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Having One's Cake And Eating It Too –
An Analysis Of Behavioural Economics From A
Consumer Policy Perspective*

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Behavioural economics is a discipline within economics that studies suggested problems in standard economic theories, with particular reference to the observed, as opposed to theorised, behaviour of consumers. It is said to be a new form of paternalism – that which intervenes but respects liberty and freedom of choice. But why should we value liberty? Why should we be concerned about paternalism? Why should we value freedom of choice and free markets? This paper explores these questions. The paper then examines some of the key challenges to behavioural economics theory, including the problems of substituted decision making, occasional versus dispositional autonomy and non-coercive interference with liberty. Finally the paper discusses two market interventions suggested by behavioural economics: unfair contracts and extended warranties. The paper concludes that everything learned thus far from behavioural economics does not change one simple reality – every time we make a consumer policy choice we choose between the operation of imperfect markets on one hand and imperfect governments on the other. Indeed, the paper concludes that our default position should be to favour imperfect markets, but with the knowledge that government intervention is appropriate where we can demonstrate need, likelihood that the intervention will succeed, the absence of less restrictive alternatives than intervention and that the intervention has net benefits for consumers in the long run.

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

Having one's cake and eating it too – an analysis of behavioural economics from a consumer policy perspective

Chris Field[1]

Introduction

I am delighted to be here today to participate in this roundtable discussion on behavioural economics and public policy. The Productivity Commission should be warmly congratulated for organising the roundtable – it is timely as behavioural economics has not simply gained considerable prominence as a discipline within economics, but increasingly, is being utilised to suggest public policy interventions into the operation of markets. In terms of consumer policy – the focus of this session – the roundtable is, of course, particularly timely given that this year marks the Productivity Commission's review of Australian consumer policy and the Commission will, quite properly, be seeking to inform itself of how behavioural economics might be utilised in the design and implementation of consumer policy in the years ahead.

In their paper setting out the arguments for regulation based on the discoveries of behavioural economics, Professor Colin Camerer and his co-authors claim that behavioural economics offers the opportunity to "have one's cake and eat it too".[2] In fact, in deference to the sweet of choice of the behavioural economics literature, perhaps this statement ought to be amended to having one's Twinkie and eating it too! The principal challenge I have set myself today is to test this statement. To do so, I will begin by examining the key aspects of the behavioural economics debate, including the value of liberty and free markets and the problems of paternalism, I will then move on to consider some of the challenges to behavioural economics theory, before moving to consider two practical applications of behavioural economics theory: unfair contract terms and extended warranties. This will lead me to some concluding remarks about behavioural economics and its use in designing consumer policy.

Before I start my paper proper, I do need to make clear that the views I express are mine alone and do not represent the views of the office of the Western Australian Ombudsman,

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[2] Colin Camerer, Samuel Issacharoff, George Lowenstein, Ted O'Donoghue and Matthew Rabin, 'Regulation for conservatives: Behavioural economics and the case for "asymmetric paternalism"', 151 *University of Pennsylvania Law Review* 1212.

the Western Australian Government or any other organization with which I have been, or am currently, involved.

Behavioural economics: Key aspects

Any analysis of behavioural economics requires an understanding of its key aspects. Here I have identified four: behavioural economics itself, liberty, paternalism and free markets.

What do we mean by behavioural economics?

Behavioural economics is a discipline within economics that studies suggested problems in standard economic theories, with particular reference to the observed, as opposed to theorised, behaviour of consumers.[3] Behavioural economists have also applied their theories to public policy problems, suggesting solutions to correct behavioural mistakes.[4] These corrections range from interventions that are obviously paternalistic to those that are said to be a new form of paternalism – that which intervenes but respects liberty and freedom of choice. In this paper, I will largely leave unexamined those consumer policy solutions that are said to be “hard” paternalism (those that clearly remove choice or restrict liberty), to concentrate on those policy solutions that are said to be newer “soft” paternalism. This is largely because I think it is much easier to refute the interventions which are paternalistically “hard”. This leaves the more complex challenge to discuss which I think is more interesting for me, and I hope, for you.

Why should we value liberty?

