Federal Trade Commission

Behavioral Economics: Observations Regarding Issues That Lie Ahead

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before the

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I've been asked to make some opening remarks about behavioral economics. Most of my thoughts are not original. Many of them have been voiced before by, among others, Cass Sunstein or in a new article by Maurice Stucke and Mandy Reeves.[1] Some of them are reflected in things that the FTC's Bureau of Consumer Protection has done. Tim Muris has testified that the Bureau didn't know what it was doing when it issued most of its rules, and I've taken vehement exception to the assertion. But Tim is right

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[*] The views stated here are my own and do not necessarily reflect the views of the Commission or other Commissioners. I am grateful to my attorney advisor, Amanda Reeves, for her invaluable assistance preparing this paper.

[1] *See* Amanda P. Reeves & Maurice E. Stucke, *Behavioral Antitrust* 19-27 (U. Tenn. Legal Studies Research Paper No. 106 (Apr. 24, 2010)), *available at* http://ssrn.com/abstract=1582720; RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008). *See also* Christopher R. Leslie, *Rationality Analysis in Antitrust*, 158 U. PA. L. REV. 261, 265 (2010); Maurice E. Stucke, *Behavioral Economists at the Gate: Antitrust in the Twenty-First Century*, 38 LOY. U. CHI. L.J. 513, 529-30 (2007); Avishalom Tor, *The Methodology of the Behavioral Analysis of Law*, 4 HAIFA L. REV. 237, 242-43 (2008).

insofar as the connection between those rules and behavioral economics is concerned—I didn't connect the dots until I became a Commissioner at the beginning of 2006 both because I fell in love with the rival Chicago School of economics after *GTE Sylvania* in 1976[2] and because I was too busy with my antitrust defense practice in San Francisco to think big thoughts like that. Finally, I've discussed all these things with my two attorney advisers for antitrust, Mandy Reeves and Darren Tucker.

To focus the discussion today, I have structured my thoughts in three parts. First, I will briefly discuss some of the insights that behavioral economics has to offer. Second, I will survey some of the criticisms of behavioral economics. Third, I will offer some observations about where we go next. I should note that while I've done a good amount of thinking on this topic, I certainly don't have all of the answers – nor, do I think the behavioral economists. Nevertheless, I do believe that there is much we can draw on from their scholarship, even if it remains in a relative primitive state.

I.

At its core, behavioral economics posits that human beings sometimes act irrationally in making commercial decisions. Put differently, they do not always "profit maximize" because neither sellers nor buyers always strike the bargain that is the most advantageous to them. There are a number of reasons for this, according to behavioral economics.

First, there may be asymmetry in the information that is available to both buyers and sellers. For starters, some sellers may have information that other sellers lack. This is one reason why the FTC may consider deception by one buyer of other buyers—in the

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[2] *Continental T.V., Inc. v. GTE Sylvania Inc.,* 433 U.S. 36 (1977).

context of standard-setting for example—to be an unfair method of competition. Similarly, some sellers may have information that buyers may not have. That is why the FTC has frequently considered a seller's failure to clearly and conspicuously disclose material information to buyers to be an unfair or deceptive act or practice. Personally, I always considered the FTC's Franchise and Vocational School rulemaking proposals in 1975 to be rooted in that information asymmetry—the vocational schools generally knew how many graduates they placed, but their students did not; franchisors generally knew how much their franchisees earned, but prospective franchisees did not.[3] To remedy this asymmetry, we required disclosure of that information. More generally speaking, behavioral economics seeks to identify similar instances of asymmetry which prevent perfect decision-making and then, if possible, adjust the default rules to eliminate as much of that asymmetry as possible.

Second, behavioral economics recognizes that instant gratification is more important than long-run profit maximization for many human beings. This means that, among other things, we demand much more to give up or sell an object than we would be willing to pay to acquire that object,[4] and we tend to overestimate our chance of success in the short term, but underestimate our chance of failure over the long term.[5]

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[3] *See, e.g.*, "Proprietary Vocational and Home Study Schools," 16 C.F.R. § 438 (regulating unfair and deceptive advertising, sales, and enrollment practices, engaged in by some vocational and home study schools). For a discussion of the Rule which was ultimately struck down by the D.C. Circuit, see *Katharine Gibbs School Inc. v. FTC*, 612 F.2d 658 (D.C. Cir. 1979).

