Assessing Whether What We Know is So

By

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One of my favorite quotes is, "It ain't what you don't know that hurts you so much as the things you know that ain't so." I first heard it from a college professor of mine who attributed it Will Rogers. I have also seen the same basic idea attributed to Mark Twain and to one Josh Billings. Many economists will tell you that anything truly wise can be found in *The Wealth of Nations*. I haven't located the direct quote; but if you think about it, that is the theme of the entire book. Before Adam Smith, the pundits of the day "knew" that the amount of gold determined a society's wealth, and that "knowledge" hurt them in choosing destructive mercantilist policies.

It was my great fortune this past year to have Chairman Majoras ask me to be the Director of the Bureau of Economics. As I am sure many of you know, the Bureau has about 70 Ph.D. economists and 30 other professional staff working on virtually all aspects of the FTC's mission. Because the FTC is involved in such a wide range of activities and a BE economist participates in one way or another in most of them, the activities of the Bureau are quite diverse. I am still struggling for that pithy cocktail party one-liner to explain what the Bureau of Economics and I do. I do have the one-liner for what I do not do. I do not speak for the Commission. Whatever I say today reflects my views and not necessarily the views of the Federal Trade Commission or any of the individual Commissioners.

Getting back to what we in fact do, I have come to realize over the past eight months that some of the most interesting work in BE is aimed at assessing whether what we or someone else thinks they know is or is not so.

Let me begin on the consumer protection side. Shortly after I arrived at the Commission, the FTC held a joint workshop with HHS on childhood obesity.[1] One of the things that we know is so is that obesity in general and childhood obesity in particular is a growing problem. BE has not independently assessed whether that is indeed so, but I am confident that the existence of a childhood obesity crisis is something that we "know" and that is indeed so. There are many alleged culprits, one of them being increased food advertising to children. Surely, this seems like it must be so. When I was a kid, we did not have Nickelodeon or the Cartoon Network. We watched cartoons on Saturday morning. Now our kids can watch advertising-supported children's programming during any normal waking hour for children; and food companies are big sponsors of those programs. Surely, kids must be watching more television and seeing more television ads for food. But, based on research that BE's Pauline Ippolito and Debra Holt are currently doing, we think that this falls into the category of things we "know" that are not so. First of all, compared to the late 1970's, when kids were thinner, kids are not watching more television. Nielsen reported that in 1976 children watched approximately 4 hours of television per day.[2] Current estimates vary, but consistently find lower viewing times. For instance, the Kaiser Family Foundation estimated that in 1999 children watched

[1] FEDERAL TRADE COMMISSION and U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES, PERSPECTIVES ON MARKETING, SELF-REGULATION AND CHILDHOOD OBESITY, (July 2005) http://www.ftc.gov/bcp/workshops/foodmarketingtokids/index.htm.
[2] Media Research Division, A.C. Nielsen Company, Nielsen Television 1977.

about 2 hours and 46 minutes of television per day.[3] When you think about it, this shouldn't be a surprise. When I was a kid, we did not have video games, instant messaging, computer games, DVDs, video movies, and the like. Kids may be sitting in front of screens more than they used to, but it is not in front of advertising-supported television shows; and they are not watching more food ads.

Another area where BE has learned that perhaps we "know" things that are not so concerns mortgage lending and the information that consumers get about loans. One of the things we "know" is that more information makes consumers better off. Often, it does, but selective presentation of information can be misleading, and presentation of irrelevant information can be confusing. For example, you might think that when a consumer uses a mortgage broker, it would be useful to know how much the broker is being compensated by the lender for delivering the loan. Indeed, there was a proposal that this third-party compensation should be given particularly prominent placement on HUD mortgage forms. But shopping for a mortgage based on the broker's third-party compensation is like buying a car based on the salesman's bonus rather than the price of the car. My BE colleagues Jan Pappalardo and Jim Lacko tested the proposed disclosure with a group of recent mortgage customers and found that the disclosure confused consumers about the cost of the loan.[4] When asked to choose between two loans, many mistakenly chose the more expensive loan rather than the cheaper loan. Based in part on that research, the HUD proposal was withdrawn and is undergoing reconsideration and further development. When it was withdrawn, OMB instructed HUD to consider the FTC's findings in any future proposals. Drs. Pappalardo and Lacko continue to study how well consumers understand mortgage cost information and mortgage cost disclosures and whether the current disclosure forms can be improved.

One of the things we think we know is so is that identity theft is a significant problem that we need to confront. Of course, we all believe we know this is so. For many people, however, the foundation for their belief might be television commercials for credit cards offering protection against identity theft. How do we know that these are not just scare tactics? To find out the extent of identity theft, the FTC in 2003 had Synovate – a survey research firm – include questions about identity theft in a consumer survey. (The survey is currently being repeated, so updated figures should be available later this year.) My colleague Keith Anderson has been the primary person in the Bureau of Economics analyzing the survey results. They suggest that 2.4% of adults are victims of serious identity theft each year.[5] (That is, the person experiences more than the misuse of a credit card.) That strikes me as being a shockingly large number. It means that, if the rate persists unabated, most people will have their identity stolen sometime between when they leave school and are eligible for social security. In light of that, the efforts of the Bureau of Consumer Protection to make consumers aware of the problem and to

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[3] THE HENRY J. KAISER FAMILY FOUNDATION, KIDS & MEDIA @ THE NEW MILLENIUM, (Nov. 1999).
[4] JAMES M. LACKO & JANIS K PAPPALARDO, THE EFFECT OF MORTGAGE BROKER COMPENSATION DISCLOSURES ON CONSUMERS AND COMPETITION: A CONTROLLED EXPERIMENT (Bureau of Economics Staff Report, Feb. 2004) *at* http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf
[5] KEITH B. ANDERSON, IDENTITY THEFT: DOES THE RISK VARY WITH DEMOGRAPHICS (Bureau of Economics Working Paper No. 279, Aug. 2005) *at* http://www.ftc.gov/be/workpapers/wp279.pdf.

combat the problem is the sort of work that makes people proud to say they work at the FTC.

