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### **Session 3: Behavioural economics and consumer policy**

#### **Behavioral Economics and the Federal Trade Commission\***

Joe Mulholland

This paper discusses behavioral economics from the perspective of the U.S. Federal Trade Commission – past, present, and future. It begins with a brief description of the legal and economics basis of consumer protection policy at the FTC. It then describes the decision making process at the FTC and how it relates to behavioral economics approach. It turns out that the Commission has been doing a good deal of behavioral economics – if the term is considered broadly to encompass the reliance on the boundedness of consumer behavior due to cognitive and emotional shortcomings – albeit using different terminology. But there are also a number of differences that go beyond semantics where behavioral economics can offer unique insights into the consumer protection. In conclusion, I think the principle value of behavioral economics to consumer protection lies in its ability to help in the more efficient implementation of *existing* policy goals. But I am less confident about the value of behavioral economics in formulating goals for consumer protection policy not already justified by conventional economic theory.

*\* Draft, may be subject to revision prior to publication as part of the Roundtable Proceedings later this year.*

*The views expressed in this paper are those of the author and do not necessarily reflect those of the Productivity Commission.*

## **Behavioral Economics and the Federal Trade Commission**

**Joe Mulholland**

Presentation to Productivity Commission Roundtable  
on Behavioural Economics and Public Policy  
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### **I. Introduction**

My aim in this paper is to discuss behavioral economics from the perspective of the U.S. Federal Trade Commission B past, present, and future. My presentation proceeds in four parts:

- The first part provides a brief description of the legal and economics basis of Consumer protection policy at the FTC, and how it fits into the larger consumer protection field. A key point here is the consumer choice orientation of the Commission's mission, which stems from its dual role as antitrust enforcer as well as the absence of direct authority over price and product quality.
- The second part describes the decision making process at the FTC and how it relates to behavioral economics approach. My focus will be on advertising and fraud regulation, the areas where I have the most knowledge and experience. It turns out that the Commission has been doing a good deal of behavioral economics B if the term is considered broadly to encompass the reliance on the boundedness of consumer behavior due to cognitive and emotional shortcomings B albeit using different terminology. But there are also a number of differences that go beyond semantics where behavioral economics can offer unique insights into the consumer protection task.
- The third part summarizes the recent FTC conference on behavioral economics that I helped organize. Our aim was quite similar to that of the Productivity Commission in that we sought to determine the ways in which behavioral economics can help in the development and enforcement of consumer protection policy.
- In the final section I discuss a number of policy areas where the utilization of both conventional and behavioral economics can prove useful.

My views on the policy role of behavioral economics can be described in the form of answers to the two questions posed by Chairman Banks for this conference: To what extent can the behavioral approach 1) help achieve existing goals more efficiently; and 2) be used to support or justify a particular policy goal.

I think the principle value of behavioral economics to consumer protection lies in its ability to help in the more efficient implementation of *existing* policy goals. In particular, psychological insights derived from experimental and field research can be of significant help in communicating with consumers in ways that recognize their cognitive and emotional constraints. This is particularly the case for the various information policies that form the basis of consumer protection policy at the FTC and other agencies. While we know a lot about how consumers perceive various kinds of information, we are much less confident in understanding how these perceptions are acted upon in real world markets. Behavioral economics, with its focus on individual decision-making, can help close this gap.

I am, however, much less confident about the value of behavioral economics in formulating goals for consumer protection policy. This is especially so in regard to the generation of new government interventions that could not be justified on the basis of conventional economics. In fact, I think the behavioral economics literature cautions against the use of ‘hard’ paternalistic interventions by illustrating the variety of behavioral patterns that exist and the difficulties involved in attempting to divine what consumers truly prefer. Similarly, the literature illustrates the pitfalls facing the regulator attempting to identify situations where the preferences of consumers are known, but deemed to be incompatible with their overall welfare.

## **II. Consumer Protection at the FTC: The Basics**

### *1. Jurisdiction*

The FTC’s jurisdiction is a broad one, allowing the agency to challenge practices such as fraud, deceptive advertising, unilateral breach of contract, and unauthorized billing. It also enforces a number of laws legislated by congress, including credit, privacy, do not call etc. The FTC is part of a much larger consumer protection apparatus, which includes a number of independent as well as executive branch agencies. How responsibilities are divided is grounded both in subject matter, differences and specialization, as well as in history. Several other US agencies have law enforcement authority, including criminal law enforcement authority, over matters relating to consumer protection, including the Department of Justice, Federal Bureau of Investigation, U.S. Customs Service, U.S. Postal Inspection Service, and the Secret Service. In addition, all 50 U.S. states have their own versions of the FTC Act, and have their own important consumer protection policy and law enforcement authority.

One rough line dividing where the agency’s consumer protection jurisdiction ends and other agencies take over is the fact that the FTC does not have authority to directly set the price,

availability, and characteristics of good and services. Thus, for example, the Commission jointly regulates the advertising of prescription drugs with the FDA, but the FDA controls the kinds of drugs that will be allowed on the market. Similarly, the FTC's oversight over the way tires are promoted, but the Department of Transportation specifies the minimum safety standards for them.

This limited authority, along with the FTC's joint competition enforcement role, no doubt has influenced its focus on enhancing consumer choice as the dominant consumer protection policy. Without control over price and product quality, it becomes easier to avoid reaching for the more direct form of regulation utilized by other agencies. As will be discussed, the Commission does have indirect ways to come to the same end, and clearly does influence both price and quality in the market. But for the most part it has focused on developing the kinds of competitive environments where output and price are instead determined by market processes. In a nutshell, its policies are based on the notion that competition among producers coupled with accurate information for consumers will result in the best products at the lowest prices.