[4] RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE 63 (1992) (discussing the endowment effect).

[5] *See, e.g.*, Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1091-95 (2000) (discussing overconfidence and self-serving biases).

Recognizing these tendencies of individuals to focus on the present at the inevitable expense of the future, the FTC sponsored a workshop on mortgages in 2006 before the current financial crisis, in which we warned (too subtly I fear) that some of the more exotic mortgages, like some adjustable rate mortgages and balloon payment mortgages, might look great in the near term but might be very expensive long-term.[6] As some have suggested, particularly aggressive regulation in this regard – such as outlawing certain mortgage products – would perhaps be overreaching.[7] On the other hand, surely there is something we can do to reset the defaults or create incentives for consumers to purchase products that are less risky over the long run. Behavioral economics offers important insights in that regard.

Third, behavioral economics recognizes that human beings are creatures of habit—we tend to stick with what we have even if that doesn't make sense. This tendency is often referred to as the status quo bias.[8] This means that some people will make very conservative financial choices, such as keeping their deposits at one bank even when they are offered a better rate of interest by a bank which is essentially identical in all other respects. Likewise, the status quo bias can also play a role in the world of marketing, as companies have learned to their chagrin when they radically redesign

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6 Public Workshop: Protecting Consumers in the New Mortgage Marketplace, 71 Fed. Reg. 15,417 (Mar. 29, 2006) (announcement of workshop); *see also* http://www.ftc.gov/bcp/workshops/mortgage/index.shtml (website accompanying workshop).

7 Richard A. Posner, *Treating Financial Consumers as Consenting Adults*, WALL ST. J., July 23, 2009, at A15, *available at* http://online.wsj.com/article/SB10001424052970203946904574302213213148166.html

8 THALER, *supra* note 4, at 68-70.

packaging or ingredients of popular products: consumers will often refuse to buy the product, simply because of the new packaging.

At the FTC, status quo bias explains why the FTC has tended to look askance at negative options where the default position is a continuation of the status quo. These are situations that many of you have likely encountered where you sign up for something that is free or discounted—be it a credit card with no annual fee during the first year or a discounted magazine subscription—only to find out that you automatically will be charged a higher (sometimes exorbitant fee) after an initial trial period. In these circumstances, there is a sales term or condition that allows a seller to interpret a customer's silence or failure to take an affirmative step as acceptance of an offer; this means the burden is on the consumer to cancel the purchase. In January 2009, following a workshop on negative options, the FTC announced principles that firms should rely on in determining whether it has structured a negative option plan in a way that limits consumer deception.[9] The Commission has also promulgated rules requiring that companies make certain disclosures to consumers so that they are fully informed about the consequences about entering into transactions at the outset that involve negative options.[10]

Fourth, behavioral economics has provided important insights that suggest the assumption that corporations – i.e., sellers – always behave rationally may not be correct. Neoclassical economics assumes that rational behavior cancels out irrational behavior, meaning that there is no need for economic analyses to account for irrational individual

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9 FTC Staff Report, "Negative Options" (January 2009), *available at* http://www.ftc.gov/os/2009/02/P064202negativeoptionreport.pdf.

