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EDITORIAL

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The authors' analysis resulted in a number of solid proposals. Some are aimed at making major improvements to information available to the consumer.

Others are related to ex post regulation. The report proposes more severe fines to be imposed by the DGCCRF. It advocates the acknowledgement of group action in France, as already exists in the United States and several European Member States.

Christian de Boissieu
Executive Chairman of the CAE

Consumer Protection: Bounded Rationality and Regulation

Report by Xavier Gabaix, Augustin Landier and David Thesmar

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This report was discussed in the presence of the Minister of the Economy and Finance and his Minister responsible for Social and Solidarity Economy, and Consumption, on September, 10th 2012. This letter, published under the responsibility of the permanent team, covers the main conclusions.

According to a European Commission study, almost 40% of French consumers believe that they have little or very little protection. Understanding the performance of consumer protection systems would, therefore, seem to be a crucial social issue.

In their report, Xavier Gabaix, Augustin Landier and David Thesmar aim to explain the economic foundations of consumer protection in order to assess how effective the current protection system is and to propose measures likely to improve it.

Given the psychological and cognitive biases inherent in household decision-making, their study reveals that the markets are incapable of protecting the consumer effectively: it thus proves necessary to develop regulation to protect the consumer. This report therefore provides six proposals aimed at improving consumer protection focusing on three key levers for action: facilitating the consumer's decision, promoting their effective mobility and intensifying sanctions to penalise deviant businesses.

1. Why do the markets fail to protect the consumer effectively?

Many studies, both theoretical and empirical, reach the same conclusion: consumers are affected by bounded rationality, which the markets do nothing to compensate for.

Psychologists and economists have broadly analysed the psychological and cognitive bases that may limit rational decision-making on the part of the consumer. Basically, the latter is not absolutely capable of gathering information together, or even understanding the information available: whether there is too much information and it is too complex, or it is hidden, it is very expensive to gather and analyse information, even by the most motivated of consumers. Even in the case where they are not faced with an information-related problem, consumers will still find it difficult to infer the consequences of their decisions on their own well-being: a preference for the present, excessive optimism, or even certain cognitive limits would prevent them from defining and acting upon a decision, however apt it may be.

Under the influence of bounded rationality, consumers may therefore find they are offered expensive and low quality goods and services by the markets. First of all, while price competition protects all consumers of ordinary goods, even when only a small number of companies are competing, this is not the case for consumers of non-ordinary goods. In this case, there would be no advantage in a company informing a competitor's customers of that competitor's bad practices since it would only win well-informed consumers who, ultimately, by their very nature, are not particularly profitable customers. Second, it has not been demonstrated that

a company has any interest in focusing on quality to build its reputation and, consequently, its market power. In fact, it is not possible for a potential customer to assess, in real time, the level of satisfaction felt by all consumers that have purchased the product in question on the basis of the company's reputation. Short-term companies, occasional consumption, delays in communicating consumer satisfaction levels and high output costs are all factors that make reputation a flawed indication of consumer satisfaction and, therefore, of product quality.

Since this implies that regulation is necessary in order to protect the consumer, we need to decide on the institution to which this should be entrusted: trade associations or central government? While the relative effectiveness of self-regulation or of central government depends *a priori*, on the level of corruption or competence of public bodies, self-regulation may nonetheless strengthen the market power of certain companies to the disadvantage of the consumer and, generally-speaking, is unlikely to result in sanctions with enough dissuasive power to act as an incentive for companies to comply with regulatory standards.

2. How can we improve consumer protection?

Having established the need for the consumer to be protected under the law, this report sets out six key proposals designed to improve consumer protection. The aim of these measures is also to shed light on product quality using the possibilities afforded by the Internet, to propose well-chosen default options, to simplify the process of changing service provider and to enable the consumer to pose a real threat to illegal practices.

3. Comments

According to Jean Tirole and Philippe Mongin, the report very clearly explains the two major faults of the market that make consumer protection necessary: manipulation of the consumer's bounded rationality by the provider and the imperfect nature of the information available to the consumer.