For those of you familiar with the behavioural economics literature, you will know that it spends some time considering the relationship between behavioural economics theory and restriction of liberty. But why should we value liberty? As much as the behavioural economics literature on new paternalism seeks to defend the concept of libertarian paternalism from accusations that the concept is an oxymoron, the value of liberty is taken, largely correctly I think, as being tautological (or else there would be little point in making the defence).

Indeed, whether you believe that liberty has value as a matter of right, or as a consequentialist consideration, its value is widely accepted. The capacity to live one’s life in an autonomous way is one of the most central of all social values in modern, democratic societies.[5] Critically, for what I will say later in this paper, autonomy is a freedom to choose correctly and a freedom to choose poorly. The value of autonomy is

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[3] See, for example, Wolfgang Pesendorfer, ‘Behavioural economics comes of age: A review essay on *Advances in Behavioural Economics*’, *Journal of Economic Literature*, Vol.XLIV (September 2006) at 712.
[4] Colin Camerer *et al*, n 2 above at 1224 onwards.
[5] Michael Trebilcock, ‘An Introduction to Law and Economics’,23 *Monash University Law Review* 1 at 133. The classic defence of the libertarian principle can be found in John Stuart Mill, *On Liberty*

that we are the author of our successes and failures, and we have the capacity to learn and develop from the mistakes that are made.

Why should we be concerned about paternalism?

As much as the behavioural economics literature spends time on considering its potential to restrict liberty, it also counters the claim that it is paternalistic (or at least a form of paternalism that is considered egregious). Why should we be concerned about paternalism? In the context of consumer policy, paternalism has at least two fundamental problems. First, it adds red tape and costs to consumer transactions. In its report on "red-tape", the Australian Taskforce on Reducing the Regulatory Burden on Business[6] noted:

> a 'regulate first, ask questions later' culture appears to have developed. Even where regulatory action is clearly justified, options and design principles that could lessen compliance costs or side-effects appear to be given little consideration. Further, agencies responsible for administering and enforcing regulation have tended to adopt strict and often prescriptive or legalistic approaches, to lessen their own risks of exposure to criticism. This, in turn, has contributed in some areas to excessively defensive and costly actions by business to ensure compliance.[7]

Second, paternalism goes to the heart of the exercise of liberty and autonomy by consumers – it restricts autonomous action and is disapproved of accordingly. Excessive paternalistic action undertaken by government is often referred to as the "nanny state" – overbearing governmental action whereby we are protected from ourselves on the basis that others know best for us.[8]

We should be clear that paternalism takes many forms – not all forms are as restrictive of liberty, nor involve the same level of costs.[9] Most notably, paternalism can be strong – for example banning smoking. This kind of paternalism has been described by noted philosopher Joel Feinberg as having an "acrid moral flavour, and creates serious risks of governmental tyranny".[10] Paternalism can also be weak – interference to ensure voluntariness of action, rather than the action itself. Moreover, many governmental regulations that appear paternalistic may also have other (or multiple) motivations – say, for example, the wearing of seatbelts.

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[6] Taskforce on Reducing the Regulatory Burden on Business, *Rethinking Regulation: Report of the Taskforce on Reducing the Regulatory Burden on Business*, January 2006. This report is available at http://www.regulationtaskforce.gov.au/ (viewed on 15 July 2007).
[7] Taskforce on Reducing the Regulatory Burden on Business, n 2, p ii.
[8] Ibid.
[9] See the very helpful entry by Gerald Dworkin on Paternalism in the Stanford Encyclopedia of Philosophy available at http://plato.stanford.edu/entries/paternalism/ (viewed on 15 July 2007).
[10] Joel Feinberg, 'Legal Paternalism', *Paternalism*, Rolf Sartorius (Ed), University of Minnesota Press, 1983 at 11.

Why should we value free markets?