10 *See, e.g.*, FTC, "Use of Prenotification Negative Option Plans," 16 C.F.R. § 425.

conduct in the analysis of firm behavior. [11] As former Commissioner Leary aptly noted as early as 2003, however, this assumption does not account for basic agency problems.[12] Sellers, after all, no matter how large, are comprised of individuals who have "objectives of their own which do not necessarily coincide with those of the enterprise as a whole" and, as a result, the incentives of these "employee agents can prompt conduct that does not maximize the profits of their employer."[13]

These individual biases can manifest themselves in firm behavior in several ways that U.S. antitrust law does not predict. For example, although our Section 1 law assumes that implausible cartel agreements will collapse because participants will exploit opportunities to cheat provided those opportunities are in the firm's financial interests, some participants may not cheat out of perverse loyalty to other cartel members.[14] Likewise, although our predatory pricing law assumes that below cost pricing is not anticompetitive so long as the seller can recoup its losses, employees whose compensation depends on sales volumes may engage in below cost pricing even if there is no opportunity for the firm to recoup its losses.[15] And, although our merger law assumes that firms merge when it is in their self interest to do so, recent literature from the behavioral finance context suggests that CEOs and other individuals charged with

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11 HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION 134 (2005) (suggesting that the "entire antitrust enterprise is dedicated to the proposition that business firms behave rationally").

12 Thomas B. Leary, *Thinking Creatively About Remedies: The Bipartisan Legacy*, 80 TUL. L. REV. 605 (2005).

13 *Id. at 609.*

14 *Id*.

15 *Id.*

analyzing and predicting firm behavior may suffer from their own overconfidence bias that prohibits them from acting in their firm's best interest over the long run.[16]

This is all to say that while behavioral economics is still relatively young, it has already provided important insights that should give us pause at the very least before we accept the rule that humans always behave rationally; they may, in fact, behave "predictably irrationally" even if we still lack the ways to predict with any certainty when irrational conduct will occur.

II.

Behavioral economics, of course, has not been without its critics. Thus far, most of the criticism has come from neoclassical microeconomists who scorn behavioral economics or, at the very least, are highly skeptical that it can or should play any role in modern competition analysis. There may be a number of reasons for their criticisms.

First, the fundamental assumption of neoclassical microeconomics is that most buyers and sellers act rationally and that when individuals or firms behave irrationally, they are disciplined by the rest of the market participants. That fundamental assumption, as Robert Bork espoused in his *Antitrust Paradox*,[17] is why government intervention in all but the most extreme cases of horizontal price-fixing is unnecessary: imperfect markets tend to correct themselves quickly and without intervention; government intrusion therefore undermines the marketplace's invisible hand. The problem, of course,

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[16] *See, e.g.*, Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1091-95 (2000) (discussing overconfidence and self-serving biases); Mark Armstrong & Steffen Huck, *Behavioral Economics as Applied to Firms: A Primer, in Competition Policy Int'l,* Spring 2010, at 3, 26 (discussing prevalence of over-optimism in CEOs and entrepreneurs).

[17] ROBERT H. BORK, THE ANTITRUST PARADOX (1978); *see also* RICHARD A. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE (1976).

is that the neoclassical assumption of rationality is fundamentally at war with the position of behavioral economists that buyers and sellers do not always behave rationally. Unless behavioral economics can find a way to fit its insights within a neoclassical framework, behavioral economics will continue to be a likely target of the old and established neoclassical guard.

Second, many neoclassical economists (and their clients) yearn for certainty and predictability. There is a certain irony in this. When I started practicing antitrust law in 1965, there was plenty of predictability because certain practices were considered illegal per se. Then, the advent of the Chicago School of economics in the 1970s and 1980s with its notions about all the ways in which conduct that we had always assumed was anticompetitive could be procompetitive, led the U.S. Supreme Court to hold in a series of cases beginning in the 1970s and through the present that conduct that once was *per se* illegal should instead be judged under the rule of reason.[18] I believe that those decisions were generally correct in modifying the law to comport with new economic thinking.[19] My frustration, however, lies with the fact that many of the same thinkers who pushed

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18 *See, e.g.*, *Continental T.V., Inc. v. GTE Sylvania*, 433 U.S. 36 (1977) (holding that non-price vertical restraints are subject to the rule of reason), overturning *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967) (holding that such restraints could be per se illegal); *State Oil Co. v. Khan*, 522 U.S. 3 (1997) (rejecting per se ban on maximum resale price maintenance agreements), overturning *Albrecht v. Herald Co.*, 390 U.S. 145 (1968) (holding that such restrains were per se illegal); *Leegin Creative Leather Products v. PSKS, Inc.* (2007) (rejecting per se ban on minimum resale price maintenance agreements), overturning *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911). For a more thorough discussion of this argument, see Reeves & Stucke, *supra* note 1, at 18-25.