## 2. *Enforcement approaches*

Enforcement entails both administrative actions against individual firms and the use of industry wide rules. Once the Commission has promulgated a rule, anyone who violates the rule with 'actual knowledge' or knowledge implied by the circumstances is liable for civil penalties of up to \$11,000 per violation. FTC rules are extensive, but their genesis and degree of economic input have varied widely over time and can be roughly characterized by the following three stages:

- Prior to the mid-1970s rulemaking was very ad hoc and often based on little evidence and even less economics. It was during this period that the infamous Automatic Sewing Machine rule was enacted (see below).
- Pendulum swung very much the other way during the 1970s where there was extensive proceedings and a good deal of evidence presented. Input expanded in part due to the specifications of the Magnuson-Moss law which set out extensive guidelines for the rulemaking process. Many of the rulemakings from the 1970s and early 1980s were very time consuming exercises that generated extensive formal 'records', but relatively little systematic evidence regarding the problem to be solved or the best way to solve it. As a result of the cumbersomeness of the rulemaking process (combined with the belief that many of the rules could not pass a benefit-cost test), many of the large rulemakings were abandoned or scaled back in the early 1980s.<sup>1</sup>
- Current phase started in the 1990s and involves a more streamlined approach where Congress passes a law and directs the FTC to devise a rule to enforce it. There is still the semblance of a cost-benefit analysis, but it is constrained by the general framework of the rule set out in the

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<sup>1</sup> For a general description of the rulemaking period, see Clarkson & Muris, eds. (1981, pp. 161-221) and Meiners and Yandle eds. (1989, pp. 71-88).

legislation that created it. The bulk of the evidence analyzed is generated by outside parties. Among the rules developed in this way include the Truth in Lending Act, Equal Credit Opportunity Act, Fair Credit Reporting Act, Fair Debt Collection Practices Act, CAN-SPAM Act, the Children's Online Privacy Protection Act, the financial privacy provisions of the Gramm-Leach-Bliley Act, the Telemarketing and Consumer Fraud and Abuse Prevention Act, including the Telemarketing Sales Rule and the Do-Not-Call Registry.<sup>2</sup>

### 3. *Current FTC Activity*

Since the mid 1990s, there has been an increased emphasis on fraud cases along with a corresponding drop in actions against national advertisers. There has also been an expansion of the FTC's authority into a number of new areas spawned by new technologies and fueled mostly by Congressional legislation. The Commission's consumer protection focus on promoting informed decision-making by consumers is also reflected in its advocacy interventions before both federal agencies such as the FDA (commenting on the agency's advertising policies) and state legislatures (e.g. commenting on regulations of professions that affect the information available to consumers via advertising and other marketing activities). All of these activities, to varying degrees, are motivated and guided by the deception and unfairness doctrines that underlie the FTC's consumer protection authority.

## III. Behavioral Analysis at the FTC

Although behavioral economics is not explicitly utilized at the FTC, there is a long tradition of formulating policy that recognizes various cognitive and emotional limitations of consumers. This is not surprising since the very nature of consumer protection, viewed as a complement and not a substitute for competition policy, must be based on a premise that consumers are in need of assistance in making purchase decisions even in fully competitive markets. The result has been an inevitable mix of approaches that encompass both the use of traditional economic techniques where the consumer is modeled as behaving as a consistent utility maximizer, and more psychological views where the consumer behaves in ways that are not that easy to describe or predict.

Until the 1970s, consumer protection policy at the FTC paid little attention to economic or behavioral theory in its advertising enforcement, using instead a very expansive interpretation of a misleading ad as one that included any statement that had the tendency and capacity to mislead or deceive a prospective purchaser – including the 'ignorant, unthinking, and credulous'.<sup>3</sup> This led to the bringing of a number of relatively trivial cases targeting claims that were unlikely to mislead the

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<sup>2</sup> See <http://www.ftc.gov/ogc/stat3.htm> for a complete list and summaries.

<sup>3</sup> *Floresheim v. Weinburger*, 346 F. Supp 950, 957 (D.D.C. 1972) (citing *Florence Mfg. Co. v. J.C. Dowd & Co.*, 178 F. 73, 75 (2d Cir. 1910)). *U.S. v. 'Sudden Change'* at 741.; *U.S. v. Article Consisting of 216 Cartoned Bottle ... 'Sudden Change'*, 409 F.2d 734 (2d Cir. 1969)

majority of consumers. Targeted suspects included Indian trinkets that were not made by American Indians, automatic sewing machines that did not operate by themselves, etc. The agency's low assessment of consumers' cognitive abilities was also reflected in its hostility toward comparative advertising, ignoring the potential for such ads to both inform consumers and stimulate competition.<sup>4</sup>

The 1970s saw a shift toward a more nuanced view of the consumer, from both economic and behavioralist perspectives. Developments in the economics of information led to a more relevant economic theory in which consumers were modeled as bounded by the various costs of acquiring and processing information. The information economics approach did not supplant the neoclassical model but rather extended it to include an explicit analysis of how information influences the behavior of both buyers and sellers. In this formulation, consumers make consistent decisions that enhance their welfare, but do so under constraints that lead them to acquire less than full information. Instead of being endowed with perfect information, they are boundedly rational entities that acquire information up to the point where the marginal benefit equals the marginal cost. The behavior of firms is similarly influenced by the costs of both acquiring and disseminating information.<sup>5</sup>

One key component of the economics approach is the role played by advertising in providing information to consumers. While the negative effects of false and deceptive ads have always been apparent, important theoretical and empirical research has demonstrated the various ways that advertising can inform consumers on the products and services they wish to purchase. This information role goes well beyond the (very important) function of describing the price, location and physical characteristics of goods. For example, research conducted at the FTC and elsewhere has demonstrated that truthful health and safety claims by producers in their advertising has transmitted important information to consumers.<sup>6</sup> Also, consumers at times create heuristics based on the level and placement of a product's advertising as a means of inferring quality in situations where direct evaluation is not possible.

