Behavioral Exploitation and Its Implications on Competition and Consumer Protection Policies

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Three Fundamental Questions

- What Is Competition?
  - *What is Competition?, in* THE GOALS OF COMPETITION LAW (Academic Society for Competition Law ed., Edward Elgar Publishing forthcoming 2012).
  - *Reconsidering Competition,* MISSISSIPPI LAW JOURNAL (forthcoming 2011), *available at* http://ssrn.com/abstract=1646151
- What Are the Goals of Competition Law?
  - *Reconsidering Antitrust's Goals*, 53 BOSTON COLLEGE LAW REVIEW (forthcoming 2012), *available at* http://ssrn.com/abstract=1904686.
- What Should be the Legal Standards to Promote These Goals

What Is Competition?

- Competition as an End-State
  - Economic Model of Perfect Competition
- Competition as a Process
- Competition as Rivalry

Assumptions Underlying Competition

Any characterization of competition will depend on the underlying assumptions:

- ***Rationality of Market Participants***
- Amount of Knowledge They Have
- Transaction Costs
- The Degree To Which Market Participants Act Independently Of One Another and Care About the Interests of Third Parties
- Role of Legal And Informal Institutions, Such as Social, Ethical, Or Moral Norms in Affecting Behavior.

Rationality

Neo-Classical Economic Theory

- Neoclassical economic theory assumes that humans are
  - rational,
  - self-interested beings
  - with perfect willpower

Behavioral Economics

- Behavioral economics characterizes human behavior as defined by three traits:
  - bounded rationality,
  - Bounded self-interest, and
  - bounded willpower.

Rationality

Rationality under neoclassical economic theory has a narrower meaning:

- Individuals are objective
- Individuals seek out the optimal amount of information
- Individuals readily and continually update their prior factual beliefs with relevant and reliable empirical data
- Individuals choose the best action according to stable preferences.

Bounded Rationality

- Reasoning versus Intuition.
- Consumers are not perfectly objective.
  - Biases & Motivated Reasoning
- Heuristics (Mental Shortcuts)
- Changing Preferences & Prospect Theory

