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THE ECONOMICS OF COMPETITION AND CONSUMER POLICIES

Contribution by Ms. Louise Sylvan

-- Session V --

This contribution is submitted by Ms. Louise Sylvan (Deputy Chair, Australian Competition and Consumer Commission) under session V of the Global Forum on Competition to be held on 21 and 22 February 2008.

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**THE ECONOMICS OF COMPETITION AND CONSUMER POLICIES:
ONGOING WORK OF THE OECD CCP**

-- by Ms. Louise Sylvan --^(*)

1. The project on Economics for Consumer Policy of the OECD Committee on Consumer Policy (CCP) arose out of a desire to create a clearer or better economic underpinning for the work in consumer policy – whose roots have tended to be primarily from a legal framework which focussed on consumer rights. This work is complementary to that framework.
2. The purpose of the Toolkit is to move the CCP forward in developing unifying concepts and principles, in sharing the insights derived from the research of various agencies on consumers in markets, and further, to sharing our analysis and evaluations more generally in order to build global better practice. The title of the Toolkit is an important indicator of this: Consumer Protection and Empowerment: Building a Toolkit for Policy Makers. The title uses the active voice of **building** a Toolkit which is an evolving one as our understanding and practice of various elements of the Toolkit improve.
3. At the heart of the concept of the Toolkit is the notion that consumers do not only benefit from competition, they drive it – and whether they are able to do that well, is an important question. It is an important question not only for consumer outcomes; ultimately, it's important for competitiveness of firms and more generally, it is one element contributing to the productivity of a nation.
4. The EU in its current Consumer Policy Strategy put the concept succinctly: 'Confident, informed and empowered consumers are the motor of economic change as their choices drive innovation and efficiency.'¹
5. The Toolkit could as easily have been called Making Markets Work for Consumers – because that is the task; and of course, because of the interface in the work of competition and consumer policy agencies, making markets work is also the task of competition policy. I note that one of our colleague organisations is already clearly in that space; the home page of the UK Office of Fair Trading website carries the motto 'Making Markets Work FOR CONSUMERS'.
6. The CCP emphasis and focus in the Toolkit will not be on firm rivalry and competitive structure but on exploring how best to identify, measure and evaluate consumer outcomes in the market. But it is recognised that both competition and consumer agencies are looking at the same coin – the market – and that the interface is important since agencies are examining different aspects of one dynamic entity. When evaluating a consumer problem in the market, consumer policy needs to bear in mind that the solutions may be competition ones and the same principle holds in reverse as well.

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¹ EU Consumer Policy strategy 2007-2013 *Empowering consumers, enhancing their welfare, effectively protecting them* Commission of the European Communities Brussels 2007.

1. Behavioural Economics

7. In the first Roundtable which the CCP held in 2006 to look at economics for the demand side (which is what the project was initially called), invited speakers presented elements of behavioural economics research; being new material to most Member nations, the CCP held a second Roundtable to examine further aspects.² The ideas from the body of published behavioural economics work challenged established thinking and continues to do so; after examining this literature over the past couple of years, however, most participants in the Toolkit project think that this discipline has important insights for consumer policy – Professor Camerer’s lecture here today is a fairly good indicator of some of the considerations.

8. In this forum, at least in relation to colleagues trained in economics, it is unnecessary to sing the praises of either conventional or information economics; these areas of economics have provided important bases from which to look at consumer protection and empowerment issues. Information economics, in particular, has brought an understanding of bounded rationality and of information problems in markets – it treats information itself as a scarce resource and so points strongly to important asymmetry problems.

9. Behavioural economics, which I don’t see as antithetical to conventional economics as some have suggested – in fact I see them increasingly as complementary – provides empirical evidence about people’s behaviour, and in the context of the discussion today, about consumer behaviour in markets. Understanding real behaviour in markets is essential if for reaching policy decisions that work effectively in those markets.

10. Two key categories of behavioural economic findings seem particularly important to consumer policy.

- The first key area is evidence about how people think or reason. People appeal to heuristics and rules of thumb when making decisions – for example people are often over-confident, they anchor to what one would say should be irrelevant information or words, they are poor at probability judgments, they often use a simple rule of thumb when the task requires some serious calculation, they are easily overloaded when presented with too much information or choice and so on – in simple terms, people have human cognitive or reasoning biases that mean that some of their decisions do not maximise their welfare (or their expected utility). A typical example is the over-confidence people display – about things like driving ability; and about being able to make complex financial decisions – in one of the major literacy surveys in Australia, 80% of consumers they said they were quite confident about choosing products (some of which required complex calculations in order to make an informed choice) while only 59% of people could do a basic multiplication task they were given.
- The second key area of findings is that, not surprisingly, people do not have complete self-control – they are human, they have frailties such as the human propensity to value immediate gains over their longer term interests (or hyperbolic discounting it is called in behavioural economics). So, for example, people *intend* to pay off their credit card, but when the time comes, that often doesn’t happen even when the consumer is fully informed about the high cost of this form of credit – that individual’s discount rate has changed. A further example comes from the retirement policy area. When left to themselves, people are unlikely to save sufficiently for their retirement – they know they should, they understand why savings are crucial – this is not primarily an education or information problem; even among those who can easily do the

² Roundtable 1 summary: <http://www.oecd.org/dataoecd/31/46/36581073.pdf>; Roundtable 2 summary: <http://www.oecd.org/dataoecd/5/38/39015963.pdf>

calculations, people just don't do get around to establishing a pension plan. That is why most governments have mandated pension or retirement savings programs, to ensure most people do not end up with requirements for publicly-provided income support at their retirement date.