The level to which we are concerned about interventions into free markets to correct consumer behaviour is dependent upon the level to which we value free markets. I hesitate, given the audience today, to spend much time on this question. While, I will assume that most of you readily accept the value of markets and, concomitantly, will therefore be concerned that market interventions, such as those suggested by behavioural economists must be carefully considered, I am not prepared to take this assumption for granted. There are at least three reasons for this. First, a conversation that I recently had with my mother-in-law after we both watched a *Lateline* story on regulated shop-trading hours whereupon she proceeded to argue for greater protection for small business owners who needed a government-guaranteed fair price to stay in business. Second, my own research undertaken for Consumer Affairs Victoria on the role of consumer advocacy where I found:

> Yet, despite the fact that competitive markets are the bedrock upon which the long term interests of consumers are built, ironically, this is the area of activity which Victorian consumer advocates are most disinclined to embrace. It is, therefore, unsurprising that consumer advocates are regularly ineffective as a voice against anti-competitive industry protectionism – they are suspicious of the benefits of competition (or, put another way, the harm caused by anti- competitive behaviour).[11]

Third, a very good article by Bryan Caplan, an Associate Professor at George Mason University, titled "The myth of the rational voter: Why democracies choose bad policies".[12] In his article he sets out very cogent reasons for why citizens tend to display an irrational bias against markets (drawing, in fact, upon behavioural economics literature). Having read Professor Caplan's piece, I have decided that perhaps it isn't even too bold of me to suggest that some behavioural economists might, from time to time, display a certain amount of anti-market bias![13]

The value of markets: normative and empirical considerations

If you place weight on individual liberty, then it follows that you must place weight on private exchange and private ordering. A market system promotes private exchange and

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[11] Chris Field, Consumer Advocacy in Victoria, Consumer Affairs Victoria Research Paper No.7, March 2006 at 39. Available at http://www.consumer.vic.gov.au/CA256902000FE154/Lookup/CAV_Publications_Reports_and_Guidelines/$file/consumer_advocacy.pdf viewed as at 15 July 2007.

[12] Bryan Caplan, 'The Myth of the Rational Voter – Why Democracies choose bad policies', available at http://www.cato.org/pubs/pas/pa594.pdf (viewed on 15 July 2007).

[13] In fact, Professor Caplan's piece is directed not at the misunderstanding of economists, but citizens generally (at 1): "…if there is one thing that public deeply misunderstands, it is economics". In discussing, anti-market bias he notes that (at 10): "[a]lmost all economists recognize the core benefits of the market mechanism; they disagree only at the margin". In fact, authors have suggested biases by behavioural economists against the fundamental underpinning of markets, including, particularly, property rights: Daniel Klein, 'Status Quo Bias', *Economic Journal Watch*, Volume 1, Number 2, August 2004 at 67.

ordering. Professor Michael Trebilcock notes that free-market scholars have surmised that:

> Private ordering … minimises the extent to which individuals are subjected to externally imposed forms of coercion or socially ordained forms of status. Private ordering is the quintessential form of government with the consent of the governed.[14]

Combined with this valuing of private ordering, those who place strong value on liberty (again in the words of Michael Trebilcock):

> often bring some degree of scepticism to bear on the capacity of collective decision-makers eg legislatures, regulators, bureaucrats, or indeed courts, to adopt policies or laws that will unambiguously increase net social welfare.[15]

Apart from these normative considerations, we can point to a range of empirical observations about the success of open, competitive market-based economies, including their comparative success against other ways of ordering and exchange that have been utilised throughout human history. In the words of Stanley Fischer:

> The world and the economic system we live in is highly imperfect. There is much that needs to be done to make it work better. But as we do that, we should maintain a perspective that reflects what Winston Churchill said of democracy: 'The pro-market, pro-globalisation approach is the worst economic policy, except for all the others that have been tried.'[16]

There is reliable, independent evidence that demonstrates the value of competition to consumers. In its 2005 report on the outcomes of Australian competition reform, the Productivity Commission set out a series of these benefits:

- National Competition Policy was a key aspect improved productivity performance in the second half of the 1990s.[17]
- A permanent (at least) 2.5% increase in our Gross Domestic Product (GDP). This equates to, at minimum, an additional $20 billion for the Australian economy.[18]
- Average real prices for goods and services have fallen, for example, in the electricity sector by 19% and in the telecommunications sector by 20%.[19]

All of our economic policies, be they founded on neo-classical, behavioural or other theories, are means to ends, not ends in themselves. The end that we are seeking to promote is the enhancement of the long-term interests of consumers. As I discuss

