

Behavioural economics and consumer issues

Introduction

This paper addresses the policy contribution the study of behavioural psychology can make to benefit consumer interests.

It considers the rationale for policy makers to apply behavioural psychology in their work. The paper then discusses some consumer policy issues through a behavioural psychology lens. Additionally, it draws some policy conclusions governing application of psychology to consumer policy before calling for action to improve the policy decision making process using this knowledge.

Anomalies and cognitive biases relevant to consumer issues

Human psychology evolved to cope with challenges faced by small hunter-gatherer bands, such as food scarcity, lack of accumulation and sophisticated trade, and short and uncertain life spans. In this evolutionary environment, survival depended on the short term and local environment, not on events and prospects remote in time and space.

People are thus naturally hardwired to fear snakes and heights but not power points, moving cars, or unviable financial products. Our psychology evolved on the basis of face to face exchange with one another not by immersion in abstract and impersonal markets, and with direct observation rather than abstract reasoning. It favours immediate rather than deferred consumption. Evolution has left us with a host of psychological characteristics that are inconsistent with rational modern world assumptions.

Unstable preferences

Despite what is often taught in orthodox economic textbooks at university, people do not generally have stable well-ordered preferences that deliver on their expected utility. Preferences are unstable – what is observed at one point in time changes with time. People value gains and losses differently. Gains and losses display diminishing sensitivity, so the difference between \$10 and \$20 seems bigger than the difference between \$1000 and \$1010. People go to more trouble to save a small sum (e.g. \$5) over a small purchase (e.g. \$20) than saving a larger sum on a larger purchase, such as several hundred dollars on a house purchase (Camerer et al 2004 p 79).

Importance of reference points

People fail to achieve optimal long-run welfare because of extreme sensitivity and responsiveness to arbitrary reference points and particular local situations (Glaeser 2003). Prospect theory is a model of risk choice where carriers of utility are not states of wealth but gains and losses relative to often arbitrary and ephemeral reference points (Kahneman & Tversky 1979). People assign value to gains and losses against reference points rather than final assets. So, someone may buy a share at \$5, see it drop to \$3, and stay there for long enough for the \$3 to become

the new reference point. They then feel a profit has been made at \$4 because the reference point is now \$3.

Thinking often *anchors* on an irrelevant reference point such as the spin of a wheel, a random number, unrelated fact, or a credit card minimum repayment rate lower than what is optimal for the consumer. Salespeople may offer consumers an expensive product which they do not expect to sell, since this creates an anchor against which consumers judge a lower cost product to be reasonably priced.

Importance of framing

How information is framed, and broader issues of choice architecture and choice bracketing will often determine outcomes (Kahneman & Tversky (eds) 2000; Tversky & Kahneman 1981). Choice bracketing relates to whether people make choices narrowly or broadly. People tend to make more diverse choices when choices are bracketed broadly. Narrow framing means choices are evaluated one at a time rather than as a portfolio. This suggests giving someone too many choices may reduce the chance they will make the best decision for themselves.

Framing can alter perceptions of gain or loss. A “discount” is seen as a gain and a “surcharge” is seen as a loss even when they are financially neutral. For example when tested, the credit card industry has insisted that the difference between paying in cash or through a credit card be framed as a cash *discount* not a credit card *surcharge*. Were the wording the other way round the economic behaviours and outcomes would possibly be different.

Framing influences how risk and uncertainty are perceived and managed. People will more often decline a medical operation framed as having a 10% failure rate than one with a 90% success rate, even though the risk is equivalent. Consumers will perceive differently foods advertised as “95% fat free” compared to “5% fat”.

Loss aversion, endowment effect and status quo bias

Individuals are loss averse (Kahneman et al 1991; Kahneman & Tversky 1984). This may explain why consumers are more responsive to price increases than price cuts. They place higher valuation on what they have, compared to what they may aspire to obtain (“a bird in the hand is worth two in the bush”). Experimentally, people reject 50:50 bets to lose \$100 or gain \$105.

People have a bias in favour of the status quo and current endowments (Thaler 1980). The endowment effect is recognised in the “possession is 90% of the law” principle. Samuelson & Zeckhauser (1988) contend that the status quo bias results from loss aversion.

Status quo bias together with procrastination means that specification of default provisions has economic consequences. For example, making enrolment in the Kiwisaver savings scheme automatic rather than requiring an opting-in choice increases the Kiwisaver participation rate. This design architecture has been cited as important in the scheme’s success. By accounting for the inertia of many consumers and their reluctance to take a positive action to enrol, the participation rate is higher

than it might otherwise have been. This has helped achieve the government's policy goal of having more New Zealanders saving for their retirement.

Heuristic shortcuts

Petty & Cacioppo (1986) argue there are two different decision-making routes: a central route involving purposeful cognitive effort and a peripheral route used when "...motivation, experience, skills or ability is low" (see also Cialdini et al 1981). Central versus peripheral route approaches are akin to systematic versus heuristic programming.

