

# Behavioral Economics and Merger Analysis

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The papers in this volume by Eliana Garces, and Matthew Bennett, John Fingleton, Amelia Fletcher, Liz Hurley & David Ruck provide a very clear overview of behavioral economics and its application to competition policy generally. In this note I will comment on some implications of what they have to say for merger analysis.

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## I. Introduction & Summary

The papers in this volume by Eliana Garces (“Garces”),<sup>1</sup> and Matthew Bennett, John Fingleton, Amelia Fletcher, Liz Hurley & David Ruck (Bennett *et al.*)<sup>2</sup> provide a very clear overview of behavioral economics and its application to competition policy generally. In this note I will comment, in particular, on some implications of what they have to say for merger analysis.

## II. Consumer Biases

Bennett *et al.* draw a useful distinction between consumer biases and supply side biases, and I start my comments by looking at the implications of consumer biases for merger control. (These comments are relevant only for mergers where the customers are final consumers, and the following should be read as being limited to consumer-facing mergers, even if this is not made explicit.)

In short, there are some intriguing possibilities, some of which have already begun to have a modest impact. However, the field needs further development if it is to have substantial effects. Interestingly, it is unclear whether taking on board the lessons from behavioral economics would lead to more—or less—enforcement.

ANALYZING THE REASONS WHY CUSTOMERS BEHAVE AS THEY DO CAN PROVIDE USEFUL CORROBORATION FOR OTHER EVIDENCE ABOUT THE DEMAND FUNCTION.

### A. CONSUMER DEMAND

The most obvious area where behavioral economics could influence the practice of merger analysis is in the understanding of consumer demand. The response of customers to changes in the terms of sale is at the heart of all merger analysis. It is often the most important constraint on the actions of firms in a market, and is the focus of market definition analysis.

However, merger control is, in the end, concerned with the impact of a change in market structure. The response of customers to changes in terms affects this but, in many cases, the analysis can proceed taking this response as a given. There is, therefore, an argument that there is no need to understand why customers behave as they do as long as the demand function has been correctly measured. There is some weight to this argument, though it should not be pushed too far: It may sometimes be useful to understand what underlies the demand function.

First, analyzing the reasons why customers behave as they do can provide useful corroboration for other evidence about the demand function. In this respect, the three “A”s introduced in Bennett *et al.* combine to provide a helpful organizing principle for some factors affecting the willingness of customers to switch. The three “A”s are: information about how well consumers Access information

(including search costs), how well they assess that information, and the degree of their freedom to act on it (including switching costs). However, it should not be forgotten that information about the extent to which products are, or are perceived to be, differentiated will often be more important.

Second, considering the reasons why customer responses are what they are could highlight possible ways in which the merger might affect the demand function itself, and so suggest reasons why demand should not be treated as a given. This is because firms can sometimes choose to act in ways that exploit consumer biases, causing consumers to make worse choices. Interestingly, however, it is not clear from the papers whether mergers that reduce competition mitigate or exacerbate this problem.

Both papers note that competition can sometimes reduce the extent to which firms benefit from exploiting consumer biases. This can happen if firms can take customers from their rivals by making a virtue of their plain dealing. In these cases, a merger that reduces competition could potentially lead to worse outcomes than would be expected from simply taking the existing demand function as a given.

Both papers also report, however, that the opposite can happen: Theoretical and empirical papers show that obfuscation and complexity can increase with competition, so that mergers that reduce competition could, in principle, make consumers better off by reducing the incentives to obfuscate.

In addition, Garces notes that advertising and branding are close cousins of some of the ways that firms can exploit consumer biases. These are areas where there is a lot of uncertainty about the relationship between the extent of competition and the level of investment by firms, and about the impact on consumers of any investments made.

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In sum, although both papers provide reasons why it may be useful to understand—as well as measure—demand, they both also suggest that our understanding of the implications of consumer biases on the effects of a merger is still in its early stages.