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[14] Trebilcock, n 5 above at 133.
[15] Trebilcock, n 5 above at 132.
[16] Stanley Fischer, 'Globalisation and its challenges', *Ely Lecture*, 2003, at 33. The lecture is available at http://www.iie.com/fischer/pdf/fischer011903.pdf (viewed 15 July 2007). I am grateful to Lyndon Rowe for drawing my attention to this paper.
[17] Productivity Commission 2005, *Review of National Competition Policy Reforms*, Report no.33, Canberra at XVII.
[18] Productivity Commission 2005, note 10 at XVIII
[19] Productivity Commission 2005, note 10 at XIX.

behavioural economics, I do so in this context. How do we achieve the long-term interests of consumers?[20]

First, economic efficiency is the bedrock upon which the long-term consumer interest is built – we should recognise that it is, principally, the free operation of markets that will be the primary tool to achieve economic efficiency. Of course, when I use the term "free market", I don't mean market freedom in the way that, say, a Milton Friedman would think of free markets. I accept as proper a range of interventions into markets, for example, regulation of natural monopolies, regulations designed to ensure open competition by making unlawful anti-competitive conduct (in other words, the provisions of Part IV of the *Trade Practices Act*), laws prescribing product safety and minimum standards, laws to protect consumers from inappropriate market practices (such as misleading conduct), to provide redress for disputes (and enforcement of bargains) and to ensure that consumers are properly informed in their choices.

I think the real issue here is not one of regulation versus no regulation, but ensuring that, since our starting point is the efficiency-enhancing effect of markets, that regulation is never introduced, regardless of whether it is suggested by behavioural economics theory or any other theory for that matter, unless:

(1) there is a demonstrated need for the regulation;
(2) the proposed regulation will actually remedy the problem;
(3) the proposed regulation is the least restrictive on consumer sovereignty of the policy tools at our disposal; and
(4) the costs imposed by the regulation are outweighed by the benefits of the regulation.

In short, regulatory protections suggested by behavioural economics research that stifle economic efficiency are undesirable, unless it can be clearly demonstrated that the cost of that inefficiency is outweighed by the benefits of our protective actions.

Whilst I am of the view that redistributive policies are among the most important for governments to pursue – and there can be no doubt that some aspects of applied behavioural economics have a redistributive character, we should generally be cautious when using consumer policy as a social (or distributive) justice mechanism. Generally speaking, although not exclusively, our otherwise perfectly reasonable redistributive aspirations are best served by more efficient means such as the taxation and welfare systems and spending on health, education and other sectors of the economy.

[20] I have drawn upon material previously published by me for the remainder of the text in this section, in particular, Chris Field, *Current Issues in Consumer Law and Policy*, Pearson 2006 at 71-76 and Chris Field, 'Competition, Consumer Protection and Social Justice – Providing a Consumers' Voice', (2005) 33 *Australian Business Law Review* 45 at 45.

Challenges to behavioural economics theory

In the next section of my paper, I want to examine some of the key challenges to behavioural economics theory. In particular, I want to explore problems of substituted decision making, occasional versus dispositional autonomy and non-coercive interference with liberty.

The problems of substituted decision-making

In their article, *Libertarian Paternalism*, Professors Richard Thaler and Cass Sunstein describe the problem faced by a hypothetical director of a company cafeteria.[21] The director has become aware that the order in which food is placed influences the choices that people make. The authors set out the three strategies available to the director. First, "she could make choices that she thinks would make the customers better off".[22] Second, "she could make choices at random".[23] Third, "she could maliciously choose those items that she thinks would make the customers as obese as possible".[24] The authors conclude that "Option 1 appears to be paternalistic, which it is, but would anyone advocate options 2 and 3?"[25] This problem bears out a key dilemma for Thaler and Sunstein: proxy-decision makers often have no choice to act paternalistically and if that is the case then why wouldn't you choose the option that is obviously best for consumers. In the words of Thaler and Sunstein it is a:

> misconception that there are viable alternatives to paternalism. In many situations, some organisations or agents must make a choice that will affect the choices of other people.[26]

An unstated premise of this argument is that choosing to eat foods that lead to obesity (or other health problems) is something that is not in the best interests of consumers. I will leave aside two problems with this initial premise being: (1) Not all consumers will act homogenously in the committing of behavioural mistakes. That is, at least some consumers will choose the "healthy" foods even when the "unhealthy" foods are first in the cafeteria line;[27] and (2) The mere choosing to eat unhealthy foods on any given occasion in a cafeteria line is not, in of itself, causally linked to an unhealthy outcome. The choice to eat these foods much of the time, a lack of exercise and a range of other factors would need to be considered.

