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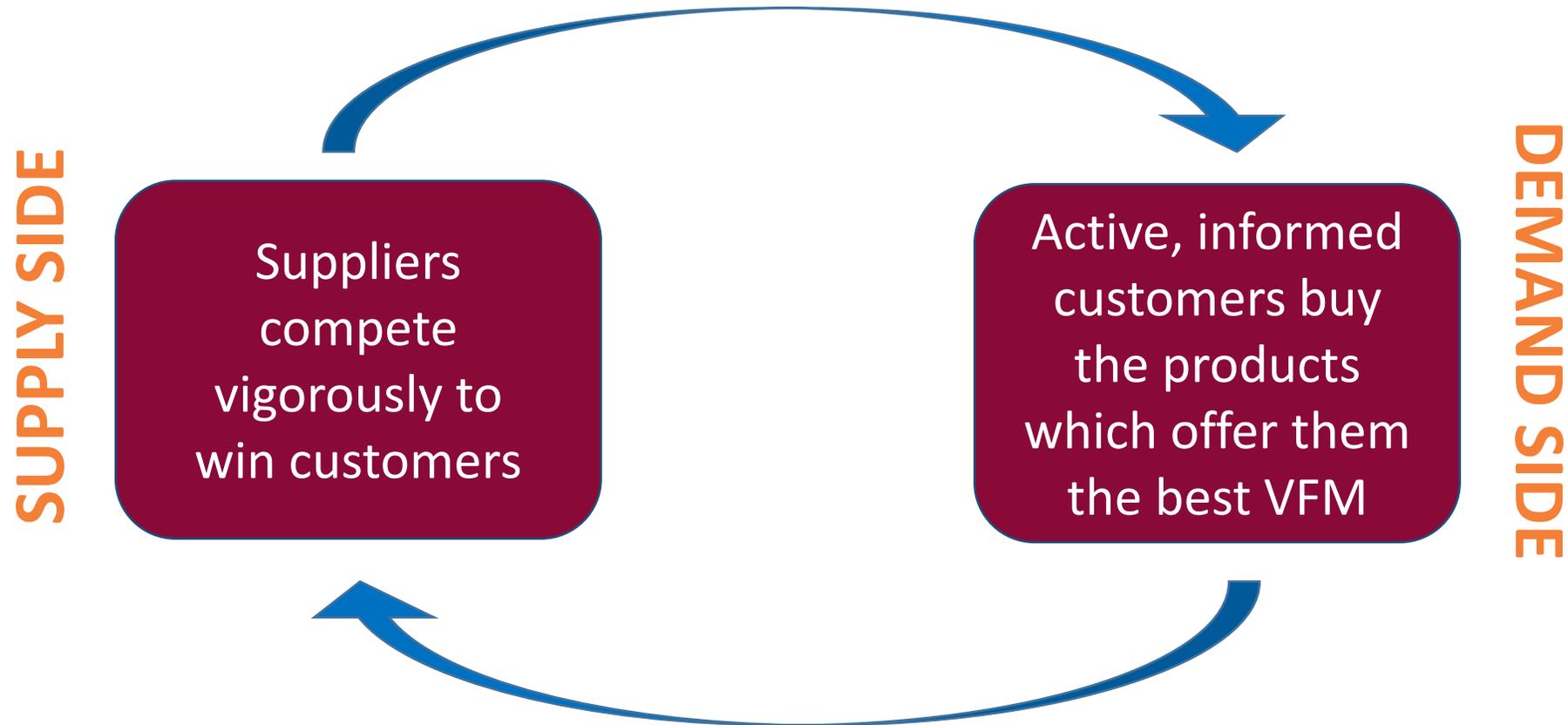
London 2015

