Volume 4 | Number 1 | Spring 2008

Competition Policy International

# Consumer Protection and Behavioral Economics: To BE or Not to BE?

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Published in Competition Policy International (print ISSN 1554-0189, online ISSN 1554-6853),
Spring 2008, Vol. 4, No. 1. For articles and more information, visit www.globalcompetitionpolicy.org.

# Consumer Protection and Behavioral Economics: To BE or Not to BE?

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The foundation of consumer protection policy is respect for consumer choice. Modern consumer protection recognizes the need to preserve information markets and to carefully structure interventions to ensure compatibility with how consumers actually process information. Behavioral economists have identified a number of behaviors inconsistent with the assumption that consumers rationally maximize their utility, leading some to argue for policy changes that would restrict choice in some instances.

Four interrelated concerns limit the applicability of behavioral economics to consumer protection policies. The experimental evidence that provides the most compelling evidence supporting various behavioral biases may not predict real-world behavior in markets. There is no consistent and coherent body of behavioral theory yielding clear predictions about which biases might be relevant in a given situation. There has been relatively little exploration of the implications of particular biases for the nature of the economic equilibrium. Finally, we have little reliable empirical evidence addressing the benefits and costs of possible interventions based on behavioral principles.

Behavioral economics offers useful insights into consumer behavior, many of which are already a part of consumer protection policy. Like other interventions, however, policies based on behavioral principles must be tested against actual market behavior. At present, we do not have an empirical foundation that would justify significant changes in policy.

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One of the hottest topics in the economics literature today is the burgeoning field of behavioral economics (BE). Based initially on experimental evidence that seems to contradict the standard economic model's assumption that consumers are rational utility maximizers, behavioral economists have increasingly questioned whether the economist's conventional respect for consumer preferences is really appropriate. Instead, some argue, it may be necessary to intervene in markets to protect consumers' true preferences, because they may fail to pursue those preferences effectively on their own. Interest in behavioral economics and the implications it should have for consumer protection policies have led to conferences exploring these issues at the Organisation for Economic Co-operation and Development (OECD),[1] the U.S. Federal Trade Commission (FTC),[2] and the Australian Productivity Commission.[3]

To their credit, most economists writing about behavioral economics issues have been restrained in their recommendations for public policy. They have a healthy skepticism about the potential unintended consequences of intervention, a respect for the importance of competitive markets, and a professional ethic of assessing the benefits and costs of policy actions. Writers in the behavioral law and economics (BLE) literature have been far less restrained, citing behavioral economics principles and findings as the basis for recommendations ranging from the relatively benign (e.g., changing the default choice for retirement savings plans[4]) to the extreme (e.g., the restoration of usury limits[5]).

To understand whether the finding of behavioral economics should change consumer protection policy, we first need to understand current policy. The foundation of consumer protection has always been the consumer's preferences, even if others might question those preferences. As the U.S. Supreme Court said in one of the early FTC consumer protection cases: "The consumer is prejudiced if upon giving an order for one thing, he is supplied with something else. In such matters, the public is entitled to get what it chooses, though the choice may be

1 OECD, Directorate for Science, Technology & Industry, Committee on Consumer Policy, Roundtable on Demand-Side Economics for Consumer Policy: Summary Report (2006) [hereinafter OECD Report].

2 U.S. Federal Trade Commission, Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), *at* http://www.ftc.gov/be/consumerbehavior/index.shtml (last visited Feb. 19, 2008).

3 Australian Government Productivity Commission, Review of Australia's Consumer Policy Framework, Draft Report app. B (2007) [hereinafter Australian Report], *available at* http://www.pc.gov.au/__data/assets/pdf_file/0006/73662/consumer2.pdf.

4 C.R. Sunstein & R.H. Thaler, *Libertarian Paternalism is Not and Oxymoron*, 70 U. Chi. L. Rev. 1159 (2003).

5 O. Bar-Gill, *Seduction by Plastic*, 98 Nw. U. L. Rev. 1373 (2004).

dictated by caprice or by fashion or perhaps by ignorance."[6] The issue is whether the findings of behavioral economics raise sufficient doubt about the assumption that consumers are rational utility maximizers to undermine this fundamental respect for revealed preferences.

This article begins with the modern economic approach to consumer protection, which is based on the economics of information and transaction-cost economics. It then turns to a brief review of the decision-making problems that behavioral economists have identified. Section III discusses the limitations of behavioral economics: its heavy reliance on experimental evidence, the lack of a clear theory of which behavioral biases matter in any particular context, the need to examine the effect of possible biases on the market equilibrium, and the limited empirical evidence addressing the benefits and costs of behavioral remedies. The final section discusses the relationship between behavioral economics and consumer protection policy.

## I. The Economics of Consumer Protection

The twin foundations of consumer protection policy are the economics of information and transactions costs. Contrary to the assumptions of the perfectly competitive model, consumers do not have complete information about all products and all providers. Intervention may be necessary to prevent consumer deception, or to assure that consumers have sufficient information to make reasonable choices. Moreover, transactions are not cost-free, particularly when they require legal action to enforce their terms. When small amounts are at stake, it may not be worthwhile for consumers individually to enforce contractual rights, but the aggregate costs of breach of contract can be quite significant.

THE TWIN FOUNDATIONS OF CONSUMER PROTECTION POLICY ARE THE ECONOMICS OF INFORMATION AND TRANSACTIONS COSTS.