At about the same time, the FTC began to utilize insights from the marketing literature on consumer research, which in turn was heavily influenced by developments in cognitive and social psychology.<sup>7</sup> The combined use of economics and marketing tools in the application of consumer protection policy is illustrated in Beales et al. (1981) which used psychological research to show how consumer's cognitive ability and previous experiences influence their information processing

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<sup>4</sup> Describing this period, former Commissioner Pitofsky observed that the FTC acted as a surrogate enforcement arm for competitors... many enforcement actions against advertisers grew directly out of competitor complaints and appear to have been primarily intended to protect sellers against competition from cheaper substitutes. (Pitofsky, 1977)

<sup>5</sup> See Schwartz and Wilde (1979), Ippolito (1984), Rubin (2004)

<sup>6</sup> See Ippolito (2004) and the references cited therein.

<sup>7</sup> See the Simonson et al. (2001) review of the relevant consumer research literature starting in the 1970s. The authors also discuss the 'postmodernist' consumer research movement that arose in the 1980s seeking to develop a unique discipline that moves the research agenda away from relevant managerial and policy issues (p. 259).

capability. Also relevant in this regard was the startup of the *Journal of Public Policy & Marketing* in the 1980s, an academic marketing journal that regularly includes a significant number of articles (many written by current or former FTC professionals) that report on the relevance of behavioral research for consumer policy.

The end product of these developments is the present eclectic mix of economic theory and behavioral research at the FTC that shares important similarities with the behavioral economics paradigm, but also reveals important differences as well. In the remainder of this chapter I describe the analytic approach used at the FTC using the behavioral economics paradigm as a frame of reference. I will focus on the regulation of advertising, considered in its broader sense to include public policy issues beyond Section 5 enforcement such as the agency's views on advertising and disclosure regulations of other Federal agencies (e.g. FDA and HUD).

### *1. Decision-making Models: Unfairness vs. Asymmetric Paternalism*

The decision-making process at the FTC revolves around its deception and unfairness authority. Both have important behavioral components that have changed over time in response to analytic and research developments and to political considerations. Deception focuses on false and misleading claims while unfairness is a broader concept that extends the FTC's reach to acts and practices that cause consumer injury without necessarily being false or misleading. Unfairness is thus the more general concept with deception being a subset. It provides a generalized cost-benefit standard for evaluating whether a particular intervention will generate net benefits to consumers.<sup>8</sup>

An unfair act or practice is defined as one that 1) imposes significant injury on consumers; 2) is without offsetting benefits and 3) cannot be reasonably avoided by consumers. These conditions are used to identify market failure situations in which the benefits of government action are greater than their associated costs. Satisfaction of the first two conditions can be interpreted as insuring that the act or practice in question results in a more than trivial cost to consumers and that this cost is not offset by the benefits it imposes on consumers with both factors being interpreted in the context of the particular remedy being proposed. The 'reasonable avoidance' condition influences both cost and benefit calculations by addressing the ability of consumers to take due precaution to avoid injury.<sup>9</sup>

Advertising deception cases often focus on what is considered 'reasonable' behavior by consumers. The Commission considers the claims consumers receive from an ad, judged in the context of the ad and background information. In that sense, the policy incorporates behavioral problems consumers

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<sup>8</sup> Deception is in effect a streamlined operational rule ('heuristic') where the presumption of injury from a deceptive ad avoids the necessity of an extensive rule of reason analysis. This undoubtedly helps in the prosecution of advertising cases, but the reality is that something akin to the unfairness test is used to select which cases to bring. While an extensive cost-benefit analysis is not normally used, staff will at times evaluate extrinsic evidence such as copy tests to identify the extent of injury as well as the feasibility of possible remedies.

<sup>9</sup> See Beales (2005) for a description and history of the unfairness doctrine at the FTC.

might have in a particular circumstance. Often the ad claims being evaluated are not express false statements, but rather *implied* ones where an important task is to determine the message actually received by consumers. Another complication occurs when consumers vary in the kinds of messages they take from an ad, as well as the importance they attach to the claims that they do receive. For any particular claim, whether express or implied, there is the further task of determining whether the advertiser has a sufficient level of substantiation consistent with the claim being made.

For instance, the Commission might find an ad deceptive if the ad frames the claim in a way that misleads substantial numbers of consumers on a material issue. Similarly, if copy tests show that a significant percentage of consumers misunderstand claims about particular types of risk or intertemporal issues, the Commission might require more from the firms making claims on those issues to avoid the deception.

