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# ECONOMIC PERSPECTIVES

## BEHAVIORAL ECONOMICS, CONSUMER CHOICE, AND REGULATORY AGENCIES

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**R**egulatory agencies have traditionally focused on mitigating the harm imposed on individuals by market failures, that is, harm caused by such things as pollution, misleading advertising, and unsafe products. These regulatory theories were built upon the neoclassical economic theory that individuals are rational actors who act to maximize their own welfare. The purpose of regulation was to mitigate the effect of “external” forces that would reduce consumer welfare.

In the mid-1970s *behavioral economics* began to challenge the neoclassical rational actor model by fusing the insights of psychology and economics. Over the course of the next 40 years, a prescriptive framework built around these insights shifted focus toward attempting to mitigate the harm individuals cause themselves as a result of what the agencies view as “irrational” behavior.

Agencies increasingly began to intervene to “nudge” consumers toward “better” choices through regulation, arguing this improves consumer welfare. The restriction of consumer choices is then counted as a benefit rather than a cost of regulation. As much of the research highlighted in this paper shows, this approach is dubious.

This paper begins with a brief overview of behavioral economics as well as the derivative field of behavioral law and economics. This sets up a discussion of several studies that demonstrate how limiting consumer choice is a cost, not a benefit, to consumers. Many of these choice-constraining regulations disproportionately burden lower-income households. To help preserve consumer choice, we offer some suggestions for protecting consumers from these heavy-handed regulations.

### I. THE RISE OF BEHAVIORAL ECONOMICS

The rise of behavioral economics has dramatically altered the way we view consumer choices. Behavioral economists have gathered an increasing body of evidence demonstrating that individual choices systematically deviate from the rational behavior predicted by the traditional economic model.<sup>1</sup> These deviations are said to be the result of an individual’s “cognitive biases”<sup>2</sup> that lead to faulty decisions and systematic failures to act in one’s best interest, and ***increasingly provide regulators with grounds for intervention in the absence of conventional market failures.***

These biases include two broad categories: *contextualization errors* and *self-control errors*.<sup>3</sup>

*Contextualization errors* occur when an individual, faced with the same set of choices, makes different decisions depending on the context in which the decision is made. Examples include:

- The *endowment effect*<sup>4</sup> helps explain why there is such a small resale market for Super Bowl tickets. Particularly for goods that are in limited supply or not traded often, individuals require much higher compensation to part with an object than they are willing to pay to acquire it. In the context of Super Bowl tickets, once a football fan has acquired tickets, few will sell them even if offered a much higher price than they paid for them.
- People also tend to exhibit *loss aversion*.<sup>5</sup> Most people will turn down a bet where there is a 50 percent chance of winning \$100 and a 50 percent chance of losing \$100, even though the expected gain from the bet is zero and people should be indifferent between betting and not

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betting. To engage in a bet, however, people usually require a potential gain above and beyond any potential loss.

- *Status quo bias*,<sup>6</sup> a combination of the endowment effect and loss aversion, yields a preference for the current state of being, or for not changing anything. As a result, individuals weight the potential loss from switching from the status quo more heavily than the potential gain.

*Self-control errors* are deviations resulting from errors such as:

- *Hyperbolic discounting* causes individuals to value present gratification over future well-being.<sup>7</sup> This can explain a range of errors, including overeating, incurring excessive debt, gambling, and many forms of addiction.<sup>8</sup>
- *Optimism bias*<sup>9</sup> causes individuals to underestimate the likelihood of losses and take on too much risk. This explains imprudent and high-risk choices implicating an apparent lack of self-control.<sup>10</sup> This can also explain the tendency to underestimate the time and resources needed to complete a particular project, as happens often in government—leading to cost and time overruns.<sup>11</sup>

## II. BEHAVIORAL LAW AND ECONOMICS

The “behavioral law and economics” movement has expanded economic analysis into the legal and policy consequences of these biases and has brought this perspective into the realm of regulatory policy.