### A. THE ECONOMICS OF INFORMATION

Since at least George Stigler's seminal 1961 article,[7] economists have recognized that the cost of acquiring information is an important issue in many markets. Consumers must decide how much information to acquire, and will not find it worthwhile to obtain complete information about every alternative. Because information will usually have value in the future as well as in the present, decisions about information acquisition are investment decisions. Consumers can obtain information from their own search across competing sellers in the market, they can purchase information from third-party intermediaries such as Consumer

6 FTC v. Algoma Lumber Co., 261 U.S. 67, 78 (1934) (citations omitted).

7 G. J. Stigler, *The Economics of Information*, 64 J. POL. ECON. 213 (1961).

Reports, they can hire experts to assist them with difficult decisions, or they can obtain information from advertising.

Advertising is a particularly important source of information for most consumers in most markets. Because advertising reduces the cost of search, it is, in Stigler's phrase, "an immensely powerful instrument for the elimination of ignorance."[8] Advertising may provide information directly, as it does when retail stores advertise the prices of various items, or when sellers describe easily verifiable characteristics of their products (available colors, size, and the like, frequently identified as search characteristics). It may provide information about characteristics that are more difficult for consumers to verify, such as whether a product will relieve minor pain or a stuffy nose, or the gas mileage of a new car. Advertising may also serve as a signal of product quality. If sellers depend on repeat purchases, then sellers of higher quality goods can signal their quality with greater advertising expenditures.[9] Advertising may also serve as a performance bond, because sellers may lose their intangible investment in advertising if they do not deliver the promised quality.[10]

Two insights from the economics of information are critical in understanding consumer protection policy. First, in a world of imperfect information, sellers have strong incentives to provide information to consumers. Of course, some sellers may try to take advantage of ill-informed consumers, and others may actively mislead consumers. Other sellers, however, will profit if they provide the information, and the product options, that consumers value. The incentive to provide positive information is straightforward, but the unfolding principle implies that sellers will also provide information about negative product characteristics. Sellers with less of the negative characteristic than others will reveal that advantage, which in turn will create incentives for others to disclose, until all but the worst seller discloses.[11]

Second, it is possible to achieve perfectly competitive outcomes without perfectly informed consumers. As long as an informed minority large enough to be worth competing for exists, competition for those who are informed will drive all sellers to provide product characteristics that informed buyers' value.[12] Even in

8 *Id*. at 220.

9 P. Nelson, *Advertising as Information*, 82 J. Pol. Econ. 729 (1974).

10 B. Klein & K. B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615 (1981).

11 Unfolding occurs if consumers assume that absent disclosure, a product is worse on the characteristic than products that disclose. *See* S. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & Econ. 461 (1981); and P. Rubin, *The Economics of Regulating Deception*, 10(3) Cato J. 667 (1991).

12 A. Schwartz & L.L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. Pa. L. Rev. 630 (1979).

standard form contracts, the marginal informed consumer drives the contract terms that are offered to all consumers.[13]

Case studies of advertising restrictions, whether they restrict the ability to advertise at all or restrict specific content, demonstrate that seller-provided information produces important market benefits for consumers.[14] When sellers can advertise more freely, prices fall, and products are improved, compared to circumstances in which advertising is restricted. The value of advertising in enhancing market performance is well-documented, and protecting this flow of information is a key element of consumer protection.

Consumer protection economists have borrowed many insights about the flow of information in markets from the marketing literature. Marketing studies have found that consumer misunderstanding of advertising and other communications is commonplace, with a quarter to one-third of consumers generally giving incorrect answers to questions about the communication.[15] The fact that some consumers will misunderstand virtually any communication creates the need to distinguish actionable deception from simple mistakes.

At times, the FTC has attempted to protect consumers from what can only be described as idiosyncratic misinterpretations, contending, for example, that consumers might believe a "permanent" hair dye would color hair that had not yet grown out and that consumers might really think a one volume desktop encyclopedia actually did contain "everything you've ever wanted to know on every conceivable subject." Such efforts, however, plainly interfere with efforts to communicate with consumers, and have long since been abandoned.[16] Claims are not actionable unless they mislead a sufficiently large fraction of the audience, a test

13 For evidence addressing shopping for standardized franchise contracts, *see* J.H. Beales & T.J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence*, 2 J. Corp. Fin.: Contracting, Organization & Governance 157 (1995). For evidence of shopping for personal loan terms, *see* J.R. Barth, J.J. Cordes, A.M.J. Yezer, *Benefits and Costs of Legal Restrictions on Personal Loan Markets*, 29 J.L. & Econ. 157 (1986).

14 The first study finding that advertising reduced price was L. Benham, *The Effect of Advertising on the Price of Eyeglasses*, 15 J.L. & Econ. 337 (1972). For evidence of the impact of health claims on the market, *see* P.M. Ippolito & A.D. Mathios, *Information, Advertising and Health Choices: A Study of the Cereal Market*, 21 RAND J. Econ. 459 (1990). Other studies of both price and quality benefits of seller-provided information are identified in J. Howard Beales & Timothy J. Muris, State & Federal Regulation of National Advertising ch. 2 (1993).

15 For broadcast advertising, *see* J. Jacoby, W. D. Hoyer & D. A. Sheluga, Miscomprehension of Televised Communications (Am. Ass'n Advertising Agencies, Nov. 1980). *See also* 46 J. Marketing 12-43 (1982) for a summary of the study, critical comments on its validity, and a rejoinder. For print advertising, *see* J. Jacoby & W. D. Hoyer, *The Comprehension/Miscomprehension of Print Communication: Selected Findings,* 15 J. Consumer Res. 434 (1989).