Consumer testing, typically with controlled copy tests, is a relatively standard part of assessing the claims consumers take away from an ad when the claim is not reasonably obvious in the ad. It's a behavioral test not influenced by economic theory in the sense that if consumers looking at an ad take a claim from that ad, that would be the basis for a case. The test would not be whether that was a reasonable interpretation of the ad, but rather whether the interpretation was there. Thus the 'ignorant, unthinking, and credulous' standard is not completely eliminated, but rather comes back under a more empirical definition of what is reasonable. But even in such situations there remains the more general cost-benefit conditions under the unfairness test to satisfy.

The asymmetric paternalism test set out in Camerer et al. (2003) has many similarities to the unfairness one. A regulation inspired by behavioral theory is asymmetrically paternalistic 'if it creates large benefits for those who make errors, while imposing little or no harm on those who are fully rational' (p 1212). The authors argue that regulations are desirable only when they are asymmetrically paternalistic; total social welfare is increased, even though fully rational consumers and producers may be hurt. The authors thus embrace cost-benefit analysis as a method of determining the desirability of paternalistic regulations, concluding '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' (p 1251). They review potential regulations such as default rules, framing issues, cooling-off periods, and limiting consumer choice and describe circumstances under which each regulation may be asymmetrically paternalistic.

The obvious similarity to the unfairness test is the resort to empirical analysis to ensure that a proposed intervention will generate more benefits than costs. One contribution of the asymmetric paternalism concept is the explicit recognition that the benefits and costs of regulations will tend to fall differently among consumers, with some benefiting more than others. This provides a useful framework for analyzing regulations by sorting out the winners and losers according to their decision making acumen. Such an analysis is implicit in the FTC formulation, especially when the agency focuses on the harm a particular practice may impose on 'vulnerable' consumers. Nevertheless, the asymmetric paternalism concept can be helpful in the use of a more systematic

way of analyzing the cognitive differences among consumer groups and their regulatory consequences.

Although Camerer et al. discuss the asymmetric paternalism cost benefit calculus at length, they do not provide examples of how the test would actually work in the consumer protection area. This is because their examples of regulations justifying the asymmetric paternalism standard are dominated by those the authors view as imposing little or no cost on the more informed and sophisticated consumers. In addition, most of the consumer protection examples consist of existing regulations that were not originally justified by insights from the behavioral economics literature. These include cooling off rules and mandated disclosures such as the ones required under the Federal Truth in Lending Act. The problem is that many of these type regulations were not evaluated by a cost-benefit standard before enactment, and a number of disclosures have been shown to be ineffective or at times harmful to consumers in retrospective studies.

Camerer et al. also tend to oversimplify the cost benefit calculation by assuming that the costs of an intervention fall only on the sophisticates and not on the cognitively impaired consumers that the regulation is presumably designed to help. But the Law of Unintended Consequences often rules in these situations, so that the beneficiaries of a regulation can end up being harmed by it. Thus the empirical question to be answered is more than 'whether the benefits of mistake prevention are larger than the harms imposed on rational people' (p 1254). Indeed it may be the case that a mandated disclosure policy will have greater beneficial effects on the sophisticated consumer than on one who does not bother to read the product information. In such situations, the uninformed consumer turns out to be the loser if the effect of the enhanced disclosure is to immunize the seller from legal action. (Hillman, 2006) Such an effect is at this point largely speculation because an important but largely unexplored aspect of mandated disclosures concerns the type of consumer who actually uses them.

A useful framework that incorporates the potential costs of regulatory actions such as those envisioned by Camerer et al. is the net error analysis used in the evaluation of advertising deception cases. (Rubin 2004) Borrowing terms from statistical decision theory, the task of the regulator is to compare the costs associated with letting a possibly deceptive ad continue (type 1) to the costs of mistakenly stopping an informative one (type 2). Viewed in this way, the appropriate objective of the regulator is to minimize the expected costs associated with both kinds of error, not to eliminate one kind of error completely.

This analytical framework can be usefully employed to analyze the costs of mandated disclosures that are linked to the limited attention span of consumers and thus their ability to process information. Specifically, mandated disclosures usually add to the amount of information already contained in an ad or contract document, thus raising the potential for the new information to crowd out or dilute existing messages that may be of use to the consumer.

In the case of a disclosure linked to an advertisement, the firm may react by reducing the number and content of the ads and thus reducing the information provided to consumers in them. Increasing

the prominence of a required disclosure may also reduce the attention consumers pay to other information, conceivably leading to worse decisions rather than better ones. Survey research by Lacko and Pappalardo (2005) has shown this kind of effect in the case of mortgage disclosures. Similarly, the field experiment reported in Bertrand et al. (2005) showed how some formats appear to direct a consumer's attention to the interest rate information, while others (e.g. lottery and cell phone offers) have the opposite effect.

The cost-benefit calculus required of the regulator in the case of mandated disclosures is well described in Craswell (2006):

..... the disclosures that produce the least amount of interference are those that are the least prominent, and therefore the least selective in communicating the disclosed information. Conversely, more prominent disclosures are more likely to be more selective at conveying their own information, but these are also the ones most likely to interfere with something else. Of course, which course is preferable overall depends on the importance of the information being disclosed, the importance of the information that is interfered with, and the actual extent of that interference. In this respect, too, designing a disclosure format requires close attention to the relevant costs and benefits. (p.24)

## *2. Empirical Research*

Behavioral research at the FTC relies heavily on the use of surveys to identify how consumers perceive information. The chief instrument used is the copy test in which consumers are shown hypothetical or actual ads in order to identify the types of messages they take away from them. Copy tests are used to identify the kinds of claims being made in an ad, to evaluate the effectiveness of proposed wording designed to qualify an ad claim, and to test the effectiveness of proposed disclosures to be mandated in an ad or other marketing documents.

