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The future of consumer policy: should we regulate to protect *homo economicus*?

Address to the ACCORD Industry Leaders Briefing

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I am very pleased to be here today to talk about the latest developments in competition and consumer policy, and thank ACCORD for inviting me to participate.[1]

As business people, ACCORD's members have a keen interest in consumer policy. Consumers buy and use your products every day, so we have a common interest in ensuring markets are functioning efficiently and consumers are able to make their decisions with confidence.

In 2008, the Ministerial Council for Consumer Affairs agreed to a national consumer policy objective: '*To improve consumer wellbeing through consumer empowerment and protection, fostering effective competition and enabling the confident participation of consumers in markets in which both consumers and suppliers trade fairly*.' This objective — which highlights the importance of consumer wellbeing and well-functioning markets — will inform the development of the Australian Consumer Law.

In thinking about consumer policy, Treasury — as an economic policy agency — is also guided by four core principles articulated by the Treasury Secretary, Dr Ken Henry, in his 2007 address to the National Consumer Congress:

- first, competitive markets drive consumer welfare, and consumers drive competitive markets;
- secondly, government intervention in the market should utilise the regulatory or non-regulatory tool best suited to each situation;
- thirdly, government policy should not impede the expansion of national markets — rather, it should support that expansion;
- and finally, government policy should empower consumers, protecting them when appropriate.

Reforms to Australia's consumer laws

As you all know, the Government is currently engaged in the most substantial reform of Australia's consumer laws since the Trade Practices Act was introduced in 1974.

In June this year, the Government introduced a Bill to:

- establish the Australian Consumer Law, which will be applied as a law of the Commonwealth and of each State and Territory;
- prohibit the use of unfair contract terms;
- and enhance the range of enforcement measures available to the Australian Competition and Consumer Commission in enforcing the consumer law.

And, in early 2010, further legislation will be introduced to:

- fully implement the Australian Consumer Law, which will be based on the existing consumer protection provisions of the Trade Practices Act;
- implement a new national legislative and regulatory framework for product safety;
- and introduce new national provisions based on best practice in existing state and territory consumer laws.

This last category of reforms is presently the focus of discussions between jurisdictions, and a final list of proposals will be agreed late this year. It includes proposals covering a wide range of areas, many of which are intended to give rise to national consistency, such as laws covering door-to-door sales and telemarketing.

The Productivity Commission tells us that the creation of one nationally consistent Australian Consumer Law could deliver a net annual gain to the Australian community of between 1.5 and 4.5 billion dollars, primarily by ironing out inconsistencies across jurisdictions and providing savings to businesses and consumers.[2]

This reform process is giving policymakers the opportunity to look at the consumer law as a cohesive whole, and to find ways to make these laws better for the future.

Consumer choice and consumer risk

We're in the midst of a dynamic time for consumer policy.

Not only are major legislative and institutional reforms under way; policymakers are confronting new pressures on how best to manage the impacts on consumers of choice and risk.

The global financial crisis has thrown into sharp relief the tensions between regulation and competitive markets. It has reminded us all that governments cannot wash their hands of adverse market outcomes by claiming all parties entered the market of their own free will.

As a result of the global financial crisis, governments all over the world now own enterprises from car companies to banks and have guaranteed trillions of dollars of 'private sector' deposits and bank capital. This effectively takes the risk from the private sector onto the taxpayers' balance sheet; an appropriate response given the seriousness of the economic circumstance governments confronted.

Interestingly, **while some governments' lax approaches to regulation have been identified as a major cause of the global financial crisis** by many economic commentators, this is not necessarily the case among the broader public.

A recent poll conducted by the ANU suggested that many Australians — perhaps in a reflective mood — **placed a 'great deal' of responsibility** for the global financial crisis not on overly exuberant businesses or lax government regulations, but **on consumers, for taking on too much debt**.[3]

One wonders what this means. **Should we regulate these unreliable consumers, prevent them from borrowing 'excessive' levels of debt and prohibit them from certain types of investment products?** I suspect that this might be the tail wagging the dog, but there is little doubt **the global financial crisis has put the focus on appropriate regulation**.

