, notably personal finance, it is important to recognize that a good share of Americans have difficulty figuring things out.

Most people get financial advice only from sales representatives of one sort or another: real estate agents, mortgage brokers, sellers of financial products. Some of these providers could use their sophistication to exploit people's tendency to behave irrationally, and to manipulate the judgment errors that consumers typically make. And competitive pressures tend to make providers promote products that exploit those errors to the hilt, unless, of course, we offer consumers real financial advice.

Such advice is tax deductible, so it is already subsidized indirectly. But most lower-income people do not itemize deductions on their tax returns, so they don't receive this benefit. In addition, their income tax rates are lower, so the deduction's benefits can be even less — sometimes zero if they pay no taxes. That's why it makes sense to subsidize the advice enough that lower-income people will really buy it, much as we do with health care in [Medicaid](#) and [Medicare](#). In this case, it means reimbursing qualified private financial advisers for most or, sometimes, all their fees.

SUBSIDIZED financial advisers should be licensed by self-regulatory organizations that verify their qualifications. Licensing will be imperfect, and some incompetent advisers will

end up with subsidies. Still, the net effect of getting professional advice to the public is surely positive.

To qualify for a subsidy, the advisers would have to sign a statement promising loyalty to their clients and agreeing to accept only the subsidized hourly fee, and never any commissions or kickbacks. The subsidies might come to \$75 an hour, at a very rough estimate, and if 50 million Americans averaged four hours of consultations, the eventual cost might be \$15 billion a year — a substantial expenditure, but a worthwhile one.

If personal financial advisers had been subsidized years ago with the best incentives, they still might not have stopped their clients' bubble thinking during the boom. Many advisers probably thought that housing investments were a good bet. But it's still likely that advisers who built long-term relationships with their clients, and who pledged to look after their welfare, would have been a helpful influence, suggesting caution to those who were getting over their heads in debt, and warning that adjustable-rate mortgages could be reset upward, just as the fine print said. For these reasons, financial advisers probably would have reduced the severity of the housing bubble.

Professional financial advice is now generally accessible only by the relatively wealthy. Changing this would be an important corrective step. Giving the general public access to trained advisers would be a boon for the nation in this time of doubt and distrust.

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