In contrast to copy tests used by firms, where the focus is on determining whether a particular ad will generate sales, the typical FTC copy test is designed to identify the way consumers perceive the information provided in a document and not to directly test whether this perception will lead to actual purchases. This is particularly so in the case of deception cases where the finding that an ad conveys a particular misleading claim is sufficient to infer materiality and thus a section 5 violation.

The copy test research approach is also used to evaluate the ability of ads to accurately describe the level of scientific support attached to health claims for a particular product. Results of research conducted by Dennis Murphy and others at the FTC indicate that consumers can distinguish between claims that are qualified to convey differing levels of scientific certainty – although the ability to qualify claims where the science is relatively weak is more problematical. This research is used in the formulation of remedies in FTC ad cases and is also used to advise the FDA concerning the degree to which health claims can be made for supplements and other products regulated by the agency.

An especially active area of copy test research at the moment involves the testing of proposed mandated disclosures in credit documents. The most recent effort is Lacko and Pappalardo (2007),

which tested 800 mortgage customers (along with 36 in-depth interviews), to examine how consumers search for mortgages, how well consumers understand current mortgage cost disclosures and the terms of their own recently obtained loans, and whether better disclosures could improve consumer understanding of mortgage costs, consumer shopping for mortgage loans, and consumers' ability to avoid deceptive lending practices.

Both the FTC survey approach and the psychological experiments highlighted in the behavioral economics literature attempt to shed light on consumer behavior in ways that are not tied to standard economic theory. The lack of a theoretical base is perhaps most pronounced in the FTC approach where the focus is on determining the messages conveyed by ad copy chosen for its connection to a particular case, a regulation, or its likelihood to convey a particular message to the consumer. In contrast, many experiments involving tests of specific hypotheses are generated from the psychological literature.

The FTC survey method also shares with behavioral economics a lack of external validity. Just as the results of laboratory experiments (often using college students as subjects) cannot be confidently extrapolated to real world situations, copy test results are rarely linked to actual decision making. While the FTC tests tend to use subjects that are closer to the market place (shoppers in ad copy tests, recent mortgage customers in the Lacko/Pappalardo research) than do psychological experiments, they do not examine actual decisions – only how the subjects perceive the information presented to them.

Alternatively, the survey and experimental approaches both have the advantages of being able to focus on particular aspects of consumer behavior in ways that are difficult to achieve through the analysis of market based data. One promising technique to bring more reality to both approaches is the field experiment, which allows the use of controls in market situations. Recent examples of this type of research include Syndor (2005), Bertrand et al. (2005), and Miravete and Palacios-Huerta (2004). These type studies test hypotheses generated in both the conventional and behavioral economics literature and are conducted by economists from both fields as well. One possible extension here is to employ the field experiment approach to link the results from FTC survey studies reporting on how consumers perceive a particular ad or disclosure to how they actually use this information in their purchase decisions.

### *3. Fraud*

The FTC'S fraud program stands largely outside the decision-making approach described above. Since the fraudulent activities addressed by the agency involve false claims for typically useless products, regulatory actions against a firm involve none of the costs to be considered under the unfairness or asymmetric paternalism decision rules. But there nevertheless is a behavioral element because fraud cases involve consumers whose decision patterns often stray far from those predicted by the rational actor model and are difficult to classify as 'reasonable'. Past cases have involved claims for products that strain credulity, such as ionized bracelets, weight-reducing insoles, 'structured water' globes to wash clothes without soap, etc., etc. Fraudulent weight loss products

are particularly popular at present, leading the Commission to provide a guide to the media and industry listing a number of ‘obviously’ false claims.<sup>10</sup>

The reasons for such overly credulous behavior on the part of consumers is perhaps best explained in the behavioral economics literature, although there has been little attempt to bring such results formally into consumer protection policy deliberations. Rather, justification for such programs is based partly on traditional economic rationales such as a) the public good aspect of unchecked false claims reducing the value of legitimate advertising messages, and b) the possibility that well publicized enforcement can both deter fraudsters and put customers on greater alert. Probably a more important rationale is rooted in societal values concerning fairness and equity.

Reaching consumers of the more egregious frauds is quite difficult and is an area where behavioral economics research could help. Interestingly, there does not appear to be much of a focus on the types of individuals most susceptible to fraudulent claims in behavioral economics research, which seems to deal more with ‘normal’ people who go off the tracks in certain predictable ways. An FTC report (Anderson, 2004) on fraud activity provides a general profile of those most likely to be victimized by fraud, which can serve as a starting point for identifying the types of subjects that are most relevant to psychological research.

#### *4. Concluding Remarks*

The FTC, as well as most other consumer protection organizations, has been practicing various forms of behavioral economics for some time now. This is probably most apparent in the fraud area where informational policies are deemed insufficient in many instances because of the difficulties fraud victims have in overcoming emotional attachments to the attractions of weight loss products that entail no diet or exercise, get rich schemes without risk, etc. etc. It is also the case in the regulation of more legitimate products where there is a strong emphasis on defining a reasonable consumer as one revealed by copy tests and not economic theory.

