

## The Economist and five bucks off a bottle of wine

May 2015

### Speed read

Most of us zero in on those bottles in the supermarket said to be marked down from full price, when we wouldn't do so if the wine was priced only at the reduced price in the first place. We are "*unduly influenced in our choice ... by notices that say it has been discounted*".<sup>2</sup>

Our choices are somewhat irrational: other bottles not marked down could provide much better value.

And there are plenty of other examples. In fact, we can even be described as **predictably irrational**, so prevalent is this irrationality. (And *Predictably Irrational* ends up being a nice title for Dan Ariely's book on this theme).

But much competition and regulatory practice – such as the idea that free market competition itself produces optimal outcomes - assumes we aren't quite so irrational. That, for example, we will freely move to a competitor's offering if it is superior, when in fact, again irrationally, we tend to think more about the risks of switching mobile providers than about potential gains (and we tend to be fairly sticky as customers anyway, that is, we can be inert rather than active).

So, is competition law and regulation answering the wrong issues or dealing with them inadequately?

This was overviewed by Lord Currie, who heads up the UK equivalent of our Commerce Commission, in an excellent paper [Homo economicus and Homo sapiens: The CMA experience of behavioural economics](#) given last month at a Commerce Commission presentation.

His focus? The emergence of behavioural economics, an idea started back in the day by Daniel Kahneman, economics Nobel prize-winner, and the author of that top of the charts recent book, *Thinking, Fast and Slow*. So, there's a nice overlap into the territory of better decision making by businesses and others.

As Lord Currie says "*At the heart of behavioural economics is the insight that ordinary consumers do not behave as the so-called perfectly rational consumer of neoclassical economics*".

While he recognises the ongoing central importance of encouraging competition, he outlines the UK experience under new legislation around additional remedies. He shows that evidence based design is key or you can end up with counter-intuitive and flawed outcomes. He says the new UK legal regime works well.



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**The Detail**

As consumers, we get seduced by that first website page setting out an airfare, and via that “marketing web” as the courts call it, we end up, in Lord Currie’s words, putting “*too much emphasis on the headline price and under-estimate the cost of the add-ons*”. That’s a problem recognised by both economists (a behavioural economics issue) and by the law (see, e.g., our article, [Carpet Manufacturers’ spat clarifies marketers’ legal obligations](#)).

**Confusopoly**

Another of the many examples of behavioural economics that he gives is “*confusopoly: consumers can be overwhelmed by more information than they can process*”. He uses telco services as an example.

And we have a notorious telco example of confusopoly at play here in New Zealand, which was one of the factors leading to the forced operational separation of Telecom in 2006. Then Telecom CEO, Theresa Gattung, was quoted as saying:<sup>2</sup>

*“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. They know we’re not being straight up.”*

Naïve to say it – duh – but candid!

**Solutions?**

How to solve these problems? Lord Currie explains that intermediaries and comparison tools can help solve confusopoly, for example, and consumers can learn their biases are being exploited. But problems can persist, such as where purchases in a particular category are

infrequent and too small to trigger a consumer response. Or big data tools might be used to find better ways to play the game against consumers, such as offering consumers different prices online, for say accommodation (e.g. the suggestion that Apple users might be offered higher prices online than PC users as the former are typically wealthier and less price sensitive). Or the supplier can game? The position as between active and inert consumers, and so on.

So, standard competition remedies of removing barriers to entry, in order to enhance competition, along with increased transparency and consumer information, may not be enough, states the paper.

However, Lord Currie emphasises how critical it is to design remedies so that they don’t create worse problems. For example, to address confusopoly, regulators might impose a simplified pricing regime. But that has the countervailing harm of reducing consumer choice, plus “*Simplified pricing may also facilitate tacit collusion*”.

Another example, is that by focusing on the wrong metrics and information, you can get a perverse outcome. In New Zealand, a poorly designed broadband performance comparator has all the hallmarks of leading to poor market outcomes.

The same can happen if the information is not available in the right place.

In the UK, the market study and market inquiry tools available to the regulator can be particularly successful in dealing carefully with these issues, says Lord Currie.

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### Are firms predictably irrational too?

The paper also queries whether firms also act irrationally. He concludes that the large firm is less likely to do so, but still may be irrational: as evidence, he cites the research that the majority of mergers reduce rather than increase shareholder value. He is clearer about SMEs acting irrationally though:

*"SMEs typically have scarce skilled resource, their transactions are more sporadic, their information is limited and their access to high volume data processing and analytics is limited. So they may be much more like individual consumers, so that their biases risk being used by large companies, just as for individual consumers."*

1. Lord Currie, in the paper referred to above.
2. [http://www.nzherald.co.nz/business/news/article.cfm?c\\_id=3&objectid=10380894](http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10380894)

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