Firms sometimes offer what seems like a bewildering range of products or services. Does this reflect a genuine desire to provide maximum flexibility to consumers (“a plan for everyone”), or is it instead a strategy designed to increase firm profits by confusing customers? And even if it is the latter, does it necessarily follow that “something needs to be done”? Eugenio Miravete considers these issues.

On September 1st 2007, President George W. Bush made the following observation about the US sub-prime mortgage market upheavals:

“It’s not the government’s job to bail out speculators or those who made the decision to buy a home they knew they could never afford, yet there are many American homeowners who could get through this difficult time with a little flexibility from their lenders or a little help from their government.”

This was not the first call from a US politician to implement some sort of bailout policy to correct for the failures of the sub-prime mortgage market. Presidential candidate Hillary Clinton remarked last March at a meeting of the National Community Reinvestment Coalition:

“We need to expand the role of the Federal Housing Administration to issue more mortgages at better rates to these homeowners. We need to give consumers more counseling and information, prevent families from being trapped in high interest loans with pre-payment penalties and in some cases, allow more breathing room from foreclosure.”

Perhaps such statements indicate a belief that consumers are inherently unable to make the right decision and thus need protecting from themselves, or perhaps they reflect a fear that the mortgage troubles may trigger a wider financial crisis. Either way, very disparate politicians are suggesting that the government should bail out households, at least partially. Senator Clinton adds an interesting justification for implementing such a policy:

“But what if that family that we are trying to get into their home decides they will seek out a sub-prime loan? Well, we have to put ourselves in the shoes of a parent signing a mortgage product unaware of a complicated, escalating payment formula that has been worked out on some computer that has balloon payments and pre-payment penalties, which includes the cost of taxes and insurance, and other added on costs that the owner
doesn’t really understand and nobody takes the time to explain them. Clear and easy to understand disclosure, plain talk meant to inform, not to confuse must be the starting point.”

In other words, policy makers should prevent and remedy the effects of business practices that take advantage of consumers’ ignorance. When businesses make use of complex computer programs to design profitable strategies, consumers have a limited ability to discern what is best for them. Therefore, politicians should defend them against greedy corporations.

This political view echoes a long-standing debate among economists. The work of “behaviouralists” has not only integrated many of the tools and concepts of psychology into the analysis of individual choice, but also questioned the basic rationality assumption that is at the core of all modern economic modeling. Their fundamental conclusion is that individuals make systematic errors and hence need ongoing assistance in order to make the right decisions.

If consumers are limited in their ability to compare products or contract options, firms may find profitable to engage in deceptive strategies. But what is meant by this, and how does ‘deception’ differ from, say, collusion or simple sales promotion? Although somewhat subjective, a reasonable definition of deceptive strategy includes three basic features: 1. It must not be openly illegal, 2. It aims to profit from consumers’ mistakes, and 3. Expected gains per individual need to be limited.

Let’s turn to an actual example to illustrate these points. Imagine that you moved to Texas in the middle of the 1990s and wanted to sign up for a long distance telecommunication carrier. After fifteen minutes of answering questions about your personal details, the operator asks you which carrier you choose for long distance calls. You say “I do not care,” and the operator continues with the questionnaire. Only two months later, when you get your first bill, you realize that you are indeed subscribed to “I Do Not Care, Inc.” which by the way is charging astronomical rates for your long distance calls.

Setting up a virtual long distance operator named “I Do Not Care” is not illegal in the US. Other similar companies included “It Does Not Matter,” “Any of Them”, or “They Are All The Same.” Setting high rates is not illegal either, although there is an important constraint: rates cannot be so high so that most customers declare themselves insolvent or find it profitable to sue the carrier in court. Potential profits per customer are thus limited and the life of these deceptive strategies is limited by how fast consumers learn about their existence. But what if consumers are inherently dumb? Shouldn’t the government intervene?
Ultimately, this depends on whether consumers are capable of rational learning. Behavioural economists argue that consumers do not behave rationally - based on laboratory experiments and on observations that people break their New Year’s resolutions, under-contribute to savings plans, and so on. This leads to the frequently employed argument that consumers, because of their inherent limitations in accounting for the consequences of their actions, are unable to properly choose among numerous contract options. One difficulty with this view lies in the definition of “properly”: it may simply mean the least expensive option, regardless of other dimensions of consumer preferences - such as risk aversion towards bill variation.