Hypothetical 3

- Suppose you were given the following two options:
  - **Option A**: $500

  or

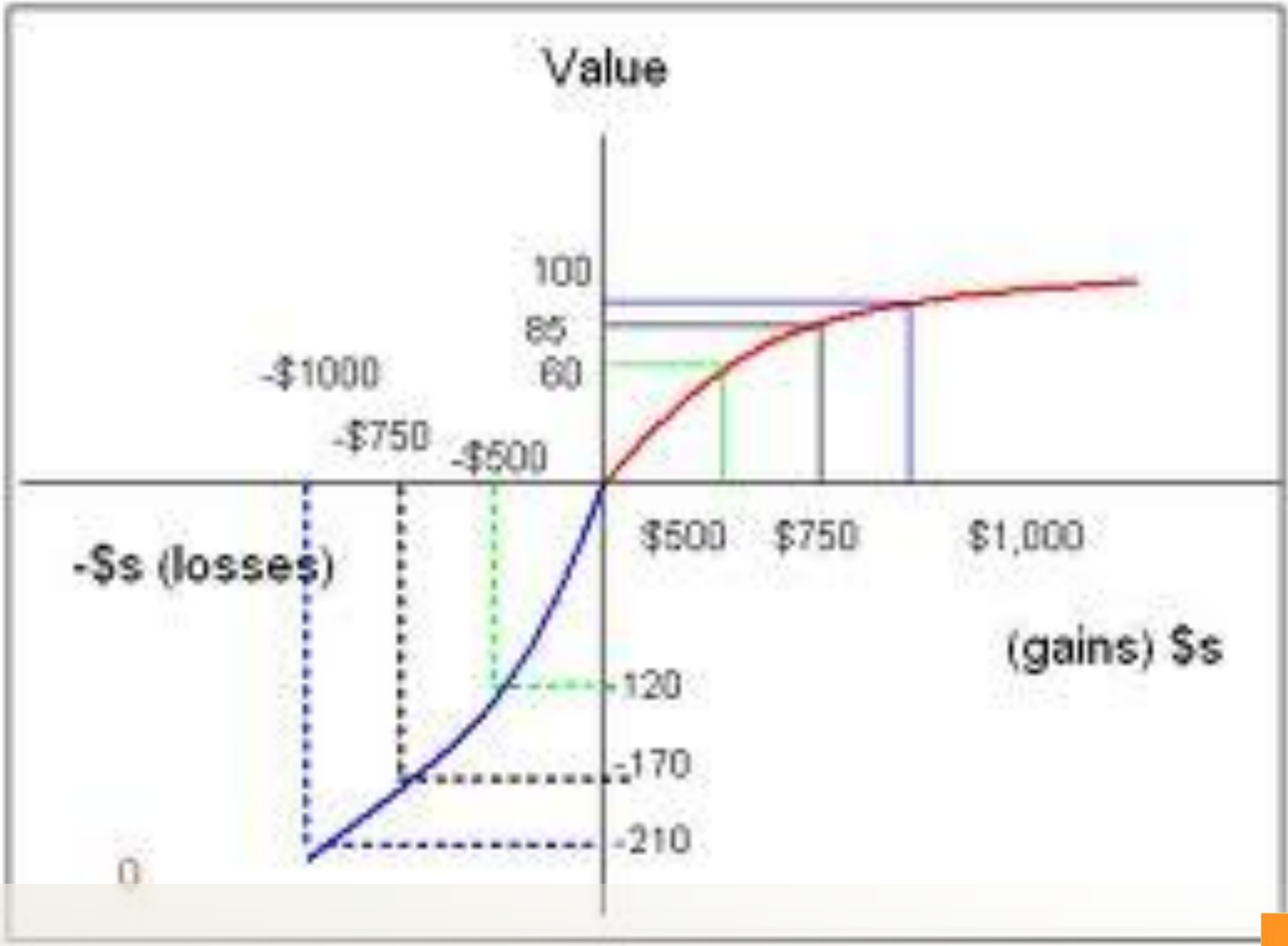
  - **Option B**: A fifty percent (50%) chance of getting $1,100 and a 50% chance of getting nothing (0).
- Which option would you choose?

Hypothetical 5

- Suppose you get a traffic fine.
- Suppose you were given the following two options:
  - **Option A**: You have to pay a $500 fine.
  - **Option B**: You go immediately to court where you have a fifty percent (50%) chance of not having to pay any fine (0) and a fifty percent (50%) chance of paying a $1,100 fine.

- Which option would you choose?

Prospect Theory



Prospect Theory

- **Graph Characterized by 3 Features:**
  - **it is concave in the domain of gains, favoring risk aversion;**
  - **it is convex in the domain of losses, favoring risk seeking;**
  - **most important, the function is sharply kinked at the reference point, and loss-averse-steeper for losses than for gains by a factor of about 2-2.5**

Willpower

Perfect Willpower

- People take actions that promote their short- and long-term interests.
- People eat, drink, exercise, and save the optimal amount.

Bounded Willpower

- This term refers to the fact that human beings often take actions that they know to be in conflict with their own long-term interests.
- Use "commitment devices," such as
  - having money automatically deducted from salary into savings account
  - Deadlines for papers

Self-Interest

Neo-classical Self-Interest

- Broadly, to maximize one's utility (interest)
- One common definition of self-interest:
  - people seek to maximize their wealth and other material goals, and generally do not care about other social goals, to the extent they conflict with personal wealth maximization.

Bounded Self-Interest

- People care about treating others, and being treated, fairly.
  - People will incur a cost to punish unfair behavior.
  - individuals at times act benevolently when it is not in their financial interest.

Hypothetical 1

- Suppose you are given $100 with one condition.
- You need to share some portion of that $100 with another person.
- If the other person accepts your offer, then you can keep the balance.
- But if that other person rejects your offer, then both of you get nothing.
- How much should you offer?

Predicted Outcome
Under Neoclassical Economic Theory

- Offer Smallest Monetary Amount Possible (e.g., one cent)

- Who Behaves this Way?