Over the past 15 years or so, consumers have been confronted with a massively expanded range of often complex credit and investment products from which to choose.

Consumers are confronting the management of risk in ways they were previously spared, because of the expansion of the range of risk-based products in investment, credit and insurance markets.

Similar developments have occurred in many other consumer product and service markets.

Consumers now enjoy a huge range of choices in relation to products and services —one of the great benefits of globalisation.

And this doesn't just apply to traded goods but also to basic services like energy and telecommunications, where previously there may have been just one provider and usually just one plan.

The markets in which your businesses operate also reflect those changes. The range of product choices now presented to consumers in the cosmetics industry, for example, is truly breathtaking, and it can sometimes be hard for consumers to evaluate what benefits they might get out of one product as compared with another.

Consumers have new and ever-evolving means of purchasing their products. They may make their purchases through traditional means such as in a shop or from a door-to-door salesman, they could take advantage of the opportunities offered them through telemarketing or so-called 'm-commerce', or they might buy online.

We have a challenge, then, to develop a national consumer policy framework that is both *timely* — so that it is robust in the face of the risks which exist now — and *timeless* — so that it represents best-practice regulation both in the good times, and the bad.

Consumer policy in the current environment

With this in mind, I want to share with you something of Treasury's approach to achieving the national consumer policy objective through the current reform processes and its wider work, and outline some of the new policy tools that can make consumer policy more effective.

Treasury will continue to apply a mainstream economic framework — embodied in those four core principles I mentioned earlier — that has been so successful in generating wealth, effectively since the industrial revolution, to inform the important policy decisions that are to come.

At Treasury we nest economic frameworks within a wider 'wellbeing framework' when analysing policy. This framework includes both traditional economic elements — such as increasing the level of consumption possibilities for consumers — and examining issues surrounding the distribution of those possibilities.

However, it also asks us to look at the level of risks that people are required to bear, the level of opportunity and freedom that people enjoy, and the level of complexity with which people are faced.

In the case of consumer policy**, it has never been seriously suggested that the market alone can achieve good consumer policy outcomes in every circumstance.**

For example, at least since the introduction of the Trade Practices Act in 1974, the most extreme form of the 'buyer beware' mentality has not been a significant part of Australia's consumer policy landscape.

While we don't expect the market to succeed for us every time, we do look to carefully identify market *failures* before taking the decision to act, as the cost of government action can easily outweigh the cost of market failures.

Perhaps the most obvious consumer market failures arise out of asymmetries of information, and over the years consumer policymakers have found ways — with varying degrees of effectiveness — to address these failures.

For example, legislation to require basic product quality has been around for well over a century now.

This type of legislation implies conditions and warranties into consumer contracts. It provides consumers with certain assurances, that the goods they buy will be of a certain minimum standard, and that the seller has the right to sell them so the consumer needn't worry that someone else will claim them.

This is good consumer policy, because it provides an efficient market to trade goods and services and allocates risk efficiently.

But even when product safety regulation works, lapses in standards can adversely affect consumers and businesses.

In a study this year from the US, Seth Freedman, Melissa Kearney and Mara Lederman analysed the sizeable increase in the number of product recalls in 2007, primarily as a result of high levels of lead in children's toys imported from China.[4]

Recalling products obviously has a direct adverse effect on consumers who have purchased the products.

But the study also found a number of industry-wide spillover effects.

The recalls led consumers to change their buying behaviour, with all toys similar to those recalled experiencing significantly lower sales, regardless of the manufacturer.

The entire industry suffered from reduced demand as a result of standards not being met, even in imported toys.

This highlights that suppliers — not just consumers — need to be concerned about standard-setting in their industries, and about ensuring that only quality goods reach the market place irrespective of their source.

Suppliers have the information about the goods they sell. And we generally accept that they should bear most of the risks associated with clearly communicating that information, rather than leaving consumers to manage risks outside their control.

When do markets fail? Identifying consumer problems

While correcting market failures is a well-accepted rationale for intervening in markets and for certain consumer policies, market failure is itself a somewhat slippery concept.

For example, how do we distinguish a complaint about poor consumer decision-making from a poorly functioning market? That is, when should we leave well enough alone — recognising that negative feedback about a product will ultimately lead to self-correcting behaviour when people stop buying it — or when should the government intervene and regulate?