19 *But see In the Matter of Nine West Group Inc.*, Docket No. C-3937, Order Granting in Part Petition to Reopen and Modify Order Issued April 11, 2000, *available at* http://www.ftc.gov/os/caselist/9810386/080506order.pdf (Commission decision finding that post-*Leegin* minimum resale price maintenance agreements should be subject to the "inherently suspect" analysis).

hard for the results in these cases which subject these practices to a rule of reason analysis now claim that antitrust law is too unpredictable and, to some extent, would likely prefer to have some of these practices declared per se legal. The pursuit of predictability and safe harbors would lead them to throw the proverbial baby out with the bathwater. What behavioral economics has done – by identifying ways in which the assumption of rationality may miss the mark – is to highlight the ways in which modern antitrust laws' pursuit of predictability may be costing us too much in the form of aggressive antitrust law enforcement. That's not to say, of course, that behavioral economics has all the answers, but by blurring the bright lines that neocloassical economics has so carefully constructed, behavioral economics does invariably frustrate neoclassical scholars

Third and relatedly, because of this quest for certainty and because of the elegant organizing principle it provides, neoclassical economic models are sometimes offered as a substitute for empirical evidence of the effects that a practice or transaction may have instead of simply corroborating that empirical evidence. At least in the near term, behavioral economics is less likely to be offered that way. Behavioral economics, after all – at least at this juncture – tells us very little about how firms generally will behave, but instead provides explanations for why seemingly irrational behavior is not always cancelled out and may, in some cases, lead firms to act in ways that economic models would not predict. This means that the type of evidence that is most likely to be useful to someone interested in a behavioral inquiry is not an abstract model, but is instead actual evidence of how a CEO or individual with pricing authority has historically acted or will act in a particular situation. This poses a problem for neoclassical economists: if your entire professional existence is defined by one form of analysis (i.e., models that assume rational behavior), and a new form of analysis suggests your models are imperfect and that better evidence (i.e., the parties' documents and testimony) may be just as accurate at predicting competitive effects, there is likely to be some friction.

Fourth, there may be a less benign factor at work too. To date, neoclassical microeconomists have pretty much had industrial organization and antitrust economics to themselves. With the advent of behavioral economics (which draws on insights from other fields), they must share the antitrust turf with other professionals, including Ph.D.'s from other disciplines like sociology and psychology. In short, they are losing their monopoly on economic thought when it comes to antitrust.

Apart from these criticisms, critics have dispassionately attacked behavioral economics on two other grounds as well that, in my view, carry more weight. First, there is the critique that behavioral economics offers no single "organizing principle" like the self-correcting market principle that can be used as a default if there is no empirical evidence of the effects of a practice or transaction (or if the empirical evidence is inconclusive).[20] Having myself struggled to identify the best analytical framework to

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[20] *See, e.g.*, Michael Salinger, *Behavioral Economics, Consumer Protection, and Antitrust*, *in Competition Policy Int'l*, Spring 2010, at 66 (noting that "economic analysis necessarily relies on simplifying assumptions that sacrifice realism for tractability" and that the "rationality assumption plays so prominently in the literature because it is tractable . . . and yields some quite accurate predictions"); Douglas H. Ginsburg & Derek W. Moore, *The Future of Behavioral Economics in Antitrust Jurisprudence*, *in Competition Policy Int'l*, Spring 2010, at 97; Cass R. Sunstein, *Introduction*, *in* BEHAVIORAL LAW AND ECONOMICS 1, 9 (Cass R. Sunstein ed., 2000) (noting that "an enormous amount remains to be done" in the development of behavioral economics, including determining whether "behavioral economics [can] generate a unitary theory of behavior" or whether behavioral economics is "too ad hoc and unruly to generate predictions in the legal context").

account for different economic theories,[21] I have to concede that there is much to this critique.[22] That said, this can't be a reason to shut it out altogether: given the extent to which behavioral economics has questioned the assumption of rationality that underlies neoclassical analysis, rejecting behavioral economics whole cloth for lack of an organizing principle is arguably just another way of saying that an answer is better than no answer, however wrong that answer may be.

