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Global Forum on Competition

THE ECONOMICS OF COMPETITION AND CONSUMER POLICIES

Introductory Note

-- Session V --

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Contact: Peter AVERY, Principal Administrator [Tel: 33 1 45 24 93 63; email: peter.avery@oecd.org].

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THE ECONOMICS OF COMPETITION AND CONSUMER POLICY: SUMMARY OF ISSUES

-- *Introductory Note* --^(*)

1. Key points

1. Open, contested markets promote efficiency and spur innovation. Government policy aims at assuring that competition among suppliers is vigorous. Well-informed consumers who are in position to evaluate and compare products help drive such competition. Government policy aims at assuring that markets are transparent to consumers, that information is not misleading or, in some cases, deficient, and that consumers are protected from fraud and unsafe products. In some instances, policies are also adopted to address problems that result from behavioural biases that seriously undermine consumer welfare.

- To what extent do the economics underlying competition and consumer policy coincide? In what areas could they conflict? How can conflict areas be resolved?
- In what circumstances can government policies designed to inform and educate consumers strengthen competition? In what circumstances can such policies have negative consequences for competition? In the case of the latter, how should the costs and benefits be weighed?
- How can policymakers exploit the findings of behavioural economics to strengthen competition?

2. What are the economics of competition and consumer policy?

2. The underlying goals of competition and consumer policy are to improve the functioning of markets, thereby increasing economic performance while enhancing consumer welfare.

2.1 *Competition policy*

3. Open, competitive markets boost economic performance by rewarding firms which are efficient and innovative. Such markets are key to increasing productivity and growth. The telecommunications market is a case in point. Deregulation has spurred the development of new products, while putting downward pressures on prices.

4. Governments seek to achieve competitive markets on the supply side through competition policies aimed at ensuring that there are no unnecessary barriers to entry for firms, that market concentration does not lead to economic loss or unreasonable transfers from consumers to producers, and that there are effective legal sanctions against fraud, misleading conduct, and collusion among suppliers. When markets exhibit these characteristics they can be said to be structurally sound.

5. Where monopolisation is permitted, governments generally regulate the behaviour of firms to ensure that the outcomes in markets are as close as possible to those which would occur in a competitive

^(*) This note was prepared by the DSTI Secretariat.

market. In this way even a market with a monopoly supplier can be structurally sound, provided it is well-regulated.

2.2 *Consumer policy*

6. Well-informed consumers who are in position to evaluate and compare products and reach well-reasoned purchasing decisions help to ensure that the benefits of open markets are fully exploited. Through their choices, such consumers become important instruments for driving innovation and efficiency.

7. On the supply side, governments use consumer policy to protect consumers by providing them with legal rights that enable them to defend themselves against unfair commercial practices. They also often seek to improve the ability of consumers to make welfare-enhancing decisions by providing, encouraging or mandating the disclosure of information that would facilitate more informed decision-making. Requirements that financial institutions include an annual percentage rate on interest, for example, facilitate comparisons of debt instruments.

8. In recent years, increased attention has also been paid to measures that governments could take to address the psychological biases that can influence decision-making, particularly in those instances where consumers experience significant harm. Requiring that consumers be provided with adequate time to review major contracts prior to finalisation, for example, can help to counter the techniques that are sometimes used by commercial parties to pressure consumers into making hasty and ill-advised decisions on mortgages and the like.

3. **How are the economics of competition and consumer policies inter-related?**

9. The benefits of competition are greatest when well-informed consumers are able to properly evaluate and compare products in contested, transparent markets. A key policy objective is therefore to ensure consumers have access to relevant information on price and quality. Having this basic information is not however, sufficient, to guarantee optimal outcomes. There are, for example, limits on the ability of consumers to carry out thorough evaluations, and there are instances where information needed to make proper evaluations is simply not available.

3.1 *Bounded rationality*

10. It is apparent that consumers do not have the time or interest to undertake comprehensive search and evaluation of all alternatives for each of their purchases. Information can be hard to obtain, and processing information can be complicated and time-consuming. It is quite rational, in a more general sense, for a consumer to cease searching when the costs of searching start to outweigh the benefits resulting from searching. A consumer may, for example, be content to compare prices for a low-priced tool from two local shops; he/she may, however, be willing to invest considerable time and effort to find a relatively low airfare for a planned family vacation.

3.2 *Information problems in markets*

11. Information that is available to consumers at the time they make choices is often not sufficient:

- **Disclosure.**-- On the supply side, firms have incentives to provide information which strengthens their market positions. Such information is likely to be incomplete and could well be insufficient for consumers to make well-reasoned decisions. In fact, there are situations in which firms disclosing information could actually suffer a competitive disadvantage. For example, a bottled water supplier who pointed out that its water was no better than municipal tap water would lose sales to competitors who did not reveal the same information about their water.