Nevertheless, behavioral economics can bring unique insights into the consumer protection area by its focus on opening up the black box of consumer behavior so as to understand *why* consumers make the decisions they do. The task of this conference, as was the previous one conducted by the FTC, is to identify how the behavioral economics approach can be used to inform consumer policy.

## **IV. Behavioral Economics Conference at the FTC**

The FTC conference ‘Behavioral Economics and Consumer Policy’, was held on April 20, 2007 in

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<sup>10</sup> FTC Releases Guidance to Media on False Weight-Loss Claims (2003) (<http://www.ftc.gov/opa/2003/12/weightlossrpt.htm>) The claims listed may be obviously false to the regulator but presumably are not to the consumers who continue purchasing the weight loss products.

Washington, DC.<sup>11</sup> Mulholland (2007) provides a full summary. Here I discuss two issues raised at the conference that have special relevance for the current Productivity Commission one: 1) are there new public policy initiatives that can be justified by the current behavioral economics research record? and 2) what approaches toward the empirical analysis of consumer behavior will be most effective in guiding public policy in the future?

### *1. Public Policy*

No new policy suggestions came out of the conference. This is not surprising considering that behavioral economists have only recently addressed the implications of their work for consumer protection policy. While a number of research results presented at the conference suggested possible policy initiatives, there was general agreement that more evidence based on market settings is required to justify such actions. In this latter regard, many of the behavioral economists called for greater use of field experiments, which allow for controlled testing of behavioral hypotheses in market situations.

Economists of all persuasions also recognized that the complexity of human behavior makes the formulation of policy remedies all the more difficult. For example, David Laibson's shrouded attributes paper demonstrated how market failures can arise in competitive markets where some consumers are unaware that part of the product's costs arise after the sale. While Professor Laibson showed how competition may not be sufficient to adequately inform consumers about such 'shrouded' costs, he was reluctant to propose a specific government action to remedy the problem, stating 'I think the big open question and I concur with many of the people who have spoken today is it's one thing to describe and model these problems. It's quite another to know how to fix them, and I certainly don't.'<sup>12</sup>

Notwithstanding their hesitancy to recommend specific consumer policies, the behavioral economists did suggest a number of potential areas for government involvement and where further research should be directed. Colin Camerer, noting the predominance of intuitive thinking for some consumer groups suggested that the FTC may have been too quick to abandon the 'ignorant, unthinking, and credulous' standard in deception cases for one based on the kind of 'reasonable' behavior associated with more rational thinking. In this regard he also emphasized the importance for consumer policy of doing a better job of identifying different kinds of cognitively challenged or inexperienced segments of consumers. One potentially important identifying factor here is age. Citing the research conducted by David Laibson and others, he described a U-shaped relationship between decision making ability and age, with the most problems being experienced by the young and the old.

One impression that I came away with from the conference was the added complexity of regulation

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<sup>11</sup> The conference website contains presentations and related papers, as well as a transcript and video of the proceedings. It is located at <http://www.ftc.gov/be/consumerbehavior/index.shtml>

<sup>12</sup> <http://www.ftc.gov/be/consumerbehavior/docs/transcript/transcriptb.pdf> at p. 37.

introduced by the behavioral economics research. Instead of the relative simplicity of the neoclassical model, behavioral economics confronts the regulator with a host of alternative behavior patterns that make it all the more difficult to predict how consumers will react to a particular remedy and thus how it will affect consumer welfare. The state of the literature is such that there appears to be too many ways in which consumers stray from the rational actor model, often in ways that conflict with each other.<sup>13</sup>

The ambiguity that can arise from this overabundance of theories was illustrated in the discussion of the Howard Beales research on the use of credit card data to test theories of consumer behavior based on differing predictions of the neoclassical and behavioral models. Beales' finding that consumers use of credit cards contradicted predictions of the behavioral models was challenged on the grounds that the credit card usage pattern he observed was consistent with equally plausible alternative behavioral theories. This was quite true and thus tended to weaken Beales' argument that his tests had rejected 'the' behavioral model. But at the same time, the multitude of possible behavioral theories, each with different predicted effects, makes it difficult to use any one of them as the basis of public policy interventions.

Another discussion along similar lines involved Justin Sydnor's analysis of consumer choice of deductible levels for property insurance. Sydnor reported that a prospect theory model did a much better job of predicting deductible choice than did the neoclassical one based on expected utility of wealth. But Sydnor found no basis for considering the consumers 'irrational,' since they appeared to be making choices that were consistent with their preferences as revealed in controlled laboratory experiments and incorporated in his prospect theory model.<sup>14</sup> This observation in turn generated a lively discussion of the rationality of other apparent cases of over insurance, such as the purchase of extended warranty contracts. Although all agreed that how the information is presented to consumers influences their choices of such insurance packages (and other products and services involving probabilistic reasoning), no consensus formed regarding whether a particular frame could be adopted that would reveal one's 'true' preference.

## *2. Empirical Approaches*

The bulk of research reported at the conference came from field experiments (loosely defined) in which consumer behavior is studied in market situations where the analyst nevertheless exercises some degree of control over the subjects and the rules they operate under. Field experiments described at the conference examined credit card usage, choice of phone plans, choice of deductible level for property insurance, and responses to credit offers. This research approach offers the promise of combining the rigor of the lab experiment with the added reality of research based on

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<sup>13</sup> This and similar points are made by Berg and Gigerenzer (2007) and Klick and Mitchell (2007).