A second criticism is based on the view that behavioral economics is too subjective to provide government officials with a serious tool to reach the right ends. Under this view, government regulators – like the human beings discussed in the behavioral economics literature – are fallible too and, if they get intervention "wrong," that may actually magnify the consumer or societal loss.[23] If, for example, government regulators impose a default rule that is wrong, the wrong may have broad or perhaps universal application. My problem with this criticism is that it ignores the fact that, unlike human beings who make decisions in a vacuum, government regulators have the ability to study over time how individuals behave in certain settings (i.e., whether certain

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[21] *See, e.g.*, J. Thomas Rosch, "Antitrust Law Enforcement: What to do About the Current Economics Cacophony?" Bates White Antitrust Conference (June 1, 2009), *available at* http://www.ftc.gov/speeches/rosch/090601bateswhite.pdf.

[22] J. Thomas Rosch, "Managing Irrationality: Some Observations on Behavioral Economics and the Creation of the Consumer Financial Agency," Conference on the Regulation of Consumer Financial Products (Jan. 6, 2010), *available at* http://www.ftc.gov/speeches/rosch/100106financial-products.pdf (expressing concern about the absence of an organizing principle).

[23] *See, e.g.*, Richard A. Posner, *Treating Financial Consumers as Consenting Adults*, WALL ST. J., July 23, 2009, at A15, *available at* http://online.wsj.com/article/SB10001424052970203946904574302213213148166.html ("Behavioral economists are right to point to the limitations of human cognition. But if they have the same cognitive limitations as consumers, should they be designing systems of consumer protection?").

default rules provide adequate disclosure to help them make the most informed decision). Thus, if and to the extent that government regulators are mindful of the human failings discussed above, and their rules are preceded by rigorous and objective tests, it is arguable that they are less likely to get things wrong than one would predict.

Of course, it may be the case that the concern with behavioral economics is less that regulators are imperfect and more than they are subject to political biases and that behavioral economics is simply liberalism masquerading as economic thinking.[24] My response to that is that political capture is everywhere in Washington and that to the extent behavioral economics supports "hands on" regulation it is no more political than neoclassical economics which generally supports "hands off" regulation. On a more serious note, perhaps the best way behavioral economics could counter this critique over the long run would be to identify ways in which the insights from behavioral economics suggest regulation that one would not expect from a "left-wing" legal theory.

III.

Where does this all leave us? I suspect that is what we will discuss next, but before we do, I'd like to leave you with three closing thoughts. *First*, as I have previously noted, I continue to believe that there may be a role for behavioral economics to play in merger review.[25] The Department of Justice and Federal Trade Commission's proposed changes to the U.S. Merger Guidelines reflect the agencies' joint interest in placing greater weight on what I call "direct" evidence of a merger's competitive effects

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24 Andrew Ferguson, *Nudge Nudge, Wink Wink: Behavioral economics—the governing theory of Obama's nanny state*, THE WEEKLY STANDARD (April 19, 2009), *available at* http://www.weeklystandard.com/articles/nudge-nudge-wink-wink.