Can we be confident that choosing to eat unhealthy foods is something that is not in the "best" interests of consumers? Thaler and Sunstein use what appears to be an easy

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[21] Richard Thaler and Cass Sunstein, 'Libertarian Paternalism', Behavioural Economics, Public Policy and Paternalism, (2003) *AEA Papers and Proceedings* 93 175 at 175.
[22] Ibid.
[23] Ibid.
[24] Ibid.
[25] Ibid.
[26] Ibid.
[27] Glen Whitman, 'Against the New paternalism – Internalities and the economics of self-control', 563 *Policy Analysis*, February 22, 2006.

example – these days who wouldn't think that obesity is a problem and that excess consumption of fatty foods is causally linked to obesity. Unfortunately, many (perhaps) most public policy problems simply don't have a readily identifiable "best" solution. This means that we are going to have our proxy decision makers make a decision for us on what is the "best" of a range of paternalistic options. One problem is that, in arriving at the "best" solution, proxy decision-makers will make mistakes.[28] What we know about governments, regulators and decision-makers is that they make all sorts of mistakes in arriving at the "best" solution. This is partly because the sorts of mistake-making behaviour that behavioural economists observe in ordinary consumers can be expected (and indeed observed) in those that make decisions for us. Moreover, proxy decision-makers have all sorts of other factors operating that potentially lead to worse decision-making than that made by consumers themselves. For example, you do not have to be a strict adherent to the economic theory of regulation to observe that governments of any persuasion can be overly influenced by vested (mostly producer group) interests that seek regulatory protection from markets for their gain and to the cost of consumers.[29] In fact, one very good reason why those who advocate for the interests of consumers should favour a default position in favour of open, competitive markets (and a rigorous set of pre-conditions to intervene in markets) is the fact that much of the regulatory intervention that occurs in markets is rent-seeking from producers that is detrimental to consumers.[30]

Finally, while consumers suffer from information asymmetries, so of course do proxy decision makers – in fact, their information deficits are likely to be worse than that of consumers, leading to greater error in decision-making.

In my view, when it comes to making these judgments about the behaviour of other consumers an obvious question arises. In short, says who? Much more eloquently, John Stuart Mill famously stated that:

> Mankind are greater gainers by suffering each other to live as seems good to themselves, than by compelling each other to live as seems good to the rest.[31]

I think behavioural economists do not give sufficient weight to the problems of substituted decision-making and also discount the possibility that, either deliberately or unwittingly, there is a potential for one person to substitute their version of normal behaviour for that of another person. In his seminal essay "Paternalism", Gerald Dworkin, observed that:

> Of course … there are great difficulties in deciding what rational individuals would or would not accept. Particularly in the sensitive areas of personal liberty, there is already a

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[28] Ibid.
[29] Field, n 20 above at 8-13. See generally Edward Glaeser, 'Paternalism and Psychology', 73 *the University of Chicago Law Review* 133: "On the supply-side, purveyors of influence have the capacity to change popular opinion. On the demand-side, human beings have some capacity to limit errors, especially with the time and incentives to acquire advice and information [at 134]".
[30] Ibid.
[31] Mill, *On Liberty,* n 5 above at 138.

> danger of the dispute over agreement and rationality being a disguised version of evaluative and normative disagreement.[32]

Occurrent and dispositional autonomy

Another concern is the possibility of focussing on "transactional" decision-making at the expense of "whole of life" decision making (or, in a strict philosophical sense, the difference between occurrent and dispositional autonomy). In short, we learn from our mistakes and those experiences make our subsequent decision-making stronger. More importantly, we are the authors, and the owners, of the mistakes and the successes from our learning. Similarly, behavioural economics places a bias on long-term interests in contrast to short-term interests (this is evident in behavioural economists views about matters such as retirement savings plans). In his recent critique of so-called "new paternalism", Glen Whitman, argues that:

> …new paternalism blithely assumes that, when your present self can impose costs on your future self, the outcome is necessarily bad. But preventing harm to the future self might involve even greater harm to the present self. There's no valid reason to assume, when there is an inconsistency between present and future interests, that the latter must trump the former.[33]

Does non-coercive paternalism offend liberty?