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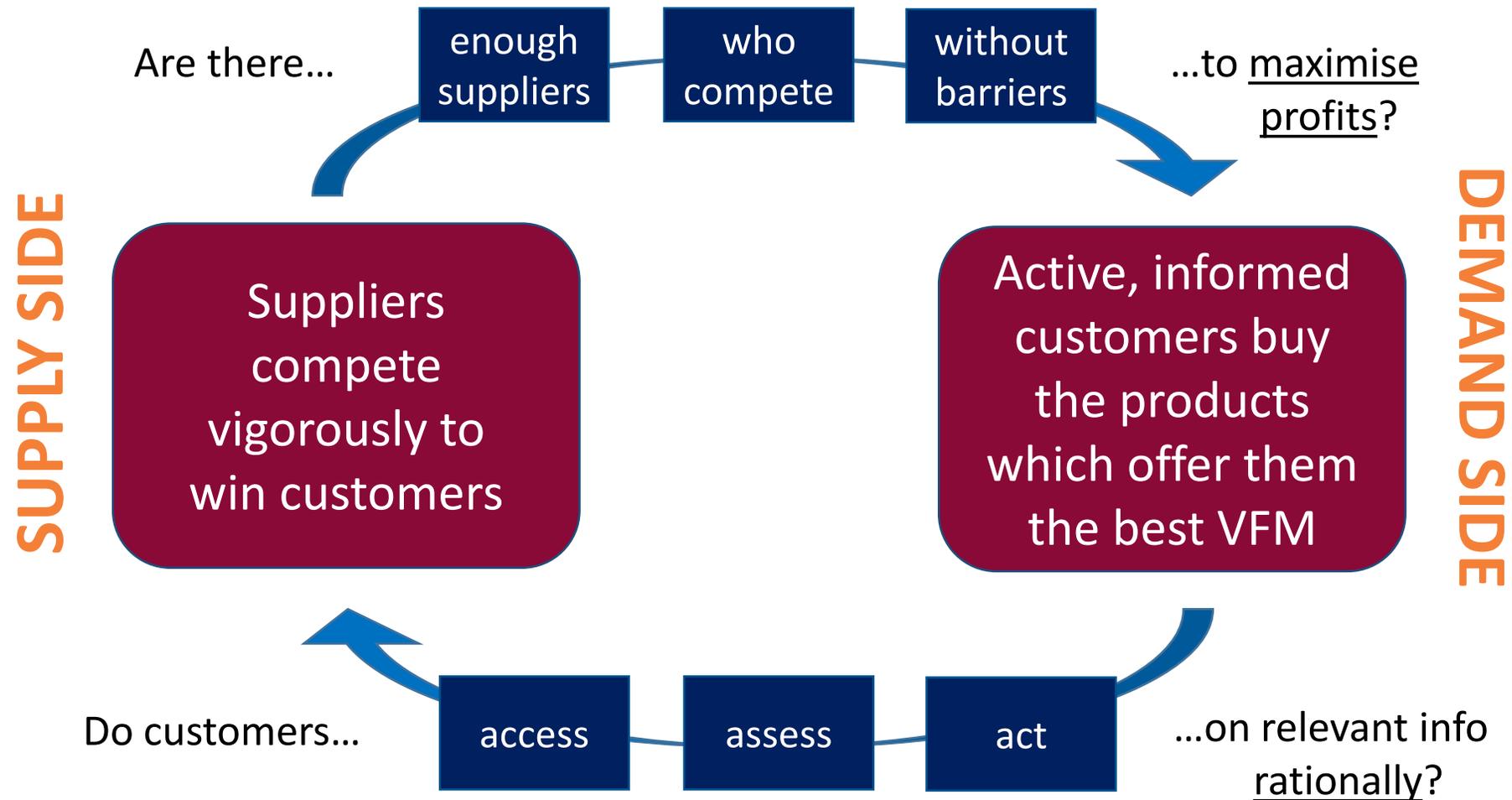
**THE
BEHAVIOURAL
INSIGHTS TEAM** ◆

Theory and practical market intervention

Competition as a 'virtuous circle'



Competition as a 'virtuous circle'



Behavioural biases: Some general implications

For a Demand-side that works effectively to deliver good consumer outcomes:

- ❖ Disclosure and caveat emptor ('buyer beware') is not enough
 - Consumer protection is an important complement to competition policy
 - Justifies more focus on 'choice architecture'
- ❖ Reducing 'real' search and switching costs may not be enough
 - Psychological barriers can be important
- ❖ 'Competition' remedies need to be tested:
 - Eg. DGComp for MS Internet Explorer; OFT for extended warranties

For a Supply-side that works effectively to deliver good consumer outcomes:

- ❖ Competition policy is crucial, but it should reduce focus on need to show rational firm incentives
 - E.g. to act anti-competitively, or indeed to cheat on a cartel agreement
- ❖ Scepticism may be justified in respect of over-confidence – and over-extrapolation - of firms
 - E.g. Enhanced prudential regulation
- ❖ Culture and governance within organisations can be important:
 - E.g. PCBS Senior Managers regime

