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Mr Robert Fitzgerald
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By email: rfitzgerald@pc.gov.au

Dear Robert,

Re: Review of Consumer Policy Framework

In discussions related to your presentation at the National Consumer Congress, you suggested it would be useful to provide a brief overview of the emerging views about the approach to consumer policy being considered in the Economics for Consumer Policy working group at the OECD which I chair; in particular, the Congress discussion focussed on behavioural economics and the research or evidence base for decision making in consumer policy.

As you are aware, the project on Economics for Consumer Policy at the OECD arose out of a desire to create a better economic underpinning for consideration of decisions about consumer policy. The working group is in the process of creating a Toolkit for governments in their consideration of consumer empowerment and protection decisions. At the heart of the Toolkit's concept is the notion that consumers do not only benefit from competition, they drive it – and whether they are able to do that well is an important question in its own right. The question is seen as important not only for consumer outcomes; ultimately, it is important for competitiveness of firms and more generally, it is one element contributing to the productivity of a nation. The EU, which is an active member of the working group, has put the concept succinctly: 'Confident, informed and empowered consumers are the motor of economic change as their choices drive innovation and efficiency.'¹

The emphasis of the Toolkit, to distinguish this task from that of the OECD Competition Toolkit, is not on firm rivalry and competitive market structures as contributors to consumer outcomes, but on consumer decision-making itself and whether consumers are able to benefit from already competitive markets. In other

¹ EU Consumer Policy strategy 2007-2013 *Empowering consumers, enhancing their welfare, effectively protecting them* Commission of the European Communities Brussels 2007.

words, the question is whether the market is working *for consumers*. The empirical work of behavioural economics, and more broadly, the need for research to provide an evidence base for policy decision making has thus been an important focus of the work.

A brief synopsis is outlined below and I would stress that this does not represent the view of any of the nation states or agencies involved in the working group, but rather the tenor of the discussions and contributions to date.

The Role of Behavioural Economics in Consumer Policy

The research and results of empirical evidence of market behaviour has been of particular interest to the working group. This includes of course any substantive areas of economic research including the range of research classed under the heading of behavioural economics. In general, it is clear that the working group members see behavioural economics as complementary to conventional and information economics; while information economics introduced the important concept of bounded rationality and examined information problems in markets (essentially by treating information itself as a scarce resource pointing to important asymmetry problems), behavioural economics provides valuable empirical evidence about people's behaviour in markets. Understanding rather than assuming how consumers will behave is essential for reaching policy decision that will work effectively in many markets. To illustrate, while information and competition economics require that consumers have truthful and adequate information to make decisions which optimise their welfare (this has led to the introduction of misleading conduct laws and a broad range of disclosure requirements), behavioural economics inquires as to how people actually make decisions (eg was the disclosure useful and helpful in making the choice and if not, why not?).

The OECD Committee on Consumer Policy organised two Roundtables which included a major focus on behavioural economics.² It is from behavioural economics that such notions as consumer information overload, loss aversion (which affects willingness to change provider), over-confidence ('irrational exuberance' is one well-researched behavioural economic example of this), hyperbolic discounting behaviour (we value the immediate benefits over the longer term benefits), systematic underestimating of risk and so on have been examined and described – a range of these cognitive or reasoning biases have been canvassed in the draft PC Review.

Being forewarned about potential biases and behaviour limitations (how consumers may systematically behave not as predicted) will lead to better questions when agencies are investigating market problems. One of the contributors to the Toolkit, from the Chief Economist's unit of the UK Office of Fair Trading, explained with the following example: 'When we are looking at hidden charges, we need to understand whether the problem derives from these charges *being* in the fine print OR whether consumers systematically underestimate the risk of an event which triggers the clause in the fine print' – if it is the latter, then we need to question whether it is likely to assist the problem if that term of the contract is simply brought to consumers' attention through a disclosure requirement.

