5-9-2014

Avishalom Tor presented at 3rd Haifa-Loyola Conference on Recent Challenges to Antitrust

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Boundedly Rational Consumers: Three Challenges for Antitrust

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Recent Challenges to Antitrust
University of Haifa Faculty of Law
May 8-9, 2014

Boundedly Rational Consumers

"Did we remember to get that thing we came here for?"

Three Challenges

1. The *prediction* challenge

2. The *efficiency* challenge

3. The *welfare* challenge

The Prediction Challenge

Inaccurate prediction / evaluation

→ → → → →

Erroneous rules / enforcement practices

The Efficiency Challenge

Competition → → → → Efficiency

The Welfare Challenge

Competition → → → → Social welfare

The Prediction Challenge

- Familiar…
- Primarily relevant for consumer-directed aspects of market power
  - Aftermarkets
  - Bundling, tying, and rebate schemes
  - Unilateral effects market definition
- Doctrine / enforcement practices can accommodate

The Efficiency Challenge

- Substantial & unsurprising empirical evidence of consumer mistakes
  - From both lab and field
  - Not universal, but not uncommon
- Basic model: distorted demand, misallocation
  - Even under perfect competition

- More advanced models in “behavioral industrial organization” over the recent decade – what happens when producers <u>react</u> to consumers’ bounded rationality?
  - Sometimes the presence of BR consumers can *improve* competitive outcomes compared to a market populated only by rational consumers
    - E.g., “reciprocal” consumers give <u>experience products</u> a chance but avoid if fail, while rational consumers realize producers prefer low quality and avoid the market altogether (Huck & Tyran, 2007)
  - Usually, *inefficiencies remain*, even under perfect competition

- Occasionally, increased competition can even *reduce* efficiency (compared to diminished competition or direct regulation)
  - Intuitive example: credence goods, when consumers rely on casual stories and cannot distinguish between skill and luck (e.g., alternative medicine, mutual funds)
    - » competition tends to drive price down
    - » but an increased number of providers increases likelihood of erroneous, anecdote-based attribution
    - » Inefficiencies remain even if some providers offer a quality service
    - » Firms respond to competitive pressure by creating artificial product differentiation

(Spiegler, 2006)

- More generally, sellers react strategically in order to exploit, even facilitate consumer error
  - Exploit underestimation of future demand by low (even free or a negative cost) upfront fees and high per-use fees later (e.g., credit card features)
  - Exploit overestimation of future demand by high upfront/low per-use fees or larger bundles (e.g., gym membership)
    - » competition to attract biased consumers ex-ante is beneficial, lowering prices of focal service / product
    - » In both cases, inefficiencies remain under competition
  - Facilitate consumer error—complex price schemes for products, with increased competition leading to a proliferation of artificially differentiated price schemes

Hence the efficiency challenge…

Competition, Judgment, and Efficiency

- Even a less-than-perfect relationship between competition and efficiency still offers meaningful guidance to antitrust law
  - Some product markets still approximate standard model
  - Heterogeneity in rationality can reduce effects of bias, particularly where learning / incentives to educate consumers exist

- The important question is **comparative**: how more competition compares to

  less competition (fewer firms with more power) --- or --- more regulation…
  - Both alternatives usually do worse the competition
  - Particularly regulation with its many familiar shortcomings
  - Note also that regulation is often present already as a potentially complementary regime in many of the affected markets
    - Professional services involving credence goods, telecommunications, banking and finance, and so on
    - But usually with a focus that is very different from consumer BR concerns

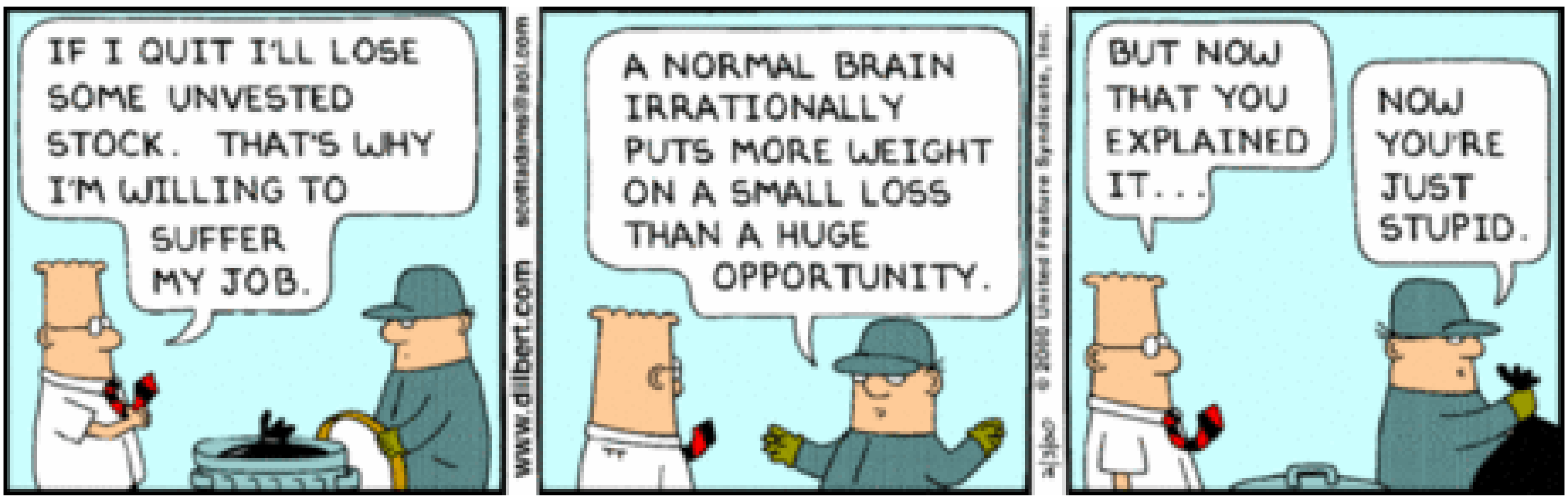
Competition and Consumer Choice

- The behavioral IO literature examines effects on market outcomes , studying the impact of phenomena relating to reference-dependent DM

  (framing effects, loss aversion, status quo bias, etc.)

  - Loss aversion (LA), for instance, tends to magnify perceived differences among substitutes in both price and product features
  - Can <u>either soften competition </u>(e.g. moving to a product with inferior fit/features) <u>or intensify it</u> (e.g. moving from a less to a more expensive product), depending on reference point, frame, and so on

. . . but treats “nonstandard” preferences as given



The Welfare Challenge

(which remains even if consumers make no errors of judgment, yet manifest constructed choices)

- Extensive evidence of constructed choice
  - Expressions of preferences are generally constructed at the time of valuation / choice
  - Construction process shaped by interaction bw/ person and task characteristics

    = <u>Highly contingent decision behavior</u>
- Applied and extended by consumer research

Which is why constructed preferences challenge the competition-welfare link…

Competition, Choice, and Welfare

- Even a less-than-perfect relationship between competition and welfare still offers meaningful justification for antitrust law
  - Substantial fraction of inherent preferences
  - Some preference stabilize over time
  - Even constructed preferences often not wholly divorced from higher-order, “true” preferences
  - Most importantly, again, this is a **comparative question**
    - less competition and choice / regulation of preferences much worse