- This moves beyond the positive approach of identifying these biases into a normative approach of attempting to “de-bias” consumers to reduce mistakes and increase consumer welfare.<sup>12</sup>
- Using this approach, the scope of agency intervention has expanded beyond the traditional role of regulating market failures into a new role of regulating what are perceived to be individual failures.
- Attempts to “de-bias” consumers range from nudges to mandates to outright prohibitions, with the goal of reducing the likelihood of consumers making mistakes. Agencies then quantify this curtailment in consumer choice as a benefit (i.e., from nudging or forcing consumers into the rational choice), while rarely considering the costs these regulations impose on consumers.

## III. THE PROBLEMS WITH BEHAVIORAL-BASED REGULATIONS

A wide array of agencies has been experimenting with regulations that correct perceived individual failures and function by limiting consumer choice. This section summarizes a few studies that demonstrate **limiting consumer choice is a cost, not a benefit**, to consumers.

### A. Mischaracterizing reduced consumer choice as a benefit.

W. Kip Viscusi and Ted Gayer surveyed the economic justifications for a major class of energy-efficiency regulations, including regulations promulgated by the Department of Energy and the corporate average fuel economy (CAFE) standards promulgated by the Department of Transportation (DOT) and the Environmental Protection Agency (EPA).<sup>13</sup> The authors concluded that the only way these energy-efficiency regulations pass a benefit-cost analysis is by characterizing reduced consumer choice as a benefit, and not a cost, to consumers.

- Such regulations force consumers and businesses to place energy efficiency above other concerns, such as up-front cost, cargo room, passenger capacity, product safety, and reliability.
- Viscusi and Gayer found that the EPA’s estimation of greenhouse-gas benefits in the United States made up approximately 1 percent of total claimed benefits of CAFE standards. The bulk of the claimed benefits—some 87 percent—were derived from expected increases in consumer welfare resulting from correcting consumer “irrationality.” That is, the vast majority of the “benefits” from CAFE standards are the result of reducing consumer choices to only those products that meet DOT and EPA standards. The CAFE rule would have failed the cost-benefit test if such constraints in consumer choice were correctly counted as a cost, not a benefit.
- As Viscusi and Gayer pointed out, consumers may rationally opt for cheaper, less energy-efficient choices, depending on their needs and resources. Consequently, energy-efficiency regulations that force consumers to pay for product features that they do not want fail to benefit consumers and impose costs on consumers in the form of reduced choice.

## B. Reducing consumer choice can restrict private-market innovation and solutions.

Mercatus Center research fellow Sherzod Abdulkadirov and Michael Marlow, professor of economics at California Polytechnic State University, examined proposed FDA regulations, such as requiring posting calorie counts on vending machines, which would “nudge” consumers away from “irrational” choices that contributed to obesity.<sup>14</sup>

Abdulkadirov and Marlow found that consumers did not lack information or motivation to avoid obesity, and the wide availability of healthy choices suggests the market is already responding by innovating to meet the demand for solutions.

FDA regulations are unnecessary as they have little to no effect on the choices that obese consumers make.

FDA regulations may have the unintended consequence of restricting market innovation by requiring companies to divert resources away from meeting consumer demands and into regulation-appeasing efforts. For example, requiring calorie counts to be published on menus makes it that much more expensive for a restaurant to innovate with new, healthier menu offerings.

## C. Generalizing a choice as irrational for *all* consumers restricts optimal choices for *some* consumers.

Mercatus Center senior scholar Todd Zywicki explained that restrictions on consumer choice of overdraft protection impose substantial costs with minimal gains.<sup>15</sup> These regulations are justified by characterizing the use of overdraft protection as an “irrational” choice and thereby treating the restriction of such products as a benefit to consumers. However, by misunderstanding the legitimate reasons that consumers make certain choices, such regulations have the effect of leaving those same consumers worse off, not better.