Thaler and Sunstein tell us that, "[i]f no coercion is involved, we think that some types of paternalism should be acceptable to even the most ardent of libertarian".[34]

Whether an intervention in a market, or restriction in individual liberty, is achieved through coercive or non-coercive measures, it does not change the fact that such intervention is, in fact, paternalistic. Of course, Thaler and Sunstein do not suggest otherwise. Their argument is that this non-coercive action (which they call libertarian paternalism) is a form of liberty-respecting paternalism, one that retains choice whilst guiding one towards the best choice. The *Economist* has stated (of Thaler and Sunstein) that they:

> offer a vision of what you might call the "avuncular state", worldy-wise, offering a nudge in the right direction, perhaps pulling strings on your behalf without you even noticing.[35]

To my mind, this is exactly the sort of summation of behavioural economics that affronts consumer autonomy. I think the behavioural economists are in error to emphasise the fact that paternalistic intervention is not egregious simply because choice has not been removed. The error made here is that it is not the retention of choice that characterises

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32 Gerald Dworkin, 'Paternalism', *Paternalism*, Rolf Sartorius (Ed), University of Minnesota Press, 1983 at

33 Whitman, n 27 above at 14.

34 Thaler and Sunstein, n 21 above at 175.

35 *The new paternalism*, April 6, 2006 at 2. Available at http://www.economist.com/displaystory.cfm?story_id=6768159 (viewed 17 July 2007).

liberty, but the capacity to exercise those choices free of intervention from others, be it coercive or non-coercive intervention.[36]

The application of behavioural economics

The behavioural economics literature is now being utilised to suggest a range of market interventions that are said to increase consumer welfare. Examples include retirement savings programs, investor protection and disclosure - most of these examples involve changing defaults, removing biases and the like. I will discuss two: unfair contracts and extended warranties.

Unfair contracts

A number of authors are now using the findings of behavioural economics to suggest that governments, courts and regulators should intervene to regulate terms of contracts that are deemed to be unfair.[37] In their article, "Unfair terms in "clickwrap" and other electronic contracts", Clapperton and Corones argue that regulation should be introduced to remove unfair terms in electronic consumer contracts. The authors set out the rational maximising view of consumers which they suggest entails that:

> If consumers are dissatisfied with the quality of a product relative to its price, or the terms on which a product is offered, they will discipline producers by ceasing to purchase the product.[38]

They go on to note that:

> Behavioural economics, on the other hand, challenges this underlying assumption. They start from the premise that that there are limits to rationality. They are sceptical about the ability of certain categories of consumers to make decisions in their best interests and believe that regulation may be necessary to protect them.[39]

The authors urge the Productivity Commission to consider the "observed behaviour" of market participants and state that there is no clear evidence that consumers faced with unfair terms in electronic contracts cease buying the product.

The fact that consumers do not cease buying a product even though it contains unfair terms may well be an example of behavioural mistakes being made by consumers. The authors seem to ignore, however, the other perfectly reasonable explanation for this observed consumer behaviour, namely that consumers continue to buy the product,

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[36] Edward Glaeser, n 29 above, at 135 notes that "soft paternalism is neither innocuous or benign".
[37] For example, Dale Clapperton and Stephen Corones, 'Unfair terms in "clickwrap" and other electronic contracts', (2007) 35 *Australian Business Law Review* 152 and Nicola Howell, 'Catching up with consumer realities: The need for legislation prohibiting unfair terms in consumer contracts', (2006) 34 *Australian Business Law Review* 447.
[38] Ibid 152. The authors, in fact, fail to discuss several aspects of the Chicago school theories on unfair terms and standard form contracts.
[39] Ibid.

perfectly cognizant of the unfair terms, but simply valuing other terms of the contract beyond these unfair terms.