<sup>14</sup> This was for the initial purchase of insurance, where a significant proportion of customers elected to pay amounts well above expected value for a low versus a high deductible option. . While this pattern, according to Sydnor's model, appears rational, he went on to suggest that the failure of most customers to change their deductible amount in subsequent periods (as their economic situation changed) may reflect consumer inertia.

market outcomes. Not surprisingly, none of the reports lived up to the ideal. One basic problem is that the experiments were largely conducted by firms selling the relevant product, which led to inevitable limitations on the ability of the economic researchers to fully control how the project was implemented.<sup>15</sup> Nevertheless, all of the studies provided a good deal of insight into consumer behavior in ways that neither the lab experiment or the econometric exercise can match.

There was much enthusiasm for the further use of field experiments to explore consumer protection policy issues. What appeared to be especially promising is the use of panel data such as employed in the credit and phone studies to analyze not only how consumers make mistakes but how they learn from them. It turns out that a good deal of the differences between behavioral economists and their more conventional counterparts are linked to differing views of consumer learning patterns. Obviously, the prospects for effective government intervention (especially of the ‘hard’ paternalistic variety) are higher where consumers are slow to learn ways to cope with the consequences of their mistaken behavior, and at the extreme fail to learn at all because they never realize that they made a mistake in the first place. Well structured field experiments can shed light on this issue in ways that labor market based studies cannot.

The other statistical approach demonstrated at the conference was the survey analysis conducted by Lacko and Pappalardo. This represented an extension of the traditional FTC copy test in that there were considerably more subjects used and there was an attempt to estimate the materiality of the differing disclosure formats by asking questions about purchase intentions. While the Lacko/Pappalardo research drew a favorable response from the behavioral economists, there was unfortunately not much in the way of advice as how the techniques used in the psychological experiments could be used to enhance the survey approach.<sup>16</sup> There seems to be a natural potential for synergy between the two empirical techniques since the survey approach focuses on how consumers perceive information while the psychological experiment examines how individuals make decisions based on the information given to them. The one possibly useful suggestion in this regard came from the behavioralist Eric Johnson who, citing his experience as a marketing researcher, suggested that the FTC and other government agencies consider doing ‘partial rollouts’ to assess the impact of the mandated disclosures being tested.<sup>17</sup>

Finally, Colin Camerer offered two interesting research suggestions to explore. The first was to conduct longitudinal lab experiments so as to assess the importance of learning and to test for the kind of ‘disclosure fatigue’ discussed at the conference. The second was to apply the ‘eye tracking’

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<sup>15</sup> Reacting to this situation, Matthew Rabin argued that agencies such as the FTC need to take the lead in generating their own field experiments. He suggested that the information released by companies to researchers may be biased toward areas where consumer problems are less likely to be found.

<sup>16</sup> Framing effects, the most obvious psychological contribution, is already fully incorporated into survey methodology.

<sup>17</sup> One effort that seems to come close to this suggestion is the ACCC program to inform the public on risk properties of low tar cigarettes, which was evaluated in stages that could be considered ‘rollouts.’ [ACCC, Evaluation of the ACCC Tobacco Education Program Campaign, March 2006]

research methods used by himself and Eric Johnson that measure a person's pupil dilation and its correlation with arousal and cognitive difficulty. Camerer suggested that this technology may have a number of consumer policy applications, e.g. in determining whether people literally read the fine print on informed consent documents. It could also be used to complement the Lacko/Pappalardo type survey study by serving as a check on the answers supplied by the subjects regarding their interpretation of particular ads or disclosures.

## V. Concluding Remarks: Where To Go From Here

I conclude by discussing a number of areas where behavioral economics may be combined with the conventional variety to provide useful insights for consumer policy.

### *Choice Overload*<sup>18</sup>

There are two strands of thought regarding the manageability of choices facing consumers. The first sees an increasingly diverse and confusing set of choices facing consumers, especially in the credit area and in some recently deregulated sectors such as telecom and electricity. At the FTC conference, Tim Brennan cited his research in electricity markets suggesting that the low rate of switching there may indicate a revealed preference among consumers not to choose. In contrast Eugenio Miraverte and Alan Schwartz pointed out instances where increases in competition leads to a more coherent set of choices for consumers that better matches their preferences.

These contrasting views do not necessarily conflict since they are often based on different sectors and markets, as well as different research methods. But there are nevertheless striking differences in inferences for policy that deserve further study. For example, contrast the Miraverte (2007) finding that the introduction of competition into cellular markets lifted the 'fog' on prices by inducing firms to offer simpler and less deceptive tariffs to the Wilson and Waddams (2005) finding for UK electricity markets that 'consumers make more efficient decisions in markets with fewer competitors'. The UK may be an especially fruitful area of research due to the recent regulatory changes there and to a large database of information on switching behavior generated by extensive Ofcom surveys.