² Roundtable 1 summary: <http://www.oecd.org/dataoecd/31/46/36581073.pdf>
Roundtable 2 summary: <http://www.oecd.org/dataoecd/5/38/39015963.pdf>

It should be noted that the behavioural economic research is not seen as significant simply because it documents fact that people can make mistakes in their decisions in markets. Under the rational actor model, there has always been a range of outlying decisions around the mean, but the mean was the rational mean. What matters in the behavioural economic research is not that consumers make mistakes, but that regular and possibly ingrained human behaviours consistently – or systematically – affect decision-making in a predictable direction. This is important not only because consumer detriment may result; systematic departures from the rational mean are also important because if people are systematically departing from ‘rational actor’ behaviour, then public policy (for example competition policy), predicated on rationality assumptions, may not deliver optimal or predicted outcomes. The Boston Reserve Bank, a major behavioural economic research institution, recently examined the implications of behavioural economics for economic policy more generally.³

To conclude, behavioural economic insights are crucial in understanding what is actually going on in terms of consumer behaviour in markets (eg why consumers may not be switching, or why they are choosing badly). These insights will also assist in preventing mistakes in interventions in markets which may have the good intention of protecting or empowering consumers, but not that result.⁴ While not a ‘silver bullet’, the empirical and evidence-based approach of behavioural economics will assist in producing consumer empowerment or protection strategies that actually work.

Evidence Base – greater attention to demand-side analysis

In general, it is agreed in principle that government interventions in markets or otherwise should be based on evidence. In the case of consumer policy, such evidence would relate both to identified consumer detriment and also to the efficacy of possible interventions designed to protect or empower consumers.

One chapter of the Toolkit is devoted to various methods for identifying: consumer problem areas in markets that require investigation; markets where consumers appear unable or have difficulty in driving competition; the most appropriate means for measuring consumer detriment that may arise in these circumstances. A later chapter on decision making – whether or not to intervene either to assist consumers in some way outside of the market or in the market itself – assumes that appropriate testing of the efficacy of any intervention *ex ante* and appropriate evaluation *ex post* is being carried out; in fact, a benefits-costs analysis cannot be fully done without some such estimation of likely benefits based on the effectiveness of a proposed course of action.

Both the detriments and the decision making segments of the Toolkit, however, presuppose that research is occurring and that some agency or agencies have responsibility for ‘watching’ the demand side, and carrying out pro-active investigative and rigorous analysis of consumer outcomes. At the recent Global Competition Forum, I noted that in some discussions of consumer policy “the quite

³ See <http://www.bos.frb.org/behavioralpolicy2007/>

⁴ The classic example of this type of government failure is illustrated by the almost identical interventions of New Jersey and Pennsylvania in relation to reducing the costs of their compulsory automobile insurance. Failing to understand consumer ‘default’ behaviour cost one State in the order of \$200 million. See E J Johnson, et al “Framing, Probability Distortions and Insurance Decisions” (1993) *Journal of Risk and Uncertainty* 7:35-51

appropriate hesitancy about intervening in markets - because of regulatory risk and uncertainty - has become translated into a lack of activity in rigorously examining consumer problems in markets ... [a] confusion between the task of final evaluation and decision-making and the process of investigation and analysis.”⁵

The working group at the OECD has also recognised that the task of greater demand-side analysis is not only important for the consideration of consumer issues. An emphasis on making markets work for consumers could also deliver reform that reduces costs to business. A range of current market interventions, for example many of those identified in the UK Better Regulation Executive’s analysis of information disclosures,⁶ are ineffective or may even have *disempowered* rather than assisted consumers while at the same time imposing a significant cost burden on business; rationalising such regulation, on the basis of sound evidence, is a fundamental part of needed regulatory reform.

Conclusion

To conclude, an evidence-based approach to consumer policy, which takes as its focus an analysis of consumer outcomes, and which bases any intervention on real consumer behaviours, can help ensure that ineffective interventions are not pursued or are remedied, and that sound alternatives are considered within a sophisticated cost-benefits analysis, including whether a market will respond successfully to consumer problems by itself within a reasonable time. Equally important, examining whether markets are working from the consumer perspective complements the type of market analysis which is undertaken on the competition (or supply side), and in some jurisdictions is an integrated task.⁷ The current draft decision tree in the OECD Toolkit for Consumer Protection and Empowerment recognises this integration and is attached for your information.

Yours sincerely,

Louise Sylvan
Deputy Chair

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http://www.oecd.org/document/25/0,3343,es_2649_37463_39410201_1_1_1_37463,00.html

⁶ *Warning: Too Much Information Can Harm* Final Report of the Better Regulation Executive and the National Consumer Council, November 2007.

<http://www.ncc.org.uk/publications/index.php>

⁷ See, for example, http://www.ofc.gov.uk/advice_and_resources/resource_base/market-studies/.

Draft Decision Tree – From Chapter 5
 Consumer Protection and Empowerment: Building a Toolkit for Policy Makers