16 The Commission formally abandoned the so-called "fools test" when it adopted the Deception Policy Statement in 1983. The emergence of the FTC's modern approach to advertising regulation is discussed in detail in Beales & Muris (1993), *supra* note 14.

that is ultimately an empirical one based on advertising copy tests of the communication in question.[17]

One key aspect of communicating information in the market is getting the consumer's attention. Like information, attention is a scarce resource, and must be allocated to some things rather than others. Many advertising techniques, such as celebrity endorsements, can be understood in part as attention-getting devices. Attention-getting devices, however, like other aspects of advertising, are subject to "wear out"; that is, an advertisement which is initially effective loses impact with more repetition.[18]

The marketing literature is also the source of the notion of information overload.[19] Providing too much information can lead consumers to ignore the information entirely. If we consider the cost of obtaining information, part of the cost of obtaining the relevant and interesting information is the irrelevant or less useful information that one must process first to obtain those useful nuggets. Unless additional information is well-organized and presented, too much information raises the costs of finding what the consumer is most interested in, and may lead the consumer to ignore the communication entirely.

An additional form of information overload is relevant to sellers. Requirements to provide more information raise the cost of conveying a message to consumers, especially in advertising. When particular claims "trigger" disclosure requirements, advertisers may choose to avoid the triggering claims entirely.[20] For example, the regulatory requirement to provide a "brief summary" of prescribing information with prescription drug advertisements effectively prohibited direct-to-consumer advertising on television until the requirement was removed.

Finally, additional information may lead consumers to make inferior choices, particularly if it suggests that consumers should consider a factor that is not actually relevant to the decision. Disclosing a mortgage broker's compensation from

17 For a brief description of the FTC's analytical approach, *see* Pauline Ippolito, Consumer Policy at the FTC, Presentation at the FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), *available at* http://www.ftc.gov/be/consumerbehavior/docs/transcript/transcriptc.pdf.

18 *See, e.g.,* C.S. Craig, B. Sternthal & C. Leavitt, *Advertising Wearout: An Experimental Analysis*, 13 J. Marketing Res. 365 (1976); A.J. Rethans, J.L. Swasy & L.J. Marks, *Effects of Television Commercial Repetition, Receiver Knowledge, and Commercial Length: A Test of the Two-factor Model*, 23 J. Marketing Res. 50 (1986).

19 *See* the discussion in J.P. Mulholland, Summary Report on the FTC Behavioral Economics Conference 25 (2007) (mimeo) (on file with the FTC), *at* http://www.ftc.gov/be/consumerbehavior/docs/070914mulhollandrpt.pdf [hereinafter Mulholland Summary]. *See also* J. Rudd, *The Consumer Information Overload Controversy and Public Policy*, 2 Pol'y Stud. Rev. 465 (1983).

20 H. Beales, R. Craswell & S.C. Salop, *The Efficient Regulation of Consumer Information*, 24 J.L. & Econ. 491 (1981).

yield spread premiums, for example, reduced the consumer's ability to identify the lowest cost mortgage.[21]

In short, imperfect information may lead to the need for government intervention in markets. The goal, however, is not perfection, an objective that is not worth the costs and may well be counterproductive. Consumer protection policy recognizes the need to preserve information markets and their mechanisms to convey information, and to carefully structure interventions that are compatible with how consumers actually process information.

CONSUMER PROTECTION POLICY RECOGNIZES THE NEED TO PRESERVE INFORMATION MARKETS AND THEIR MECHANISMS TO CONVEY INFORMATION, AND TO CAREFULLY STRUCTURE INTERVENTIONS THAT ARE COMPATIBLE WITH HOW CONSUMERS ACTUALLY PROCESS INFORMATION.

## B. TRANSACTION COSTS

A second pillar of the economic analysis of consumer protection issues involves transaction costs. In the real world, consumers bear costs to negotiate, form, and enforce contracts. Government policies can help to reduce these costs. Indeed, the basic legal rules against fraud and breach of contract are the foundations of consumer protection.

To minimize transaction costs, the government provides default rules for contract terms that the parties have not expressly negotiated. Generally, defaults are not binding—parties can contract around the default if a different rule serves their purposes. But selecting the default that most parties would choose eliminates the need for them to consider and negotiate about a variety of remote contingencies. They can simply rely on the default rules.[22]

Transactions costs are also relevant in many government enforcement actions. Although consumers may have private rights of action, the high cost of using the legal system may in effect preclude consumers from enforcing those rights. Government agencies, such as the FTC, can enforce contractual rights on consumers' behalf.[23]

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21 J. Lacko & J. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, FTC BUREAU OF ECONOMICS STAFF REPORT (2004), *available at* http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf.

22 *See* I. Ayres & R. Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Default Rules*, 101 YALE L.J. 729 (1992); C.J. Goetz & R.E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985).

23 *See* T.J. Muris, The Federal Trade Commission and the Fugure Development of U.S. Consumer Protection Policy, Remarks before the Aspen Summit, Cyberspace and the American Dream, The Progress and Freedom Foundation, Aspen, Colorado (Aug. 19, 2003), *available at* http://www.ftc.gov/speeches/muris/030819aspen.shtm.