One piece of evidence that favors behaviouralist economic models is the case of individuals who renew their monthly gym membership despite being infrequent users.\(^1\) In most cases, paying on a per visit basis would cost them less. They plan to get fit, but tomorrow, once they have paid, they discount the benefits differently and exercise less than expected. This would seem to support the idea that consumers suffer from inertia or have time-inconsistent preferences, although it may simply reflect other subscription motivations such as social opportunities, or that the user’s employer is paying the bill.

But now consider the case where a consumer must choose among several telephone plans - a repeated decision faced by a larger fraction of the population than gym-goers, that in addition does not carry any consideration regarding social interaction or status. The current evidence finds that while consumers often fail to subscribe to the least expensive plan for their usage profile, these mistakes are not systematic, and subsequent plan switching is best explained as an explicit attempt to reduce monthly bills.\(^2\) This case is challenging for behaviouralists because consumers appear to respond to minimal gains from switching, thus implying a very low bound for deliberation costs, at least in a situation where decisions are made repeatedly.

Is this conclusion affected by industry structure? Going from monopoly to competition often increases the number of options available to consumers - and this is certainly the case in telecommunications. On the one hand, this would seem to be good news as more options allow the different needs of consumers to be targeted more accurately; on the other hand, consumers may believe that this is an attempt to get them confused and thus rip them off. In practice, however, truly deceptive options (i.e., those whose features clearly aim at benefiting from consumer mistakes) are less common in competitive environments, although it can take some time after the entry of competing firms for such deceptive strategies to disappear.\(^3\)

Thus, despite the uproar it created in the New Zealand media at the time, the former CEO of Telecom New Zealand, Theresa Gattung, might have been fairly
describing deceptive strategies and what is needed (or not needed) to correct them when she claimed:

“Think about pricing. What has every telco in the world done in the past? It’s used confusion as its chief marketing tool (...) customers know that’s what the game has been. And that’s fine. (...) The Government is way too smart to anything dumb here.”

In other words, deception is just another business strategy, but consumers are fully aware of this and will eventually learn whether or not they are being unfairly taken advantage of. In general, consumers judge firms by the price and quality of their product or service. Deceptive behavior is just one of many such quality characteristics - and given sufficient competition, consumers who are unhappy with this particular characteristic can choose to take their business elsewhere. So long as sufficient competition exists, there is no need to impose standards of behavior on firms or to provide step-by-step guidance to consumers in making their decisions: consumers can and will make sensible decisions for themselves.

Eugenio Miravete is associate professor of economics at the University of Texas at Austin. During 2007, he was an ST Lee Fellow at ISCR. This article is based on a public lecture he gave in Wellington on 5 July entitled “Profiting from Confusion: The Economics of Deception”. The slides for this lecture are downloadable from http://www.iscr.org.nz/navigation/work_in_process.html

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3 Katja Seim and V. Brian Viard document in their manuscript “The Effect of Market Structure on Cellular Technology Adoption and Pricing.” (Stanford Graduate School of Business, 2006) that the number of tariff options available to consumers increases substantially after an increase in competition. Katja Seim, Nicholas Economides, and V. Brian Viard further document in their manuscript “Quantifying the Benefits of Entry into Local Phone Service,” (Stanford Graduate School of Business, 2006) that despite the increasing number of carriers and tariff options, customers generally reduce their monthly telephone bill by 5% after switching carriers. In the manuscript “The Doubful Profitability of Foggy Pricing” (ISCR Working Paper, July 2007), Eugenio J. Miravete shows that competition not only increases the offering of tariffs, but also that the share of those clearly aimed to take advantage of consumer mistakes become less common with competition.