Governments receive many thousands of complaints about consumer issues each year and these are often the product of a strong sense of frustration that moves a consumer to act. **Experience shows that in many cases actual consumer concern, and indeed harm, are much more widespread than the level of complaints would indicate.** To identify harms suffered by consumers we are increasingly looking to the toolkit of the marketers, and using consumer research techniques long employed by businesses.

The first step in solving consumer problems is to identify and characterise them accurately. Consumer policymakers have an increased awareness of the importance of identifying 'consumer detriment', and are looking at new methods of doing so.

Consumer detriment is more than simply financial loss, and a more nuanced approach is necessary if it is to be identified and remedied. It is now well understood that detriment can be non-financial. Increasing risk for consumers or reducing opportunities for consumers are both instances of detriment. But this makes 'consumer detriment' as slippery a concept as the market failure which can result from it.

For example, we recognise that there are often contractual impediments to consumers moving between service providers in markets such as personal fitness or telecommunications. Excessive exit fees or periods of notice may cause detriment for consumers wanting to switch providers or quit the market, though this detriment may be difficult to identify and, certainly, to quantify.

However, this type of conduct may not create detriment for consumers who don't want to switch, and indeed may be beneficial for them in keeping access prices low. Identifying this conduct as causing consumer detriment is not straightforward, and highlights the importance of building good tools for identifying consumer detriment before taking the decision to act.

Therefore, we must exercise a degree of caution, to ensure that the evidence which may lead to regulatory changes reflects actual harm, rather than popular perceptions or anecdotal concern. That is, **there is always a need for rigorous cost-benefit analysis** (to the extent that it is feasible) **to demonstrate that regulation is in the public interest**.

Consumer behaviour: New approaches to consumer policy thinking

In the three and a half decades that have passed since the Trade Practices Act transformed Australia's consumer policy landscape, there have been a range of new and significant contributions to economic, political, and psychological thinking that can usefully inform the way we engage in consumer policy.

In conventional economic thinking we assume that consumers are perfectly rational, and consider and make decisions in their own best interests.

To use the economist's jargon, individuals make choices to maximise their utility using the information available. Their preferences are consistent through time and independent of how the information they use to support their decisions is presented.

In other words, **this is *homo economicus*: a perfectly rational and selfish person.**[5]

But as we all know, 'real people' don't necessarily behave like *homo economicus*. Indeed, in some markets, human beings are perversely irrational a lot of the time.

Experimental analysis tells us that in fact individuals have preferences that change through time, are concerned for others, have varying attitudes to risk depending on how risks are framed and what reference points are available, violate rationality by overestimating their skills, over-project the current state, use rules of thumb or heuristics to solve problems, and make decisions affected by transient emotions.[6]

How widely these behaviours demonstrated in the laboratory persist in life, especially with the opportunity for feedback from mistakes, is less clear. However, it does appear that many of them do persist outside the laboratory.

We can all think of many examples of this non-rational behaviour. For example, the large number of Australian men who entertain the prospect of playing cricket for their country up until around the age of 40 is an example of many overestimating their skills. **The inability of forecasters to forecast significant changes** in the economy illustrates the tendency to over-project the current state.

The study of these so-called abnormal or non-rational behaviours — **behavioural economics** — has developed substantially over the past couple of decades.

It is the scientific study of intuition: of how consumers think when making economic decisions, such as purchasing, borrowing or investing. And, behavioural economics allows for the capacity of the instinctive and emotional parts of the human brain to override the more logical parts.

As Daniel Kahneman — probably the leading behavioural economist today — explained it, intuition is 'when we find ourselves reluctant to eat a piece of what we know to be chocolate that has been formed in the shape of a cockroach'.[7]

In some cases, **'intuition' can lead the consumer to make a poor decision** — with significant negative consequences for themselves — even though they know it is unwise.

Behavioural economics, therefore, endeavours to study the way the world actually is, rather than the way it is assumed to be — or the way economists and policymakers might like it to be.