## II. Behavioral Economics

Even with perfect foresight, people make mistakes, and, as a result, sometimes will make decisions that are contrary to their self-interest. Although we might sometimes wish to protect individuals from the consequences of those errors, few would think that random errors in decisions would justify significant intervention in the market. The heart of the behavioral economics proposition, however, is that errors are not random. Instead, behavioralists argue, consumer behavior displays systematic departures from the idea of rational utility maximization, particularly in the face of risk and uncertainty.

Behavioral economists and others have identified a number of biases in decision-making.[24] Choices exhibit "framing" effects; that is, consumers are more likely to find a choice attractive if it is presented as a potential gain, rather than presenting an equivalent choice as an expected loss. At least in some experiments, consumers suffer from "endowment effects," which lead them to value something more once they have it; that is, they require a larger payment to part with a particular product than they are willing to pay to acquire the product.

Consumers may experience "choice overload." If there are too many choices, they may decide not to choose at all. Similarly, they may exhibit "status quo bias," which is when they let the default rule make a decision for them. If the default rule is that consumers must "opt out" of a choice, whether it is organ donation[25] or an employer-sponsored savings plan,[26] most consumers will participate. If, however, the default rule is "opt in," most consumers will not participate. In either case, most consumers do not exercise their option to choose. Thus, choosing the default in fact determines the outcome for most consumers.

Behavioralists also argue that consumers have difficulty estimating probabilities, in particular relatively low probabilities, and appear to overestimate the likelihood of dramatic events such as airplane crashes. Because such events are widely publicized, they are more "available" to consumers, who consequently overestimate their frequency relative to more common events that garner less attention. If consumers are given an "anchor" for some quantity they are asked to estimate, estimates tend to be near whatever anchor is given. Estimates are more accurate without an anchor.

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24 There is, as yet, no generally agreed on set of behavioral effects or terminology to describe them. This categorization draws heavily on the lists developed in the OECD (*supra* note 1) and Australian (*supra* note 3) Reports. Another useful categorization focused on factors relevant to excessive borrowing can be found in C.R. Sunstein, *Boundedly Rational Borrowing*, 73 U. Chi. L. Rev. 249 (2006).

25 E. Johnson & D. Goldstein, *Do Defaults Save Lives?*, 302 Sci. 1338 (2003).

26 Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q.J. Econ. 1149 (2001).

Finally, consumers exhibit a present bias, or hyperbolic discounting. This bias has also been characterized as myopia or self-control problems. Consumers will choose a small reward today over a larger reward later. However, if both rewards are far in the future, then they will frequently choose the larger reward. Choosing short-term gains at the expense of long-term costs can lead to short-term decisions that generate long-term distress.

## III. The Limits of Behavioral Economics

Behavioral economists have produced a number of intriguing results, which point the way to possible refinements of the standard model of the rational, utility-maximizing consumer with stable preferences. There is every reason to hope that a more fine-grained understanding of consumer decision-making processes can lead to better assumptions, and thus to better predictions of what will happen in actual markets. Nonetheless, the ultimate test of a theory remains the validity of its predictions, rather than the accuracy of its assumptions.[27] In that aspect, behavioral economics remains in its infancy.

Four interrelated concerns limit the potential applicability of behavioral economics to consumer protection policies. First, the experimental evidence that provides the most compelling evidence supporting various behavioral biases may not predict real-world behavior in markets. As always, there are issues about whether behavior in the laboratory reflects actual behavior when real money is at stake, but far more important is whether laboratory measures based on average responses can tell us much about the behavior of the marginal consumers who drive the economic equilibrium. Second, there is no consistent and coherent body of behavioral theory yielding clear predictions about which biases might be relevant in a given situation. Instead, both predicted effects and the predicted impact of possible interventions are somewhat ad hoc. Third, to date there has been relatively little exploration of the implications of particular biases for the nature of the economic equilibrium (although this state of affairs is beginning to change). As a result, we know little about likely or actual market responses to the phenomena that behavioralists have identified. Finally, we have little, if any, reliable empirical evidence addressing the benefits and costs of possible interventions based on behavioral principles.

### A. EXPERIMENTS AND REAL-WORLD BEHAVIOR

The primary evidence supporting behavioral economics predictions is experimental, derived in a wide variety of laboratory settings. There is much that can be learned from experimental economics, and practitioners have made great strides in creating experimental environments that mirror real markets as closely as possible. Moreover, empirical behavioral economics research is increasingly moving

27 Milton Friedman, *The Methodology of Positive Economics*, *in* Essays in Positive Economics (1953).

to field experiments, in which an offer is manipulated in the context of an actual choice in the market.[28] Nonetheless, laboratory findings remain the foundation of behavioral economics. By their nature, experiments are designed to test predictions; they do not in and of themselves generate testable hypotheses.

From the beginnings of experimental economics, there have been questions about the applicability of laboratory results to real-world economic problems. The level of motivation and attention that consumers devote to solving problems in the real world may differ from what consumers bring to the laboratory.[29] Experimental studies find that higher rewards tend to shift observed outcomes toward the predictions of the rational choice model,[30] and that the real-world consequences of decisions are likely large compared to the typical laboratory payoff. For example, higher paid workers with more to lose from poor choices are less likely to rely on default choices for retirement plans.[31]

Inherently, any experiment tests for both a behavioral effect and the impact of the laboratory setting. Disentangling the separate effects is often difficult.[32] Plott and Zeiler (2005), for example, find endowment effects in simple procedures with limited controls for possible misconceptions about the experimental task. With comprehensive controls for misconceptions, including an incentive-compatible mechanism to elicit valuations, comprehensive explanations, paid practice rounds, and anonymity, the effect disappears.[33] The endowment effect appears in many policy discussions, but it may be an artifact of the experimental procedures used to observe it.