- Reducing choice for those consumers who might find overdraft protection to be the optimal choice for them imposes substantial costs on those least able to afford it.
- Zywicki demonstrated that consumers may rationally choose to frequently use overdraft protection, and to remove this consumer choice would impose substantial costs on those consumers. While expensive, overdraft protection is no more expensive than the alternatives available to those consumers who are frequent users of overdraft protection, specifically those with low credit scores and poor credit histories.
- Given the full costs of acquiring credit (including nonfinancial costs such as time, travel, and convenience), overdraft protection may be the optimal choice for some consumers.

- Reducing choice for those consumers imposes substantial costs on those least able to afford them, as consumers are driven to seek other, more expensive forms of short-term liquidity.

## D. Constraining consumer choice increases cost.

When agencies shift their focus away from the traditional approach of regulating market failures toward restricting choice to mitigate the harm caused by “irrational” consumer choices, the resulting regulations often increase consumer prices.

- As Viscusi and Gayer found, it may be rational for some consumers to opt for cheaper, less energy-efficient choices.<sup>16</sup> Consequently, when agencies implement energy-efficiency regulations, it forces consumers to pay for product features that they would not otherwise purchase. The regulation effectively acts as a hidden tax.
- Zywicki demonstrated that restrictions on overdraft protection actually increase the costs of access to the mainstream financial system for many low-income and young families.<sup>17</sup> Furthermore, Zywicki explained that these restrictions may actually drive consumers to depend on riskier and more costly alternatives, such as pawn shops, payday lenders, and “loan sharks.”<sup>18</sup>
- In a recent study on the regressive effects of regulation, professor Diana Thomas demonstrated that the accumulated cost of regulations as a share of income may be as much as six to eight times higher for low-income households than for high-income households.<sup>19</sup>

In order to help those in most need, regulators should respect an individual’s ability to determine his or her own needs, and regulations should preserve, not constrain, options for consumers.

## IV. BIASES AND “IRRATIONAL” BEHAVIOR OF POLICYMAKERS

While behavioral economics has been used to point out systematic biases in individuals’ decision-making processes, Zywicki has demonstrated that policymakers are also prone to their own cognitive biases.<sup>20</sup>

- Abdulkadirov and Marlow point out that policymakers are susceptible to *hindsight bias*, in which a low-probability outcome may look like a certainty after the fact.<sup>21</sup> Consequently, policymakers may focus on mitigating small, low-probability risks, imposing costs on consumers and diverting resources that could be spent more cost-effectively by individuals to mitigate the larger risks that they face.
- Justice Stephen Breyer has explained that regulatory agencies can also suffer from *tunnel vision*. He points out

that regulators tend to focus so zealously on a single goal that they lose sight of where their regulations fit in the larger cost-benefit picture.<sup>22</sup>

Professor Cass Sunstein, former administrator of the White House Office of Information and Regulatory Affairs, argues that cost-benefit analysis can be an effective tool in overcoming many of the predictable problems and systematic biases that affect regulatory agencies' decision making.<sup>23</sup> However, this assumes that cost-benefit analysis will be used appropriately.

## V. SUGGESTED SOLUTIONS

The evidence from behavioral economics has provided vast insights into the systematic biases that can lead to irrational consumer choices. However, as Nobel Laureate Vernon Smith has pointed out, the verbal behavior that individuals exhibit "strongly contradicts what their actual behavior achieves."<sup>24</sup> As Smith has explained, individuals can and do make errors, particularly in laboratory experiments, but markets often achieve relatively efficient outcomes despite these errors.<sup>25</sup>

The expansion of agency intervention using behavioral economics as justification is problematic, particularly when it goes beyond regulating market failures into regulating individual failures. Therefore:

- Policymakers should ensure that regulations are based on a clear market failure or other systematic problem, not perceived individual errors. Any agency analysis should always include a coherent and testable theory explaining why the problem is systematic rather than anecdotal.
- Policymakers should respect an individual's ability to determine their own needs, and should work to preserve consumer choices rather than limit them.
- Policymakers should require cost-benefit analysis for regulations to adhere to sound economic principles; specifically, any limit in consumer choice should be evaluated as a *cost*, not a *benefit*.

## ENDNOTES

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