In other words, some contractual terms, while unfair to lawyers, might be considered perfectly fair by consumers. Consumers might well understand that a harsh term is a trade-off for a good price. There is no rational mistake made by the consumer who chooses to benefit from a lower price that is the trade-off for a harsh term. As Ross Parish has noted:

> The economic rationale of these provisions is obvious: it is to reduce the costs and risks of doing business. Consumers benefit from them in lower prices.[40]

To the extent that behavioural economics suggests such intervention, it appears that there is an assumption that such intervention will be costless – unfairness will be removed and that is the end of the matter. This position is wrong. As Ross Parish has noted:

> The major error in the legal approach to consumer protection is the tendency of lawyers, judges and legislators to denounce particular terms or aspects of contracts as being patently unfair, without considering them in relation to the contract as a whole and without analyzing carefully their purpose, or the consequences of failing to enforce them, or of outlawing them. This is legal technocracy at work, pursuing its imperative value, 'equity', regardless of the harmful, costly and frequently perverse consequences.[41]

Extended warranties

In an episode of the *Simpsons*, Homer discovers that he has crayons lodged in his brain and that is the reason for his lack of intelligence (I won't go into how they got there). They are removed, he becomes more intelligent and to cut a 24 minute story short – so dislikes being intelligent that he has his bartender, Mo, lodge, one-by-one, the crayons up through his nose into his brain. After one crayon, he says something moderately silly, after a second, something decidedly unintelligent and after the third, spontaneously shouts: Extended warranty! How can I lose?[42]

Camerer et al, suggest that extended warranties may be one of those occasions where consumers make mistakes. They suggest:

> Behavioural economics show that people often overact to highly salient, rare events, and that people are surprisingly risk adverse for small gambles that pose the chance of a loss. Extended warranties capitalize on exactly these patterns of behaviour.[43]

But what would we do about extended warranties? Ban the product? This would seem an extraordinary reaction, particularly in the context of the fact there are a range of

[40] Ross Parish, 'Consumer protection and the ideology of consumer protectionists', *Consumer Protection Law and Theory*, (1980) Edited by A J Duggan and L W Darvall, LBC, at 239.
[41] Ibid, 238.
[42] The Simpson's episode is mentioned in Camerer *et al*, n 2 above at 1254 at fn 144.
[43] Ibid.

consumer protections already in place. Those who sell extended warranties are prevented from misleading consumers about their product[44] and prevented from misrepresenting the nature of warranties.[45] Banning the product is not the policy choice that the authors suggest. They state "…the right policy is one that encourages disclosure rather than, say, bans warranties".[46] But what disclosure? There is in fact a wide availability of information on product life and average cost of repair that aids assessment of whether the premium to be paid for the extended warranty would be justified. For example, *Choice* magazine publish this information. What other disclosure would we provide? A pamphlet to every consumer considering purchasing the product? A product warning notice? Signs in stores? These sort of interventions are potentially significant interventions into the operation of this market and carry potentially significant costs. In part this example shows us that where behavioural economics suggests a problem, that does not necessarily suggest any consumer policy response is required. In fact, as Camerer et al note:

> If informed consumers continue to purchase the warranties, then it is quite possible that they have good reason to do so, however unfathomable that decision may seem to an economist.[47]

Conclusion

I think most of us can have some sympathy for those who are motivated to correct what appears to be known and repeated mistakes made by consumers, particularly in the context where you suspect, if only they had the chance to exercise greater rationality, they would approve of your choice for them. This motivation will appear even more virtuous to those who combine a scepticism about the operation of markets with a suspicion that corporations are unfairly exploiting consumer's mistakes. An intervention to tip the balance back a little to the consumer's side is a motivation that I think is evident in the work of behavioural economists – an exercise made more palatable on the basis that the intervention appears benign.

Whilst I can understand that motivation, it must be, if not entirely resisted, at least subject to constraints. There are many reasons for this, of which I have discussed a few in this paper. Of these, two stand out for reiteration.