Most importantly, experiments measure the difference in some outcome between the average member of a test and a control group. Crucial to the economic equi-

28 For example, much of the research presented at the FTC Conference on Behavioral Economics and Consumer Policy, *supra* note 2, was based on field experiments.

29 S. Levitt & J. List, What Do Laboratory Experiments Tell Us About the Real World? (2006) (mimeo, University of Chicago and NBER), *available at* http://pricetheory.uchicago.edu/levitt/Papers/jep%20revision%20Levitt%20&%20List.pdf; and J. List, *The Behavioralist Meets the Market: Measuring Social Preferences and Reputation Effects in Actual Transactions*, 114 J. Pol. Econ. 1 (2005).

30 Vernon L. Smith & James M. Walker, *Monetary Rewards and Decision Cost in Experimental Economics*, 31 Econ. Inquiry 245 (1993).

31 Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q.J. Econ. 1149 (2001).

32 H. Ergas, Policy Implications of Behavioural Economics: The Case of Consumer Protection, Paper presented at the Australian Productivity Commission's Roundtable on Behavioural Economics and Public Policy, Melbourne (Aug. 9, 2007).

33 C. Plott & K. Zeiler, *The Willingness to Pay–Willingness to Accept Gap, the "Endowment Effect," Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95(3) Am. Econ. Rev. 530 (2005).

librium, however, is the behavior of the marginal buyer. We would expect the average consumer who participates in a market to believe that purchasing the product increases utility. The marginal purchaser, however, is indifferent between buying and not buying—and (given supply) it is the marginal purchaser who determines the market price. Experiments describing average behavior tell us little about the marginal behavior that most matters in markets.[34] Moreover, forced choices in experiments may differ from market behavior, where one of the options is not to participate at all. Given the choice in an actual market, participants whose behavior drives experimental results may simply choose not to play.[35]

Changes in consumer protection policy or interventions based on behavioral principles will play out in real markets. Before adopting such policies, we should have some empirical evidence that the particular principle supporting the intervention is actually observable in the marketplace. At present, such evidence is scant.

BEFORE ADOPTING SUCH POLICIES, WE SHOULD HAVE SOME EMPIRICAL EVIDENCE THAT THE PARTICULAR PRINCIPLE SUPPORTING THE INTERVENTION IS ACTUALLY OBSERVABLE IN THE MARKETPLACE. AT PRESENT, SUCH EVIDENCE IS SCANT.

## B. WHEN DO BEHAVIORAL THEORIES APPLY?

By and large, particular predictions of behavioral economics have a specific theoretical basis, often drawn from psychology; that is, each predicted departure from fully informed rational decision-making has a theoretical basis. As the Australian Productivity Commission noted, however, a common theme of the behavioralist literature is that behavior depends on the environment,[36] and there is no cohesive body of theory that tells us which departures are likely to be important in any particular context.[37]

Consider, for example, cooling-off periods, a remedy that some behavioral economists have advocated to allow consumers to overcome the biases of hyperbolic discounting or myopia.[38] One could argue equally well that a cooling-off

34 E. Lazear, Remarks at the FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), at 14, *available at* http://www.ftc.gov/be/consumerbehavior/docs/transcript/transcriptopen.pdf.

35 E. Lazear, U. Malmendier & R. Weber, Sorting in Experiments with Application to Social Preferences (Nat'l Bureau of Econ. Research, Working Paper No. 12041, 2006), *available at* http://www.nber.org/papers/w12041.

36 Australian Report, *supra* note 3, at 311.

37 N. Berg & G. Girgerenzer, *Psychology Implies Paternalism? Bounded Rationality May Reduce The Rationale To Regulate Risk-Taking*, 28 Soc. Choice Welfare 337 (2007), J. Klick & G Mitchell, *Government Regulation of Irrationality: Moral and Cognitive Hazards*, 90(6) Minn. L. Rev. 1620 (2006).

38 OECD Report, *supra* note 1, at 17.

period reduces the perceived risk of a purchase, and that consumers will overestimate the likelihood that they will revisit their decision. Moreover, once the purchase is made, one might expect that the status quo bias would be relevant, and consumers would be reluctant to part with their purchase.[39] On these arguments, cooling-off periods might reduce consumer welfare. The vast majority of purveyors of fraudulent products that the FTC has pursued offer money-back guarantees, which would seem to be the functional equivalent of a cooling-off period. It seems safe to say that these sellers are trying to reduce the perceived risk of the purchase, not providing a chance for consumers to reconsider their decision.

Similarly, consider the impact of credit card rewards programs. Some argue that because the rewards reduce the effective cost of current purchases, consumers who exhibit hyperbolic discounting may increase current purchases, resulting in more future debt.[40] Others argue that credit cards reduce the pain of paying, and may therefore lead to "over-indebtedness"[41] or the systematic overuse of credit cards.[42] Rewards cards, which literally pay consumers for current transactions, should be particularly prone to this bias. Either argument implies that consumers who obtain a new rewards card should be more likely to carry a balance on the card than those who obtain new cards without a rewards feature. Still others argue that rewards are often deferred, thereby reducing their importance for current choices, or that the fear of effectively losing the reward by having to pay interest on an outstanding balance would reduce the incentive to carry a balance on a rewards card.[43] In fact, consumers are less likely to carry a balance on a new rewards card than on other new cards,[44] contradicting one behavioral story, but not the other. Testing the applicability of a theory to real markets is difficult when its predictions are so uncertain.