Moving to competition policy, one of the topics that I have been particularly interested in over the years is vertical integration. During the 90's, integration between drug companies and pharmacy benefit managers was a hot topic. More recently, some claimed to know that integration between PBMs and mail order pharmacies created perverse incentives that would ultimately harm consumers. The theory was that the PBMs would negotiate discounts with drug companies, steer customers to those drugs, and pocket all the savings for themselves. Under this theory, PBM-owned mail order pharmacies would be less likely than other pharmacies to substitute generic for brand-name drugs. My BE colleague Dave Schmidt, along with various colleagues in the General Counsel's Office, examined the prices charged for drugs by PBM-owned mail order pharmacies and other non-PBM mail order pharmacies.[6] They found that PBM-owned mail order pharmacies were not more expensive. In fact if anything, they were a bit cheaper.

Let me talk about just one more topic, oil and gas – a topic that has occupied a great deal of our time not only over the past year but for many years. One of things that many people think they know is that the petroleum industry is a highly concentrated industry in which the companies have substantial market power. Many people who think this also believe that the increase in crude oil and gasoline prices since 2002 as well as the spike in those prices after hurricanes Katrina and Rita reflect the exercise of market power. It simply is not true that petroleum markets in general are highly concentrated.[7] To be sure, if one focuses on particular stages of the market, such as terminaling or gas stations, in particular geographic markets, the level of concentration can be a concern. That is why the FTC sought divestitures in many of the large petroleum industry mergers it has reviewed over the years, particularly during the wave of such mergers in the latter part of the 1990's.[8] BE staff, along with attorneys from the Bureau of Competition and the General Counsel's office, have sought to dispel misperceptions about the petroleum industry in two recent reports.[9] It is also clear that whatever role the exercise of market power may have played in recent price increases, most if not all of those increases can be understood as the result of the normal workings of supply and demand in competitive markets.

As many of you no doubt know, Congress has charged the FTC with studying oil and gas prices both leading up to and after Katrina and Rita and to see whether those price increases can be attributed to the exercise of market power. From what I have seen so

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[6] FEDERAL TRADE COMMISSION, PHARMACY BENEFIT MANAGERS: OWNERSHIP OF MAIL-ORDER PHARMACIES (2005) *at* http://www.ftc.gov/reports/pharmbenefit05/050906pharmbenefitrpt.pdf

[7] BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION, THE PETROLEUM INDUSTRY : MERGERS, STRUCTURAL CHANGE, AND ANTITRUST ENFORCEMENT (2004) 63, 77 [hereinafter PETROLEUM MERGERS REPORT] *at* http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf.

[8] *Id.*

[9] In addition to the PETROLEUM MERGERS REPORT cited above, see , FEDERAL TRADE COMMISSION, GASOLINE PRICE CHANGES: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION (2005) *at* http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf.

far,[10] petroleum markets have, by and large, been performing precisely the function that we want them to serve. They are allocating scarce resources and providing incentives to develop new sources of supply. Of course, I am not immune to the risk of being hurt by the things I know that are not so. The studies we have been asked to perform are a great opportunity to explore whether our current understanding of competition in oil and gas markets is correct.

Exploring whether what we know is so is a dangerous business. There was a time when everyone knew that smart consumers purchased whole life insurance policies. Then Mike Lynch, an economist in BE at the time and subsequently one of my predecessors as Bureau Director, showed that consumers did better by buying term life insurance policies and investing the savings.[11] That study got the FTC banned from the insurance industry.[12] My immediate predecessor Luke Froeb used to quip that one of his goals as Bureau Director was to get the FTC banned from another industry.

I would not explicitly state that as one of my goals, but that merely reflects a stylistic difference between Luke and me. When we uncover evidence that challenges time-honored beliefs, it will usually make someone angry. I do not relish the ensuing conflict as much as Luke perhaps did, but the ability of the Bureau of Economics to analyze the validity of long-held assumptions is where we can provide the most value. The things we know that are not so will be harmful. If we regulate food advertising to children when that is not the true culprit, we may avoid attacking the real problem. Moreover, as a practical matter, we will hinder children's programming. No doubt, some will count that as a beneficial side effect, but the fact is that children's programming is a product consumers value. If we provide consumers with selective information about loans that distorts their perception of the cost, they will choose higher-cost loans. If we challenge PBM ownership of pharmacies on false theories of how such integration distorts incentives, we will raise drug costs. And if we confuse the competitive response to petroleum market forces with the exercise of market power, we will not face up to the real challenges of energy policy that confront us.

Thank you.

[10] This statement is based on information that is currently publicly available. It is not meant to foreshadow any conclusions the FTC might draw.
[11] LYNCH, MICHAEL ET AL. LIFE INSURANCE COST DISCLOSURE, FTC, (July 1979).
[12] FTC HISTORY: BUREAU OF ECONOMICS CONTRIBUTIONS TO LAW ENFORCEMENT, RESEARCH, AND ECONOMIC KNOWLEDGE AND POLICY: A ROUNDTABLE WITH THE FORMER DIRECTORS OF THE BUREAU OF ECONOMICS, (Sept. 2004), 191-192, 194 (discussing the study and the subsequent restrictions included in the "FTC Improvements Act of 1980.") *at* http://www.ftc.gov/be/workshops/directorsconference/index.htm