11. Behavioural economics also demonstrates how people's preferences can be quite malleable and unstable – consumers are influenced by context and myriad (often irrelevant) events occurring in the market as they purchase.

12. All of this might not matter. Consumers have always made mistakes in their decisions in markets. Under the rational actor model, there was never a proposition that there would not be a range of outlying decisions around the mean, but the mean was the rational mean. What does matter is not that consumers make mistakes, but that regular and possibly ingrained human behaviours consistently – or systematically – appear and affect decision-making in a predictable direction. This is important because consumer detriment may result, and because human biases can be used in the design of some products (possibly adversely for consumers) which is a matter for the consideration of consumer policy.

13. Systematic departures from the rational mean are also important because if people are systematically departing from 'rational actor' behaviour, then public policy such as competition policy, predicated on rationality assumptions, may not deliver optimal outcomes.

14. In the previous Forum, a couple of years ago, (in the discussion of our shared problem of consumers not being interested in switching electricity supplier despite being given choice), one of the competition participants remarked that "we've deregulated these markets, we've created choice for consumers, and they are not switching – what is wrong with these consumers?" Well there's nothing wrong with these consumers – there is something wrong with the implementation of the policy; what was wrong is that the policy failed to take into account the market reality for most consumers. Finding an electricity provider is a complex calculation requiring knowledge of one's pattern of usage – a difficult task for most people.

15. Another example of a very good state intervention going wrong as a result of failing to take consumer behaviour into account comes from the states of New Jersey and Pennsylvania in the United States of America. Both states were seeking, within their compulsory car insurance schemes, to reduce the full-scale litigation related to injuries arising from automobile accidents.³ They did not want to use a heavy-handed approach and preferred to preserve consumer choice. So they offered consumers an alternative: a less litigation-intensive resolution process which would be faster and simpler, much less costly to the system overall and cheaper for consumers.

16. The two states made basically identical offers to consumers – pick the 'full right to sue' option and pay the higher premium or pick the 'limited right to sue' option and get a lower premium. Conventional economics would predict that a reasonable number of people would rationally assess the likelihood of an accident and the relative payoff of being able to sue vs. the time involved etc – so you'd get a reasonable price-value distribution in terms of behaviour with the results for the two States being much the same. They were not. The crucial factor was that Pennsylvania made the full right to sue with the higher premium their default, while New Jersey used as their default the 'limited right to sue' with a lower premium – if the consumer wanted the full right to sue, they needed to select that and sign their name (a very low transaction cost). The results were that 75% of people in Pennsylvania retained the full right to sue while only 20% of New Jerseyites did. This is a dramatic real-world illustration of the ease

³ E J Johnson, et al "Framing, Probability Distortions and Insurance Decisions" (1993) *Journal of Risk and Uncertainty* 7:35-51

with which policy success or failure can be created by taking into account, or overlooking, consumer behavioural issues. The difference in costs to the two states in the following year was in the order of about \$200 million.

17. The lessons that one can derive from behavioural economics findings are as follows:

18. First, being forewarned about potential biases (how consumers may systematically behave **not** as predicted) will lead to better questions when agencies are investigating markets. One of the contributors to the development of the CCP Toolkit explained with the following example: ‘when we are looking at hidden charges – we need to understand whether the problem derives from these charges being in the fine print or whether consumers systematically underestimate the risk of an event which triggers the clause in the fine print (i.e. it would not assist if that term of the contract was brought to their attention.’ Depending on the answer, how one deals with this problem will change.

19. Which leads to the second lesson from behavioural economics. Don’t assume much! People’s behaviour is complex, many of the observed biases interact (such as over-confidence with loss aversion) adding to the complexity, and one cannot be completely sure whether biases will even manifest in a number of circumstances. Industry marketing executives understand rather more than consumer regulators and consumer policy analysts do about consumers and their behaviour at the moment – and that is because they research consumer responses constantly. Consumer agencies also need the programs of proactive research in markets. Further, they need, as a matter of course, to test *ex ante* a proposed action (road test) and *ex post* as to whether the action has been effective.