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39 J.P. Mulholland, Behavioral Economics and the Federal Trade Commission, Paper presented at the Australian Productivity Commission's Roundtable on Behavioural Economics and Public Policy, Melbourne (Aug. 9, 2007); and Mulholland Summary, *supra* note 19, at 27.

40 Bar-Gill (2004), *supra* note 5.

41 G. Loewenstein & T. O'Donoghue, *'We Can Do This the Easy Way or the Hard Way': Negative Emotions, Self-Regulation, and the Law*, 73 U. Chi. L. Rev. 183 (2006).

42 R.J. Mann, Credit Cards, Consumer Credit & Bankruptcy (University of Texas School of Law, Law and Economics Working Paper No. 044, 2005), *available at* http://www.ssrn.com/abstract=690701.

43 Transcript of Session F, Consumer Choice: Credit Cards, FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), at 39-40, *available at* http://www.ftc.gov/be/consumerbehavior/docs/transcript/transcriptf.pdf.

44 J.H. Beales & L.L. Plache, Rationality, Revolving, and Rewards: An Analysis of Revolving Behavior on New Credit Cards, Paper presented at the FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), *available at* http://www.ftc.gov/be/consumerbehavior/docs/papers/Beales_Plache_Paper.pdf.

Using behavioral principles as a basis for policy interventions requires policymakers to assume that the relevant principle is applicable in the context of that intervention. Without a theory that predicts which deviation from rational choice is most important in a particular context, there is little basis for that assumption. Particularly in the absence of a clear theoretical basis, policy interventions should have a more solid foundation than laboratory experiments.

## C. BEHAVIORAL ECONOMICS AND MARKET EQUILIBRIUM

Compared to other social sciences, a unique component of economic analysis is the concept of equilibrium.[45] Economics is the study of consumer and producer behavior, moderated by the market, and it is the outcome of that interaction that is critical to either understanding or influencing market results. Because marginal, not average, consumers determine market outcomes, even if many consumers deviate from rational choice, the resulting market equilibrium may be essentially what the rational choice model would predict. Schwartz, for example, finds that if some buyers are naïve and others are not, competition may drive out contracts that take advantage of naïve buyers.[46] As with imperfect information, the flaw does not necessarily prevent efficient outcomes.

Two aspects of market interaction are particularly important in considering the policy implications of behavioral economics. First, consumers learn, from both their good experiences and their mistakes, and learning reduces the influence of deviations from rational choice. Second, firms' responses to consumer biases may moderate their influence, and may create profit opportunities for products and services that either avoid or correct the bias. Without equilibrium models, we cannot assess the impact of any particular bias on market outcomes.

Consumers who exhibit behavioral biases experience losses. These losses may be actual losses, or they may be opportunity losses in the sense that a choice yielding higher utility was available. There is every reason to expect that consumers will learn from their experience, in particular when the losses are actual losses.[47] The consumer will likely make a different decision from the one that led to the loss the next time the situation arises. Experiments that allow participants to learn over time find that learning eliminates observed behavioral phenomena in at least some circumstances. John List (2003), for example, investigated endowment effects in trading card markets, and found that "individual behavior

45 E. Lazear, *Economic Imperialism*, 115(1) Q.J. Econ. 99 (2000).

46 Alan Schwartz, *How Much Irrationality Does the Market Permit?*, 37 J. Legal Stud. (forthcoming 2008).

47 Richard A. Epstein, *Behavioral Economics: Human Errors and Market Corrections*, 73 U. Chi. L. Rev. 111 (2006).

converges to the neoclassical prediction as market experience increases."[48] Actual market participants are frequently repeat players, and may have considerable market experience. Moreover, learning may also be more general, leading consumers to make better choices in similar situations.

In general, consumers can make investments (such as in education) to learn how to make decisions in a particular type of choice situation, or they can learn from their experience with such choices over time.[49] Either approach to learning has costs and produces a stock of human capital, which yields benefits in the form of better decisions over time. Additional experience adds to that stock. Moreover, the stock of human capital is presumably subject to depreciation, either in the form of forgetting or changing circumstances that reduce the relevance of past knowledge or experience. Thus, the human capital stock is likely to increase over time as investments are made, and eventually decline as reduced investment incentives and depreciation take their toll.

In the credit card market, there is evidence that consumers learn from the experience of paying late fees to avoid the fees in the future. There is also evidence of forgetfulness, leading to additional mistakes. The probability of owing late fees because of forgetfulness declines with age until sometime in middle age, and then increases again.[50] A similar pattern has been observed in other financial decisions.[51] This is exactly what one would expect from a stock of human capital in bill-paying habits. Miravete and Palacios-Huerta (2004) also found that consumers learned rapidly to make optimal decisions about which telephone pricing scheme to choose.[52]

Firm responses are also likely to affect the market relevance of behavioral findings. Consider framing, for example. Although sellers can presumably take advantage of framing in the way they present a product or service, the market consequences are unclear. Consumers make their choices in a marketplace in which sellers of competing alternatives will also seek to frame their offerings in

48 John A. List, *Does Market Experience Eliminate Market Anomalies?*, 118 Q.J. Econ. 41 (2003).

49 Becker and Stigler use the household production model to explore a number of situations in which human capital stocks are important. *See* G.J. Stigler & G.S. Becker, *De Gustibus Non Est Disputandum*, 67 Am. Econ. Rev. 76 (1977).