## B. ENTRY AND THE EVOLUTIONARY ROLE OF COMPETITION

The papers suggest that understanding more about consumer demand could affect the analysis of entry costs. For example, Bennett *et al.* note that if search is costly then firms can invest in ways to attract consumers other than by offering the best deal (by paying to be prominent on search engines, through advertising, etc.). This would make entry more costly. Whether this creates a barrier to entry, however, is unclear.

### C. PRICE DISCRIMINATION MARKETS

One area where behavioral economics could have an early impact on merger analysis is if poorly informed consumers form a vulnerable group. Competition authorities reviewing mergers will often pay particular attention to the potential effects on groups of customers that can be targeted with discriminatory prices. In some cases such vulnerable groups will be defined as separate markets. The papers suggest that “myopes” might form a vulnerable group, distinguished by their limited ability to gather and process information, or to correct for their biases.

### D. MATERIALITY

Finally, Garces especially emphasizes the problems of understanding the welfare effects of changes to a market when consumer choices are not a reliable guide to consumer welfare. This can complicate the already difficult task of deciding whether any loss of competition from a particular merger is material or not.

## III. Supply Side Biases

Although the focus of behavioral economics to date has been on the behavior of consumers, Bennett *et al.* discuss recent developments in considering the implications for the behavior of firms. This line of research could potentially have far reaching consequences for merger control, though it is too early to say what these consequences might be. Here I point to some possibilities based on the early indications in the papers.

At a basic level, the reason why research that affects our understanding about how firms behave could affect merger control is, simply, because merger control is all about predicting firm behavior. These predictions are usually based on thinking about how a profit-maximizing firm would behave. If research into behavioral economics uncovers better ways to understand how firms behave, this could obviously affect the analysis.

Bennett *et al.* stress that research in this area is in its infancy and, to date, it has done more to highlight possibilities than to generate concrete improvements in predicting firm behavior. They also note that what matters most is the change in incentives following a change in market structure, not the details of the firm’s objective function. But still it is possible to highlight some areas to watch.

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### A. ENTRY

One area where behavioral economics might have an early impact on merger analysis involves the evaluation of evidence about entry. As Bennett *et al.* note,

it is apparent that many firms enter markets when their chances of success are very slim. This has two implications for evaluating evidence on entry:

1. Attempts at entry may be more likely than would be suggested by evaluating the barriers to entry and considering whether entry would be profitable.
2. Successful entry may be less likely than would be suggested by reviewing the plans of third parties.

## B. COORDINATED EFFECTS

Another area highlighted by Bennett *et al.* is the analysis of coordinated effects. This is an area where traditional approaches to understanding how a change in market structure could affect firm behavior have not always been especially helpful to competition authorities seeking to distinguish between good and bad mergers. If behavioral economics could add to what we know, it could make an important contribution. So far Bennett *et al.* report some additional insights. Notably, coordination is generally more likely if there is a degree of trust, fostered by contact and personal relationships. However, this is not yet the clear diagnostic test that competition authorities would like.

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## C. EFFICIENCIES

Finally, behavioral economics could affect the assessment of efficiencies. On the one hand, as Bennett *et al.* note, there is some evidence that fixed and sunk cost efficiencies matter more for pricing decisions than traditional models of firm behavior would suggest. This could mean that some fixed and sunk cost efficiencies benefit consumers, whereas competition authorities often assume they could not.

On the other hand, behavioral economics reinforces what competition authorities always suspected about claims that a merger will generate efficiencies: that these should be treated with a degree of healthy scepticism. On top of the problem that efficiencies are inherently easy to claim and hard to prove, there is evidence that firms may believe in the existence of efficiencies, but be wrong. ▼

- 1 Eliana Garces, *The Impact of Behavioral Economics on Consumer and Competition Policies*, 6(1) COMPETITION POL'Y INT'L 145-52 (Spring, 2010).
- 2 Matthew Bennett, John Fingleton, Amelia Fletcher, Liz Hurley, & David Ruck, *Behavioral Economics and Competition Policy: Some Potential Implications for the Analysis of Markets and Interventions?* 6(1) COMPETITION POL'Y INT'L 111-37 (Spring, 2010).