Actual Results

- Most people offered significantly more than the nominal amount (ordinarily forty to fifty percent of the total amount available)
- Recipients about half the time rejected nominal amounts (less than twenty percent of the total amount available).

Rationality Assumption

	Consumers Rational	Consumers *Bounded Rationality*
Firms Rational	**I.**	**II.**
Firms *Bounded Rationality*	**III.**	**IV.**

Scenario II

- Here rational firms can compete either to benefit or exploit consumers' bounded rationality or willpower.
- Firms' Ability to
  - Identify
  - Exploit

  Consumers' Bounded Rationality

Behavioral Exploitation

- Using framing effects and changing the reference point;
- Anchoring consumers to an artificially high suggested retail price, from which bounded rational consumers negotiate;
- Adding decoy options (such as a restaurant’s adding a higher priced wine) to steer consumers to higher margin goods and services;
- Using the sunk cost fallacy to remind bounded rational consumers of the financial commitment they already made to induce them to continue paying installments on an item, whose value is less than the remainder of payments;
- Using the availability heuristic to drive purchases, such as an airline travel insurer using an emotionally salient death (from ‘‘terrorist acts’’) rather than a death from “all possible causes”;
- Taking advantage of the focusing illusion in advertisements (i.e., consumers predicting greater personal happiness from consumption of the advertised good and not accounting one’s adaptation to the new product); and
- Giving the impression that their goods and services are of better quality because they are higher priced.

Policy Implications of Scenario II

- Issue of revealed preferences as people's choices may not reflect their utility
- Ability to distinguish between behavioral exploitation & competition that benefits consumers.
- Behavioral exploitation as another form of market failure.
- Remedies

Policy Implications of Scenario II

- Distinguishing between behavioral exploitation & competition that benefits consumers.
  - Commitment Devices
- Distinguishing when behavioral exploitation is beneficial or harmful overall to society
  - Stock Market
  - Prediction Markets

Policy Implications of Scenario II

- Behavioral exploitation as another form of market failure.
  - Systemic Behavioral Exploitation
    - Demand driven market biases
    - Free rider problems
  - Competition
    - creative new ways to exploit consumers to their detriment
    - seeking ways to reduce price transparency and increase the complexity of their products (or product terms)

Policy Implications of Scenario II

- Remedies
  - Assumption that Government is Rational
    - Authoritarianism and corporate autocracy are two worst-case scenarios.
  - Assumption that Government Bounded Rational
    - Citizens are overconfident in the government's ability to regulate the market for abuses.
    - Bounded rational government is overconfident in its citizens' ability to fend for themselves and the ability of markets to self-correct.

Policy Implications of Scenario II

Behavioral Remedies

- Alter existing, or create new, default rules.
- Require consumers to choose among the options.
- Educate the consumers using framing under prospect theory and the availability heuristic.
- Set one option as the default but impose procedural constraints on opting out.
- Afford purchasers a cooling-off period.
- Behavioral exploitation tax on the rational firm.
- Take preventive measures to help consumers debias themselves and improve their willpower.
  - increase (i) the supply of debiasing methods; (ii) the demand for debiasing, and (iii) the opportunities to debias, such as facilitating timely feedback mechanisms to make consumers become aware of their errors and the costs of their poor choices, and strategies to avoid errors.
- Provide consumers, if the market has not, commitment devices.
- Increase the firms’ search costs of identifying potential victims.

Conclusions

- Under any conception of competition with bounded rational consumers, one cannot view antitrust and consumer protection as unrelated.
- Both consumer protection and antitrust law promote the opportunity for informed consumer choices.
  - Ideally, informed consumers choose among the innovating firms' solutions for their problems.
- Given the importance of individual autonomy in overall well-being, the government must carefully delineate between behavioral exploitation and behavioral freedom, where firms help consumers address their bounded rationality and willpower.
- Counterproductive Outcome:
  - antitrust policy seeks to promotes diversity of products and services and the process of search and experimentation *but*
  - consumer protection law bans all products except the one the government believes is the best.
- Ideally, antitrust and consumer protection laws deter systemic behavioral exploitation while promoting choice of products to help address consumers' needs.