50 S. Agarwal, J. C. Driscoll, X. Gabaix & D. Laibson, Stimulus and Response: The Path from Naïveté to Sophistication in the Credit Card Market (Aug. 2006), Paper presented at the FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC (Apr. 20, 2007), *available at* http://www.ftc.gov/be/consumerbehavior/docs/Agarwal_Driscoll_Gabaix_Laibson.pdf.

51 S. Agarwal, J. Driscoll, X. Gabaix & D. Laibson, The Age of Reason: Financial Decision-Making over the Lifecycle (MIT Department of Economics, Working Paper No. 07-11, 2007).

52 E. Miravete & I. Palacios-Huerta, Rational Attention in a Repeated Decision Problem (2004) (mimeo, University of Texas), *available at* http://www.eco.utexas.edu/facstaff/Miravete/papers/EJM-IPH.pdf.

the best possible light. Advertisers, for example, are skilled at highlighting product benefits, but the evidence is clear than advertising enhances market performance. Similarly, if alternative choices are each framed in the way that is most likely to appeal to consumers, there is little reason to think framing distorts those choices.

Firms' incentives to sell their product can affect the market response to other potential behavioral biases as well. If, for example, consumers discount future consequences too heavily, sellers of products or services with long-term benefits have incentives to try to make those consequences more vivid and more salient to the consumer.[53] If complex pricing plans are difficult for consumers to understand, firms in competitive markets have incentives to simplify those plans to attract customers.[54]

THE MIX OF CONSUMERS, CONSUMER LEARNING, AND FIRM RESPONSES TO CONSUMER CHOICE PATTERNS WILL INFLUENCE THE MARKET EQUILIBRIUM THAT RESULTS, EVEN IF BEHAVIORAL PRINCIPLES ARE RELEVANT TO SOME CONSUMERS. WITHOUT UNDERSTANDING THE EQUILIBRIUM MARKET IMPACT OF PARTICULAR BIASES, THERE IS LITTLE BASIS FOR POLICY INTERVENTION.

The mix of consumers, consumer learning, and firm responses to consumer choice patterns (or mistakes) will influence the market equilibrium that results, even if behavioral principles are relevant to some consumers. Without understanding the equilibrium market impact of particular biases, there is little basis for policy intervention. As the Australian Productivity Commission noted, "conventional economic models explain outcomes 'as if' people behave optimally. The inability to pinpoint the dynamic, actual process that makes most markets efficient, is simply reflective of why Adam Smith called it the *invisible* hand."[55]

## D. BENEFITS AND COSTS OF BEHAVIORAL REMEDIES

Experimental economics certainly has a valuable place in the literature, but it is generally unwise to treat public policy as an uncontrolled experiment. Before intervening in admittedly imperfect markets, policymakers should have a sound basis for concluding that the benefits of the intervention will exceed the costs and that the intervention will in fact increase consumer welfare.

Advocates of "soft" paternalism, whether asymmetric or libertarian, recognize the need for careful cost-benefit analysis of possible interventions. Soft paternalists have generally focused on interventions with a relatively limited impact on

53 This point was made by Pauline Ippolito at the FTC conference. *See* Mulholland Summary, *supra* note 19, at 23.

54 E. Miravete & I. Palacios-Huerta (2004), *supra* note 52.

55 Australian Report, *supra* note 3, at 319.

the choices consumers can actually make, such as the choice of default rules. These approaches allow consumers who think the choice is important and worth considering to pursue their own preferences. Nonetheless, advocates have recognized the need for careful cost-benefit analysis of particular proposals.

The asymmetric paternalism test seeks to adopt regulations that create benefits for those who make errors, but impose little or no harm on those who make correct decisions.[56] Its developers conclude that "a richer sense of the costs and benefits of regulation on individual market actors is a necessary step in the design of proper regulatory mechanisms."[57] As Mulholland (2007) has noted, the approach is very similar to the FTC's approach to analyzing possibly "unfair" practices. A practice is unfair if it causes substantial consumer injury, without offsetting benefits to consumers or competition, that consumers cannot reasonably avoid.[58] Libertarian paternalism also argues for cost-benefit analysis when possible, but allows the use of "rules of thumb" when cost-benefit analysis is too difficult or expensive.[59]

Hard paternalism advocates have been more willing to consider significant restrictions on consumer choices. Bar-Gill (2003), for example, considers policies to address behavioral biases in the credit card market ranging from stronger disclosures to prohibitions on late fees in unsolicited card offers to usury ceilings. Because these more restrictive policies would deny many consumers a choice that has emerged from competitive markets, they are far less likely to pass a cost-benefit test. Nonetheless, Bar-Gill challenges nonintervention, but "does not make an affirmative case for intervention. To make such a case would require a comprehensive cost-benefit analysis of the proposed policy response."[60]

The need for careful empirical analysis of specific interventions based on behavioral principles has been widely noted. At the FTC conference on behavioral economics, there was widespread agreement that careful analysis of specific proposals is an essential prerequisite to policy changes. At present, we simply do not have the empirical base to support significant policy changes.[61] Mulholland's

56 C. Camerer, S. Issacharoff, G. Loewenstein, T. O'Donoghue & M. Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"*, 151 U. PA. L. REV. 1211 (2003).