25 Rosch, "Managing Irrationality: Some Observations on Behavioral Economics and the Creation of the Consumer Financial Agency," *supra* note 22.

and, more specifically, evidence of what the parties actually *intend* to do once a merger is complete (as opposed to what economic modeling predicts they *should* do).[26] Let me be clear: the agencies' interest in better understanding the parties' actual intent as reflected by their pre-merger documents and testimony during investigational hearings is not motivated by some veiled interest to eliminate the role of neoclassical economics in our antitrust analysis; as I have already noted, that neoclassical analysis still provides the only organizing principle that we can use. Nevertheless, to the extent that better understanding the merging parties' actual intent reveals that the merging parties in some cases intend to act in ways that neoclassical economics does not predict, the insights from behavioral economics may enable the Commission to better understand behavior that, at first blush at least, may appear irrational.[27]

Second, as to whether behavioral economics can and should play a role in antitrust analysis more broadly – I am thinking now about conduct cases brought under Sections 1 and 2 of the Sherman Act and Section 5 of the Federal Trade Commission Act – more work needs to be done. Much of that groundbreaking work is beginning in the academic realm and I encourage you to take a look at it, but it's important to point out that the Federal Trade Commission could do more to facilitate that work. In April 2007, the Commission's Bureau of Economics held a workshop on Behavioral Economics and

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[26] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines: For Public Comment (Apr. 20, 2010), *available at* http://www.ftc.gov/os/2010/04/100420hmg.pdf.

[27] *See* Amanda P. Reeves, *Behavioral Antitrust: Unanswered Questions on the Horizon,* Antitrust Source (June 2010) (forthcoming).

Consumer Policy oriented towards our consumer protection mission.[28] That workshop resulted in a report discussing possible applications of behavioral economics to consumer protection law. The Commission can and should hold a similar conference in the next few years that would explicitly discuss applications of behavioral economics – and perhaps other new economic thinking – to competition law as well. Such a conference, like similar conferences that have begun to occur,[29] could stimulate further research and discussion not only by economists, but by competition law experts and practitioners about whether and to what extent behavioral economics should play a role in competition law going forward.

Third and more concretely, I would suggest that if there is a role for behavioral economics to play in conduct cases more generally, the challenge for decision-makers (be they judges, advocates, or regulators), is to identify the right doctrinal framework that balances the need for predictability against the risk of under-enforcement that comes with an overly rigid approach. I think the D.C. Circuit might very well have been on to

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[28] FTC Bureau of Economics, Conference on Behavioral Economics and Consumer Policy (April 20, 2007), slides and papers accompanying conference *available at* http://www.ftc.gov/be/consumerbehavior/index.shtml.

[29] At its 2008 annual meeting, the American Antitrust Institute's (AAI) keynote speaker and panelists discussed the applicability of behavioral economics to competition policy. AAI, Audio Recordings from AAI's Annual National Conference, *available at* http://www.antitrustinstitute.org/Archives/2008conferenceaudio.ashx (last visited June 4, 2010). Likewise, at the ABA's *Next Generation of Antitrust Scholarship Conference* held at NYU law school in January 2010, several papers applied behavioral economics to antitrust policy. *See* Max Huffman, *Behavioral Exploitation and Antitrust*; Avishalom Tor & William J. Rinner, *Behavioral Antitrust: A New Approach to the Rule of Reason after Leegin*, University of Haifa Faculty of Law Legal Studies Research Paper Series (Dec. 1, 2009), *available at* http://ssrn.com/abstract=1522948; Maurice E. Stucke, *Am I a Price-Fixer? A Behavioral Economics Analysis of Cartels, in* CRIMINALISING CARTELS: A CRITICAL INTERDISCIPLINARY STUDY OF AN INTERNATIONAL REGULATORY MOVEMENT (Caron Beaton-Wells & Ariel Ezrachi eds. Hart Publishing Oxford forthcoming 2010), *available at* http://ssrn.com/abstract=1535720.

something in the *Microsoft* decision when it applied less of a bright-line approach and more of a balancing test.[30] Such an analysis (which is essentially premised on the rule of reason framework) could perhaps allow advocates the flexibility to make their case using all of the economic tools available to them in any particular circumstance. To be sure, behavioral economics would need to be sufficiently credible to be admissible as evidence,[31] but I don't think we're all that far from crossing that threshold.

I look forward to discussing these and other ideas with the rest of the panel.

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30 *United States v. Microsoft*, 253 F.3d 34 (D.C. Cir. 2001).

31 *See Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993); *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999) (laying out standards for admissible expert testimony).