20. The design of interventions – a mandated disclosure for example – will be improved if empirical evidence about how consumers might behave is considered. One of the crucial behavioural economics lessons in relation to information disclosure is that HOW you disclose – or the CONTEXT within which you disclose – is just as important as WHAT you disclose. One should re-think, for example, whether an information disclosure about commissions in the financial advice market will really be effective in helping people choose a financial planner when there is evidence from the behavioural economics studies that people tend to default to trust. One of the features of using behavioural economics insights is that through its emphasis on empirical results, it does reinforce a focus on the real issue – the outcome. ‘Is this proposed disclosure going to be effective?’ is the crucial question. And one might add, imposing a major disclosure burden on businesses which does not actually empower consumers (and might in fact disempower them) is just plain bad regulation.

21. For a real-world experiment on a disclosure matter, the Federal Trade Commission’s *ex ante* testing of mortgage broker commission disclosures is revealing; the proposed disclosure didn’t actually go ahead because it disempowered consumer decision making. In a classic information overload result, commission disclosure distracted consumer attention away from the key price features of the product and, as a result, consumers made worse decisions.⁴ Isn’t it a good idea to know that *before* one implements a policy!

22. The third lesson is that where there does appear to be a bias operating as a result of our analysis of the situation, it is better to work with that bias than against it. Many of the reasoning errors and biases that have been documented and described are made by highly numerate and literate university students – including classes of graduate economic students. Some of these behaviours are so ingrained that they are virtually hard-wired. There is increasing support from neurological science – from the use of MRI neural imaging – that people use quick emotive ‘rule of thumb’ decision-making parts of the brain in situations

⁴ JM Lacko and JK Pappalardo “The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment” *Bureau of Economics Staff Report*. Washington, DC: Federal Trade Commission. <http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf>

where the computational and deliberative decision-making parts should be being used. Finding out about this will assist in determining whether, for example, using an education or information strategy could possibly overcome a bias and how. Consumer agencies need to be clear when these situations exist.

3. Committee on Consumer Policy Toolkit for Decision Making

23. The Toolkit will consist of:

- an overview of how markets and consumers and their expectations have changed in the past 20 years or so in developed economies – though with our linked world, markets and consumer expectations are changing almost everywhere;
- an examination of the conventional or neoclassical model and in particular information economics, plus behavioural economics and possibly some references to the neurological material;
- a chapter on various methods for identifying consumer problem areas in markets, where consumers do not seem to be driving competition, and means for measuring detriment that arises in these circumstances;
- a description of the various tools of government – including some of the newer tools deriving from behavioural economics,
- and the final component of the Toolkit, the crucial segment, where all the former elements come together in the discussion of how one should go about decision making and deciding whether or not a government should intervene, whether that intervention is in a market or some other form of action, whether one needs a combination of actions or, alternatively, no action at all.

24. The Toolkit does not start from a position that a policy or regulatory agency should do nothing. In some places, the quite appropriate hesitancy about intervening in markets - because of regulatory risk and uncertainty - has become translated into a lack of activity in rigorously examining consumer problems in markets. That is in my view a bad confusion between the task of final evaluation and decision-making and the process of investigation and analysis.

25. The decision tree of the Toolkit is underpinning by an assumption that pro-active investigative and rigorous approaches to examining what is going on with consumers in markets is occurring. Without this investigation and analysis, the decision-making obviously should not proceed. Emphasising the demand or consumer side of the market does not mean that competition policy is of less importance – of course not; getting competition right is also of crucial importance to consumer outcomes – but competitive structure and behaviours are a necessary but not a sufficient condition to ensure consumer welfare.

4. Conclusion

26. In carrying out the task of examining and regulating markets – whether one comes from the competition or consumer field – it is crucial to acknowledge and engage in the interface between competition and consumer policy and effectively operate in a joined-up way. For consumer agencies, an action that will enhance consumer protection, but reduce competition, should raise a ‘red flag’ and a good look at alternatives; and for competition agencies, an action that enhances competition but which will also have some negative outcomes for consumers should also raise a ‘red flag’. This is an especially important point in deregulation of former monopolies, or where competition is being introduced into sensitive policy areas such as education and health.

27. The complexity of these markets **matters**, and much thought and work needs to be given to how well consumers can drive competition and exercise their choice for their benefit – the consumer empowerment questions are crucial.

28. And, further, where such an intervention may improve overall competition and consumer outcomes but may hurt specific groups of consumers – especially if those consumers are already vulnerable or disadvantaged – the ‘red flag’ should be waived very vigorously indeed. One of the more interesting, and perhaps controversial findings from behavioural economics is that consumers value fairness. Whether one accepts these findings or not, it is clear that if handled badly – with serious consumer detriment occurring to some consumers as an outcome of competitive reform in sensitive policy areas, or where the benefits of competition are not distributed widely (i.e. essentially where the outcome of having more competition is more inequality), then competition reform may lose political and public support. This is especially true in nations that are still developing and where considerable resistance to the use of markets remain.

29. The task, as competition and consumer agencies, should be to always strive to achieve outcomes where our activities deliver both better consumer and competition outcomes *at the same time*. In many cases, that synergy works without much effort. In some cases it does not, and these are the areas of the economy that are most deserving of our research and considered policy attention.