Behavioural economics can be an important tool for policymakers. In general, we can use the lessons it uncovers to shape the policies we pursue. And, in fact, we already do so.[8]

Regulating for self-control

One area of behavioural economics that policy has been addressing for some time is the study of people's self-control problems.

In most cases, policymakers have no role protecting people from their own self-control problems.

However, there are a number of areas where a person's self-control problems can result in significant broader social and economic problems. As a society we find ourselves focusing on questions of how to deal with the wider effects of individual behaviours like over-eating, drinking to excess, smoking, drug addiction, problem gambling, speeding, acquiring too much debt and being unable to save, all of which involve issues of self-control and, to a greater or lesser degree, risk-taking.

It is generally accepted that government interventions to help people conquer these social ills are appropriate — both for themselves and to address broader social consequences. Governments have for a long time imposed a range of controls on individual conduct in the interests of promoting wider social benefits. To this end, they have introduced so-called sin taxes, limited consumption, regulated advertising, compelled information disclosure, created and enforced speed limits, required people to wear bicycle helmets, introduced random breath-testing and made superannuation contributions compulsory.[9]

And, in the markets in which ACCORD's members are active — such as personal health and hygiene products — the presence of regulation designed to assist consumer decision-making is common and widely seen as desirable.

These policy solutions are focused on two things: reducing risk — for both individuals and governments — and defining or constraining choice for individuals.

Constraining choice lowers risks for consumers, and makes it less likely that governments will have to step in to pick up the pieces. But, of course, constraining choice may also reduce consumer welfare by denying to them legitimate consumption opportunities.

Making a more effective study of choice

Perhaps one of the newer and more controversial areas of behavioural economics is the problem of consumers who face 'choice overload', which some claim can lead them to misunderstand risk and make poor decisions.

We confront this every time we visit a supermarket and are faced with a wide variety of products that — essentially — do the same thing. And, for many people, the entirely natural reaction is to buy what they've always bought, rather than taking the time to exercise a rational choice. In this way, consumers risk missing out on the product or deal that best suits them.

Alternatively, in a newly deregulated market, as was the case in many utilities markets like electricity or telecommunications, evidence of the revealed preference of consumers not to choose, can often be found in the low rate of switching plans that occurs after deregulation.

That said, there is undoubtedly evidence that increases in competition lead to a more coherent set of choices for many consumers that better match their preferences. And governments have been guilty in the past of not heeding this. Indeed, in some cases the approach of governments around the world has been to force consumers into choices they may not need — in the apparent interests of creating a competitive market — **or to fail to manage the circumstances in which consumers may be confronted with complex choices — because markets move quickly beyond the capacity of the current state of regulation.**

In both situations, the potential for sub-optimal consequences for consumers is very real, as their cues are all wrong, and risk becomes a major concern.

How should policymakers respond to these developments?

The challenge for policymakers is how to make the **cues work for consumers to make better decisions. Cass Sunstein and Richard Thaler** — leading US scholars in the area where law and economics intersect — have conceived of **a new way of thinking about the issue of how best to make consumers make choices in their own interests. These could be called 'nudges' or, if you want to be technical about it, 'choice architecture'**.

Sunstein and Thaler contend **that the way choices are framed and presented goes a long way toward determining the kinds of decisions people make.** They argue **that a nudge is a way of organising and presenting choices 'that alters people's behaviour in a predictable way without forbidding any options or significantly changing their economic incentives'.** To count as a nudge, the intervention must be easy and cheap to avoid. For example, to encourage people to choose more healthy foods from a cafeteria, 'putting the fruit at eye level counts as a nudge; banning junk food does not'.[10]

In a policy context, this entails approaches which may provide us with ways of regulating that preserve freedom of action while, at the same time, encouraging 'optimal' choices.

We can take into account the fact that people's behaviour is not always perfectly rational and develop efficient regulation which imposes the least cost possible on individual groups and the wider society.

In particular, we **can seek to ensure that businesses do not transfer risk onto consumers unreasonably.**

Currently, the Australian Government is working with the States and Territories to rationalise some common consumer laws as part of implementing a national scheme. In this context, Treasury is currently thinking about what consumer laws represent best practice, with a view to their being included in the Australian Consumer Law.