Aside from information provided by the firms selling products and services, the government and third party entities also provide information that can help simplify the purchase process for

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<sup>18</sup> It is worthwhile to note that the debate over whether consumers are getting 'overloaded' with too much information predates the recent behavioral economics literature, going back at least to the 1970s. In his 1983 review paper, Rudd addressed the question: 'Does the provision of more information improve consumer decision making or does it instead produce information overload, and thus confusion and poorer decisions.' (p. 465) Rudd's evaluation of the relevant research leads him to conclude that the disclosures have had a net positive effect, but he also recommended that policy makers shift their emphasis from the quantity of the information supplied to its quality B defined as including presentation format, the ease with which it can be processed by consumers, and the likelihood that consumers can be motivated to use it. (p. 470)

consumers (and create important feedback incentives for firms to alter their offerings). In regard to the former, Tim Brennan's examples of government attempts to 'help' consumers in a number of deregulated markets does not inspire much confidence.<sup>19</sup> It would be interesting to find out just what went wrong in these cases. Possible reasons include a) the gains from switching were small in any event so the regulators did not put much energy into explaining them; b) regulatory constraints required excessive detail; and c) insufficient incentives for the regulators to do a good job. Hopefully Brennan's examples are located at the tail of the distribution so it is possible to examine differences in informational performance among government agencies B with behavioral as well as more conventional models of regulation in hand. (Rachlinski and Farina, 2002)

Third party information entities offer another source of help to consumers. The most cited example is Consumer Reports in the U.S., but its reach remains limited (due in part to the organization's ban on firms spreading favorable test results via their advertising). More help may come from explicitly commercial information providers that have evolved via the internet. One interesting example is the case of online insurance broker sites such as QuickQuote.com that give a clear comparison of rates and provide direct access to the various insurance companies. The policy challenge here is to create environments that allow use of the comparison site business model in markets, such as electricity and telecoms, where more useful consumer information is needed.

Another important source of information comes from online product reviews generated by consumers themselves via such sites as Amazon, Ebay, and Epinions. As described by Ghose and Panagiotis (2006):

In offline markets, consumers' purchase decisions are heavily influenced by word-of-mouth. With the rapid growth of the Internet these conversations have migrated in online markets, creating active electronic communities that provide a wealth of product information. Consumers now rely on online product reviews, posted online by other consumers, for their purchase decisions. Reviewers contribute time, energy, and other resources, enabling a social structure that provides benefits both for the users and the companies that host electronic markets. Indeed, the provision of a forum facilitating social exchanges in the form of consumer product reviews is an important part of many electronic markets, such as Amazon.com.

Important research and policy questions here revolve around whether this new kind of information available to consumers simplifies their choices or makes them even more difficult and leads to yet more biased decision making. Ghose et al. (2006) provides a number of useful cites to the emerging literature in this area.

### *Cooling off Rules*

Cooling off regulations, such as the FTC's door-to-door sales rule and similar rules promulgated in the credit area, are often cited as examples of laws that successfully incorporate behavioral economics insights. In particular, these rules are premised on the view that consumers at times make

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<sup>19</sup> <http://www.ftc.gov/be/consumerbehavior/docs/slides/Brennan.pdf>

purchases in emotionally or biologically ‘hot’ states that, in a cooler and more rational state, they would not make. Mandating a cooling-off period allows consumers to re-frame their choices and to give them an opportunity for rational re-consideration to overcome the influence of impulsive choice.

Notwithstanding the apparent widespread acceptance of cooling off rules, they have not been subjected to the kind of the asymmetric paternalism or unfairness tests described above. For example, the FTC rule appears to have been created without the benefit of any systematic research to document its value (McChesney, 1984). While there has been some research into the rule’s impact, it has been fairly limited in scope.<sup>20</sup>

From a behavioral standpoint, we know relatively little about how consumers respond to cooling off rules. The ideal is that they allow consumers to cancel those contracts that, in a more rational state, they realize are not for them. Over time as consumers cancel bad contracts, firms should be deterred from making such deceptive offers in the first place. But the existence of a cooling off periods can have the opposite effect of inducing more welfare reducing purchase decisions. This would occur if the existence of a cooling off period leads consumers to make more impulsive purchase decisions because they exaggerate their ability to revisit the contract terms in a cooler state.

The latter behavioral story is similar to that applied to consumer rebates where consumers make a purchase based on the false assumption that they will redeem the rebate in order to get the price discount. Research in this area by Silk(2005) and others suggest that the likelihood of redeeming a rebate may be *inversely* related to the length of the rebate period. This result is consistent with theories in the marketing and behavioral economics literature suggesting that as the time allotted to perform a (simple) task increases, so does the likelihood of failing to complete the task. (See Ariely and Weterbroch (2002) and Zauberma and Lynch (2005)).

The current research record is relatively sparse and does not shed much light on these two competing theories. In regard to the Cooling Off Rule, most of the available evidence concerns cancellation rates, which appear to be low. Also, an early study of the FTC rule found that cancellation rates fell after the rule was implemented. (Shanklin and King, 1977) The fact that relatively few consumers cancel during the cooling off period is consistent with the behavioral lulling story, but it is also consistent with one in which cooling off rules result in less deceptive practices and hence less need to cancel.

In addition to the general issue of how consumers use cooling off periods, there is the question of how they react to variations in the length of such periods. As illustrated in the rebate discussion, lengthening the period given to consumers for making a post-purchase action can – after some point – lead them to be less likely to follow through on their intentions. In this sense, increasing the length of the cooling off period is similar to increasing the time given consumers to redeem their

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<sup>20</sup> Examples include Shanklin and King (1977), McChesney (1984) and the FTC’s review of its rule in 1995 <http://www.ftc.gov/opa/1995/10/cooling2.shtm>

rebates.

Finally, the rise in the use of liberal return policies by retailers can be viewed as a market equivalent to mandated cooling off periods. Both allow the consumer to opt out of a purchase after a certain period of time. Of course the products and services that come under each provision differ, but the use of liberal return policies lends credence to the idea that cooling off periods can induce greater sales by reducing perceived risk of getting stuck with a bad purchase – whether or not that perception turns out to be correct.

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