First, liberty matters, because a life worth living is one that you are able to author yourself – brilliant decisions and costly mistakes, silly risks and unnecessary caution and everything in between. You grow and learn from the mistakes you make – and these mistakes can make subsequent decision-making all the stronger. Correcting mistakes before we make them is to change fundamentally the nature of autonomous living and remove from our lives one of the means that individuals, and for that matter, societies throughout history, have used to develop and improve. What entrepreneur on the way to

[44] *Trade Practices Act* 1974 section 52.
[45] *Trade Practices Act* 1974 section 53(g)
[46] Camerer *et* al, n 2 above at 1254.
[47] Ibid.

great fortune, scientist on the way to great discovery or explorer opening up new worlds, hasn't made mistakes, mistakes in many cases based on imperfect calculations the like of which behavioural economists have identified? Individual liberty, combined with freedom of markets, leads to the lowest prices, greatest choice and greatest quality of consumer goods and services. Moreover, our markets left to work, without unnecessary regulatory intervention, leads to the greatest productivity and prosperity for all consumers. To the extent to which we harbour some residual concern that some consumers are making mistaken decisions – mistakes that do not otherwise justify regulatory intervention into markets - we can remind ourselves, in the words of Professor Ross Parish: "[t[he better off we are, the more we can afford to make some mistaken buying decisions"[48]

Second, proxy-decision makers also make mistakes, driven by both internalities and externalities. If only we could all enjoy the guidance of the perfectly knowing, perfectly choosing, benign and costless hand of Plato's Philosopher King! Rather, behavioural economists fall into their own assessment problems – they underestimate all we have learned about the mistakes governments and other decision-makers make, the costs of interventions, their unintended, often perverse consequences and the lack of humility sometimes shown by those who seek to improve the lives of others. The observations of Adam Smith on this matter are as powerful today as when they were written more than 300 years ago:

> The statesmen who should attempt to direct private people in what manner they ought to employ their capitals would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted to no council and senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself to exercise it.[49]

Everything learned thus far from behavioural economics, for me at least, does not change one simple reality – every time we make a consumer policy choice we choose between the operation of imperfect markets on one hand and imperfect governments on the other.[50] I would take that process of choice one step further by saying our default

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[48] Ross Parish, n 39 above at 242.

[49] Adam Smith, *The Wealth of Nations*, Books IV-V, Penguin Classics at 33 available at http://books.google.com/books?id=LfZYW5hI5rsC&pg=PA33&lpg=PA33&dq=the+statesmen+who+should+attempt+to+direct+private+people+in+what+manner+they+ought+to+employ+their+capitals+would+not+only+load+himself+with+a+most+unnecessary+attention+but+assume+an+authority+which+could+safely+be+trusted+to+no+council+and+senate+whatever+and+which+would+nowhere&source=web&ots=TBb95eaNP9&sig=5JGgJHU9stRyrfkszAhu1TnpIms#PPA32,M1. (viewed on 17 July 2007).

Along similar lines Gerald Dworkin observes (Gerald Dworkin, n 33 above at 33):

> However, rational people who know something of the resources of ignorance, ill-will, and stupidity available to lawmakers of a society … will be concerned to limit such intervention to a minimum.

[50] A point made by the Productivity Commission in their Consumer Policy Framework, Productivity Commission Issues Paper, January 2007 at 14 available at http://www.pc.gov.au/inquiry/consumer/issuespaper/consumer.pdf (viewed on 17 July 2007).

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position should be to favour imperfect markets, but with the knowledge that government intervention is appropriate where we can demonstrate need, likelihood that the intervention will succeed, the absence of less restrictive alternatives than intervention and that the intervention has net benefits for consumers in the long run.

In my view, this places behavioural economics in its correct context. It is a set of insights about consumer behaviour that may provide useful information in considering consumer policy choices – including government intervention in consumer markets. But it should not be elevated to a status that trumps a rigorous assessment of that market intervention. That case may be made if behavioural economics was some form of unifying theory – a third way if you like - between freedom of markets and consumer protection, but I think it is neither sufficiently explored yet for that to be the case, nor has it answered the very powerful criticisms that are now being directed towards the theory.

Behavioural economists offer to us the ability to have one's cake and eat it too. On this point, we would do well to remember one of the basic axioms of consumer policy: When an offer sounds too good to be true – it probably is!