For example, one type of regulation currently under consideration is the application of cooling-off periods in door-to-door and telemarketing sales. This intervention recognises that consumers sometimes make purchasing decisions in the heat of the moment, and that in a cooler, more rational state, they may decide not to buy the good or service.

Clearly, in almost all situations, the government should not step in just to protect consumers from making poor — or at least impulsive — purchasing decisions.

The existence of cooling-off periods could — in many situations — lead consumers to make more impulsive purchasing decisions, because they are well aware of their ability to change their minds once the heat of the moment passes. But the distinctive features of door-to-door and telemarketing sales mean that consumers face additional pressure because they have been approached in their own home at a time which may not be of their own choosing.

In considering this issue, and others, we must consider a range of options — some prescriptive in approach, others less so — and come to a decision as to what approach may be best to adopt nationally. Clearly, the right policy response in relation to each such proposal will be one that balances the costs and benefits of the proposed regulation.

Thinking about risk

As I've said, risk is a key concern for policymakers. All other things equal and where possible, we aim to reduce the overall level of risk and complexity in society. But in many cases, government actions tend to reallocate risk between different groups in society.

We balance a concern for reducing risk for consumers — so that the potential for their being exposed to more serious forms of harm is limited — with the risk to businesses caused by the potential uncertainty or complexity that doing this can cause. And, for this reason we attempt to work out and address ‘unintended consequences’ to the extent that we can.

At present, the Government is implementing a new national unfair contracts law. For some this is interfering with the notion of two perfectly rational parties reaching an agreement of mutual benefit — but in many consumer transactions this is not the case.

This reform is really about risk.

In some cases, businesses approach the question of dealing with a consumer on the basis that it should be a risk-free transaction from the business’ point of view.

Unfair contract terms regulation is about making a business think about risk realistically and working out what risk it can assume, having regard to the circumstances of the transaction, rather than simply through an exercise of superior bargaining power.

The way ahead for Australian consumer policy

As I mentioned when I began my remarks, this is a dynamic time for consumer policy.

One of my key purposes today — in talking to you — is to provide some background to the way in which Treasury is approaching consumer policy questions, in circumstances where the pace of reform is faster than we may have been used to in the past.

Is Treasury still making use of the unfortunate *homo economicus*? The answer is undoubtedly ‘yes’, but there is a ‘but’. We are also taking on board the lessons that psychologists and behavioural economists are deriving about human behaviour.

In informing decisions about consumer policy, we now look to a range of tools based on a greater appreciation of consumer problems and the ways in which markets work. But, in implementing the national consumer policy objective, Treasury will continue to apply the four core principles to consumer policy I mentioned earlier, which recognise that **competitive markets drive consumer welfare**, and suggest that government interventions **must be well targeted**, **must preserve competition** and **must empower consumers** as much as possible.

We confront fast-changing consumer markets — driven by the technological development and innovation that businesses like yours undertake all the time to meet consumer needs and wants. And our laws must keep pace with these changes, to deal with the changing risks that Australian consumers confront in this kind of environment. In this climate, we need to do more than simply look at consumer behaviour and throw up our hands in despair at the irrationality of it all.

The development of the Australian Consumer Law is the first step in responding to these challenges, by creating a single national law, which will do much to **reduce costs for national businesses**, and **encourage the growth of new businesses**, all **to the benefit of consumers**.

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[1]I would like to thank to Stephen Hally-Burton, Marianne Dolman and Simon Writer for their assistance in preparing this paper. Thank you also to Treasury colleagues for their comments.

[2]Productivity Commission (2008a), page 323.

[3]McAllister (2009), page 11.

[4]Freedman, Kearney and Lederman (2009), NBER Working Paper No. 15183

[5]For more detail on this characterisation of homo economicus, see Brennan, 'Behavioural Economics and Public Policy' in Productivity Commission (2008b), pages 133-4.

[6]See DellaVigna (2009), page 316.

[7]See Kahneman (2003), page 1450.

[8]Mulholland, 'Behavioural Economics and the Federal Trade Commission' in PC (2008) at page 71.

[9]Gittins, 'Dinner Address' in PC (2008), page 151.

[10]Thaler and Sunstein (2003), pages 175-9.