57 *Id.* at 1251.

58 Mulholland (2007), *supra* note 39. For a description of the FTC's current approach to unfairness analysis, *see* J.H. Beales, *The Federal Trade Commission's Use of Unfairness Authority: Its Rise, Fall, and Resurrection*, 22(2) J. PUB. POL. & MARKETING 192 (2003).

59 Sunstein & Thaler (2004), *supra* note 4.

60 Bar-Gill (2003), *supra* note 5, at 1378.

61 Mulholland (2007), *supra* note 39, at 13.

summary of the FTC conference concludes by saying "there was general agreement that more evidence based on actual market settings is required to justify" changes in consumer or competition policy.[62] Furthermore, the Australian Productivity Commission concluded: "Crucially, most policy proposals (regardless of their supporting premises) require a case-by-case, empirical evaluation of their costs and benefits."[63] Even the OECD, perhaps the most enthusiastic assessor of the potential impact of behavioral economics on policy, concluded: "[A]lthough there has been significant research in some areas (for example in certain financial markets), a more specific evidence base still needs to be identified before there is a more widespread policy approach."[64]

## IV. Behavioral Economics and Consumer Protection Policies

Many of the key insights of behavioral economics are already a part of consumer protection policy.[65] Consumer protection economists have long understood that consumer interpretation of information, whether seller-provided or government-mandated, is ultimately an empirical question. In a world of costly information and costly transactions, consumers may rationally choose to remain imperfectly informed, and may rationally decide that the benefit of engaging in a transaction is simply not worth the cost. Similarly, the possibility that consumers may misinterpret information so that additional information may lead to worse decisions has long been recognized. Thus, consumer protection policy requires careful attention to the actual marketplace behavior of consumers.

Some behavioral phenomena fit comfortably within the conventional framework discussed in the previous sections. Choice overload, for example, if not the same is certainly a close cousin of the long-recognized phenomenon of information overload. It does not imply that consumers would wish to limit their choices, any more than information overload implies that consumers do not value more information. The lesson of information overload is that remedies must be considered cautiously, because providing additional useful information may actually be counterproductive. Choice overload has the same implication: mandating additional choices may make things worse. Even though bundling may reduce choice, it may be an efficient solution once the costs of making a decision are taken into account.

62 Mulholland Summary, *supra* note 19, at 24.

63 Australian Report, *supra* note 3, at 324.

64 OECD, *supra* note 1, at 5.

65 In the context of Australian consumer policy, which is broadly similar to the U.S. approach, the Australian Productivity Commission reached a similar conclusion: "Much policy is already based on, or implicitly accounts for, behavioral tenets." Australian Report, *supra* note 3, at 309.

In a world of imperfect information, an important dimension of competition among sellers is what information to provide and how best to convey that information to consumers. Sellers have incentives to avoid information overload, because it will undermine the message they are trying to convey. Similarly, if too many choices create problems for consumers, sellers have incentives to simplify the options. Miravete (2007), for example, finds that increased competition led to simplified pricing plans for wireless services.[66] Sellers can also simplify choices with bundling by offering, for example, a package of sports channels rather than requiring consumers to consider each component separately.

> THE LESSON OF INFORMATION OVERLOAD IS THAT REMEDIES MUST BE CONSIDERED CAUTIOUSLY, BECAUSE PROVIDING ADDITIONAL USEFUL INFORMATION MAY ACTUALLY BE COUNTERPRODUCTIVE. CHOICE OVERLOAD HAS THE SAME IMPLICATION: MANDATING ADDITIONAL CHOICES MAY MAKE THINGS WORSE.

One benefit of relying on markets wherever possible is that markets reveal what is important and what is not. If information about a particular product feature is important to consumers, then there are strong incentives for sellers to provide that information. Similarly, if particular options are valued, then there are incentives to offer them. In either case, there is also feedback to sellers that can correct mistaken or no longer valid assumptions that information or a choice was valued. Regulatory policies rarely offer such feedback.

Other behavioral phenomena can be understood in a transaction-cost framework. The importance of default rules, for example, may simply reflect the fact that making decisions is costly, and, when the consequences of the decision are small, it may not be worth the effort. Thus, the default prevails, regardless of how it is determined. If, for example, most consumers do not consider the privacy costs of commercial information sharing to be significant, they are unlikely to read privacy notices or exercise whatever choices may be permitted.[67] The default rule determines whether information sharing is permitted or not, not because of status quo bias, but simply because the decision itself is not worth the effort for most consumers. As with information provision, default rules that place costs on those who believe the decision is important protect those who are concerned without imposing costs on those who believe the costs are not worth bearing.

Behavioral economics offers many useful insights into consumer behavior, and can inform policy choices. Like other interventions, however, choices based on

66 Eugenio J. Miravete, The Doubtful Profitability of Foggy Pricing (2007) (mimeo, University of Texas), *available at* http://www.eco.utexas.edu/facstaff/Miravete/papers/EJM-Foggy.pdf.

67 J.H. Beales & T.J. Muris, Choice or Consequences: Protecting Privacy in Commercial Information, 75 U. CHI. L. REV. (forthcoming 2008).

behavioral principles must be tested against actual market behavior. Although much promising work is under way, at present, we do not have an empirical foundation that would justify significant changes in policy.