- **Experience goods.**-- There is a class of goods (and services) known as experience goods, for which consumers cannot judge quality before purchase. This can result in harm when quality differs from what had been expected by the consumer. If the purchase price is low, and the consequences of poor quality are minor, consumers can correct their purchases at a later time. In other situations where the price is high (e.g. real estate) or the consequences of poor quality are high (e.g. faulty car parts), harm to consumers can be significant.
- **Lemon products.**-- Experience goods can also impair the efficient operation of the market through what is known as the problem of lemon products. Where consumers cannot ascertain quality, the probability of receiving low quality is reflected in the market price. As the price declines, high quality sellers who have difficulty in conveying credible quality information may leave the market, potentially perpetuating a cycle of declining quality and prices until only poor quality products remain. The market for used cars is a classic case. Disreputable dealers can undermine an entire market as consumers may not be in position to
- **Credence goods.**-- Another class of goods is known as credence goods. For credence goods verification of quality may not be possible even after purchase. This can be because consumers lack the skills to assess the outcomes against any clear standard. This applies in markets such as legal services, financial counselling and medical services. It can also be because some product characteristics are difficult to verify. It can be impossible, for example, to determine whether a food product is organic.

Establishing quality can be further complicated when problems take time to emerge, particularly in retirement savings and insurance products.

By their nature, credence good problems are not amenable to simple information provision, because information in itself has little use unless it is from a trusted source. Policy interventions have to attend not only to ensuring information is accurate, but also that it is credible to consumers.

4. How does our understanding of human behaviour impact consumer policy?

12. The “rational” model of consumer choice, including the “bounded rationality” model, rests on a set of assumptions about behaviour which, at a macro level, are generally consistent with observed behaviour. Economists can generally predict the consumer reaction to events such as a tax cut or a change in commodity prices, but within specific market situations there are observed significant departures from “rational” behaviour.

13. The empirical discipline of behavioural economics extends the knowledge base of economics with insights from actual studies of consumer behaviour. Relying largely on psychological studies, in laboratory simulations and actual markets, behavioural economics delves into the ways in which people actually make decisions.

14. The research often finds systematic departures from rationality in decision-making. Rather than random departures, there are biases away from what is predicted by the rational model (Box 1). In financial markets in particular there is a well-established and applied set of theories in the subsidiary discipline known as behavioural finance, which explains why investors are subject to certain biases in their decision-making, such as holding on to stocks they would not choose to buy if they did not already hold them (known as the endowment effect).

15. In some cases these departures are trivial in their effects, but in many others these biases have costly consequences. The challenge for governments is to determine the circumstances under which they might want to take action to address such biases, particularly when a policy intervention would affect the terms and conditions under which firms compete.

Box 1.-- Examples of behavioural biases

- **Choice/information overload:** Economic models suggest that the benefits from extra choice and information are unbounded. Even the theory of “bounded rationality” does not suggest that extra choice and information is detrimental. Market research however, in products as diverse as jams and retirement savings, suggests that past a point, when provided with more choice and information, we either walk away from markets, choosing not to choose, or we choose randomly.
- **Endowment bias:** What one has is valued more than what one might have. Consumers are often reluctant to switch suppliers because of a loyalty, which may be misplaced, to existing suppliers. This is particularly evident in telecommunication and financial services.
- **Overconfidence:** in many situations consumers are overconfident in their abilities and in their future fortunes. For example many people invest, believing that they can beat the stock market, or they underestimate the risk that illness or unemployment may cause difficulty in repaying a loan. Again, this bias is important in financial services.
- **Framing biases:** Consumers are influenced not only by the objective information provided by suppliers, but also by the “frame” of that information. For example a claim “92% fat free” elicits a different response than “8% fat.”
- **Difficulty in handling uncertainty and risk:** Consumer perceptions of the consequences of uncertain outcomes are influenced by the frame in which choices are considered. When gambles (such as insurance choices) are considered in isolation consumers tend to be irrationally risk averse. When consumers consider themselves to be in a loss situation (such as becoming heavily overcommitted on a credit card) they tend to behave recklessly. Furthermore, consumers often have difficulty in thinking rationally about possible outcomes with very low probability.
- **Mis-evaluation of future benefits and costs (hyperbolic discounting, myopia):** Consumers do not rationally weigh up present against future benefits and costs; rather they put too much weight on the immediate. This bias is manifest in outcomes such as low retirement savings in the absence of compulsion.