Incorporating behavioural biases into theory

- ❖ Some argue that more behavioural economics implies a need to move away from mathematical models, and focus more on economic history and basic principles
- ❖ But 'systematic' biases can in fact be usefully incorporated into our theoretical models!
- ❖ Looking across a variety of the behavioural IO papers, a couple of general findings stick out:
 - ❖ **Market problems are not necessarily solved by competition.**
 - ❖ In general, competition from 'good' firms will drive out 'bad' firms only if customers readily switch from the 'bad' to the 'good'. But they might not! (See for example Gabaix and Laibson, 2006)
 - ❖ **Market problems can actually be made worse through more competition.**
 - ❖ Increased competition can increase the incentives of firms to limit competition again, for example through obfuscation. (See for example Spiegler, 2006)

Linking theory to practical market intervention: Issues around *reduced search/switching*

Concern highlighted in theory	Practical market intervention
Firms may engage in strategic over-complexity or other obfuscation to reduce search/switching	<ul style="list-style-type: none">• Ofcom: rollover telecoms contracts• Ofgem: 'confusopoly' in energy
Inertia (default bias) may give firms a strong point of sale (POS) advantage for secondary product sales, and maybe an incentive to shroud prices for these secondary products	<ul style="list-style-type: none">• OFT: extended warranties for domestic electrical goods• FCA: general insurance add-ons• DGComp: MS Internet Explorer, Google
Firms may refuse to sell through routes that make search/switching easier, eg PCWs or Internet more generally	<ul style="list-style-type: none">• DGComp: Policy stance on Internet• OFT: mobility scooters advertising restrictions

Linking theory to practical market intervention: Issues around *price framing/anchoring and default bias*

Concern highlighted in theory	Practical market intervention
Firms may frame its prices as being discounted from a 'true' higher price	<ul style="list-style-type: none">• OFT: furniture and carpet retailers
Firms may engage in 'drip' pricing, hiding compulsory extra charges until a late stage	<ul style="list-style-type: none">• OFT: payment surcharges for airlines• CMA: car rentals
Firms may have an incentive to 'pre-tick' options that are not included in the upfront price	<ul style="list-style-type: none">• Banned under new Consumer Contracts Regulations 2013 (outside financial services)• FCA: Introducing for general insurance add-ons to financial products

Linking theory to practical market intervention: Issues around consumer *over-confidence/myopia*

Concern highlighted in theory	Practical market intervention
Borrowers who are over-confident and/or myopic may borrow more than they can afford	<ul style="list-style-type: none">• FCA: affordability checks for mortgages and consumer credit
Firms may exploit consumers' over-confidence and myopia through extortionate contract terms	<ul style="list-style-type: none">• OFT: gyms• FCA: price cap for payday loans
Firms may exploit consumer's myopia through extortionate prices for proprietary add-ons	<ul style="list-style-type: none">• Increased interest in A102 aftermarket cases?

Linking theory to practical market intervention: Issues around *supplier rationality*

Concern highlighted in theory	Practical market intervention
<p>Abusive behaviour may be more likely if CEO motivated by empire building or self-preservation, rewarded on the basis of market share, or just a bit 'crazy'</p>	<ul style="list-style-type: none">• DGComp: A102 prioritisation guidelines place focus on likely anticompetitive effect of behaviour and put less emphasis on rational incentives (c.f. US)
<p>Cartels may be easier to initiate and sustain if parties are socially cohesive or are profit-satisficing rather than profit-maximising</p>	<ul style="list-style-type: none">• Lots of evidence of this in explicit cartel cases, but tacit coordination policy has gone in opposite direction!
<p>Firms that price on the basis of total costs, rather than marginal costs, may do better – not worse! [Also some evidence that a majority of managers do price in this way]</p>	<ul style="list-style-type: none">• Raises questions about the evidential weight of price-cost margins, and about authorities' refusal to allow for accept fixed cost efficiencies

In conclusion

- ❖ On big picture issues, behavioural economics may:
 - help justify the existing policy stance on some things - such as the important role of consumer policy for well functioning markets
 - start to change our stance on some big picture issues - such as disclosure, caveat emptor and the importance of anticompetitive incentives in competition cases.
- ❖ It also has a wide variety of possible effects on the detail of market intervention.
 - Some of these effects are already obvious and being implemented, such as an increased focus on default options such as pre-ticked boxes
 - Others will take time to gain acceptance.



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Thank you.