In line with the report's proposals, Jean Tirole believes that we should nonetheless be careful not to fall into the trap of excessive paternalism. First, in a modern economy that requires contracts and undertakings, the consumer's right to retract should not systematically be universal or free of charge. Educating consumers is another area that should not be ignored. Second, however pertinent the obligation to inform the consumer is, Jean Tirole emphasizes the fact that the information provided must be regulated if it is to be intelligible for the consumer and not manipulated by the provider. To conclude, Jean Tirole supports the recommendations regarding the development of *ratings* and standards, the systematic proposal of default options and the implementation of class action.

In Philippe Mongin's view, while the report has the merit of highlighting some of the consumer's cognitive biases that can be manipulated by companies, we still have a great deal to learn about the behavioural economy, which needs to be included in a much more exhaustive study on consumer protection. As for the recommendations made, Philippe Mongin has some reservations: he regrets the fact that the authors did not take account of the legal context of their recommendation regarding class action more accurately. They come up against certain fundamental principles of French law, including the authority relative

to *res judicata* and the capacity to bring action. Further, the issue of vital risk this would induce for some companies is passed over. Regarding the proposals relative to a public rating system on service providers, we must be vigilant with regard to anchoring biases, and, similarly, we must take account of processing biases related to increased amounts of information.

Consumer Protection: Bounded Rationality and Regulation

The six main proposals in the report

Proposal 1

The information made public by the French Directorate for Competition, Consumer Rights, and Protection Against Fraud (DGCCRF, *Direction générale de la concurrence, de la consommation et de la répression des fraudes*) should, ideally, display the following characteristics:

- it must be detailed: it must propose a breakdown of complaints by specific sector (for example, 'IT commerce', not simply 'commerce'), and by region where pertinent. For example, a geographical breakdown for services/public works and a breakdown by specific sector for electronics (hi-fi, booksellers, etc.);
- series must be as long as possible: at the moment, the information dates back to 2007, making it impossible to detect trends or breaks. This information will not only be useful to consumers, but will also simplify internal fraud detection procedures, along the same lines as monitoring of the side effects of drugs/medicines;
- the information available must not be limited only to complaints, but should also include any sanctions decided upon by the DGCCRF (legal proceedings pursued, fines, etc.). Sanctions are an effective means of gauging fraudulent behaviour (at the level of a sector or individual), and the action undertaken by central government to rectify such behaviour;
- the publication of data on each individual company, with a latency period of six months, should be considered, with a view to limiting the possibility of manipulation.

Proposal 2

The DGCCRF or the French National Consumers Institute (INC, *Institut national de la consommation*) will be the administrators of an online *rating* platform based on technology similar to that used by major online retailers. Customers can write brief comments and give a score reflecting their experience as consumers for each specific service or product:

- access to this rating database will be free, and it will be possible to search using keywords (name of product or provider);
- for a comment to be valid, customers must enter their personal details (which, of course, will not be made public);
- as part of its role as administrator, the DGCCRF will have the right to filter or withdraw any comments deemed inappropriate;
- when entering a comment, there will be a special box that customers can check if they want to make the comment an official complaint (the website will then transfer them to a web page that collects documentary evidence and the customer's personal details to validate the complaint).

Proposal 3

Organisations that manage employee savings plans must be required to propose, among the options available, a default option that must meet the following constraints: low costs, moderate risk, maximum yield (net of costs) in view of the risk. The risk involved may depend on the investment horizon (with greater weight in the case of 'PERCO' collective retirement savings plans), and less for 'PEE' plans (classic company save-as-you-earn schemes). This default option must be defined at central level and proposed by all employee mutual funds. It is the option provided by default, unless the employee specifies otherwise.

Proposal 4

Require that consumers have the right to obtain records of their use and billing, free of charge and in standard format, from the service provider (especially in the case of telephony, Internet, energy and financial services). In order for competitors or intermediaries to inform consumers of the alternatives they can provide, this information must be downloadable by third parties so authorised by the consumer.

Proposal 5

For real power of dissuasion, the DGCCRF must be able to impose severe administrative sanctions.

Proposal 6

A system for class action needs to be set up in France. In order to resolve the problems inherent in class action of this sort, the new system must comply with the following economic principles:

- the cost of participation must be low for complainants: this implies using either an *opt-out* mechanism, or an *opt-in* mechanism, publicized via mail and the Press;
- fees paid to intermediaries that represent approved associations must not be too high: the system must therefore allow for constitution;
- the scope must be as wide as possible.