People use heuristic short-cuts, that is, simple rules of thumb enabling decisions to be made without going through complex, optimality-based analysis. "Hassles" matter, and people avoid them through short cuts. Some of these short cuts may be efficient, though non-optimal, however others may be maladaptive in the modern world.

People respond to cues or primes, many of which trigger "rule of thumb" heuristics. It is easier to draw on and apply familiar associations than to imagine counter-factuals. An *availability heuristic* can be employed to estimate frequency or probability by the ease with which familiar associations are brought to mind. The availability heuristic creates a bias favouring what is more memorable, vivid or emotionally charged. The "availability cascade" sees a collective belief become more plausible through its repetition in public discourse: "repeat something long enough and it will become true". These heuristics are in turn related to the *recognition heuristic*, where if people have heard of something it must be for a reason, and so they favour this "something".

Information and choice overload

People are vulnerable to information overload, and too many options reduce the likelihood that people will make a choice (see Schwartz, 2004). Iyengar et al (2004) show that employees' participation in retirement savings plans drops as the number of fund options proposed by the employer increases. The number of options offered will influence the one chosen. People may find it easier to choose between three rather than two options since a third option helps frame the others, e.g. by drawing attention to advantages or disadvantages.

Overconfidence

People tend to overestimate their abilities and this has consequences for individuals and whole economies. Associated with this, *projection bias* or *false consensus bias* refers to people over-estimating the likelihood of people acting in the same way as an individual. Bubbles arise partly because cognitive biases such as excessive self-confidence at the individual level aggregate into herding behaviour and major distortions. Over-confidence by investors, lenders and borrowers was one of many factors that caused the recent global financial crisis.

The *confirmation bias* means we privilege information that supports a pre-ordained theory. This bias can reinforce individual overconfidence. It is associated with *hindsight bias* where people exaggerate the prior predictability of an event after it has happened.

Money illusion

Money illusion includes confusion over nominal versus real values, the illusion of free goods when costs are hidden and shifted to others, and belief that arbitrary values of money have an actual, immutable value. People may not notice a real wage decrease (e.g. due to inflation) so long as nominal wages don't fall.

Consideration of sunk costs

People's reluctance to accept they have made past bad decisions means they overvalue sunk costs, leading to "throwing good money after bad" problems. For example, consumers may fall prey to a scam where a small sum is spent to "win a Nigerian lottery" or help with the transfer of an "inheritance". The consumer is then led down a path of spending more and more money in the forlorn hope the "prize" offered will eventuate and sunk costs be recovered. There is also dead loss effect – if you pay for a club membership you want to use it even if you no longer enjoy the activity.

Misunderstanding of probabilities and of risk

People overweight small probabilities, for example when they buy raffle tickets. They draw inferences from too small a sample – the "law of small numbers". They often perceive non-existent relationships between non-contingent events. They find it easier to estimate frequencies than probabilities.

Assessment of probabilities may be distorted by false or irrelevant cues or associations. The "base rate fallacy" describes people focusing on particular data only rather than on all data bearing on a problem. An example is the roulette wheel in a casino. Some tables have displays which show the recent numbers the ball has landed on in the wheel. Some punters use this as a guide to predict what number or colour will come up next, often using the so called 'trend' as an indicator when of course the result of each spin of the wheel is independent of the previous spin.

People often prefer a small probability of winning a large prize over the expected value of that prospect. There is a tendency to make risk-averse choices if the expected outcome is positive, but to make risk-seeking choices to avoid negative outcomes (Tversky & Kahneman 1981).

Different mental accounts

The orthodox economic assumption is money is fungible, that is "a dollar is a dollar" regardless of whether it is held in cash, in a superannuation fund or in a property value. People have different mental accounts (Thaler, 1990; Thaler 1985), typically made up of three classes:

- current spendable income;
- current assets;
- future income.

Many people like shares because they involve a simple mental accounting rule: save the capital and spend the dividend. Bonus bonds draw on this mental accounting rule and exploit the innate appeal of gambling, while minimising the risk of substantial loss. Bonus bonds also exploit the vividness of prizes while masking the less salient long term interest rate loss compared to alternative investments. Consumers of course may also purchase bonds so that they are not tempted to spend their cash savings.

Different mental accounts and the difficulty people face in valuing things consistently over time leads to economic irrationality, e.g. people saving and borrowing at the same time. However, different mental accounts can assist self-control that counters present-centredness and short-term bias. For example, people are reluctant to use long term superannuation savings to pay for today's groceries and this is in their interests.

Social norms and herding effects

Humans evolved as a social species where individuals depend on others for guidance. Social norms are created and reinforced by observations or cues signalling how society expects individuals to behave. When a transparent donation box is "primed" with \$5 notes rather than coins people's average donations will tend to follow this \$5 average since a norm has been established.

Social norms can underpin civil society and positive virtues, or can be negative. People adopt beliefs held by those around them and this means false or cognitively biased beliefs can rapidly propagate and become accepted wisdom. A cognitive bias that distorts the behaviour of a few people can snowball into a herding effect and lead to major distortions and macroeconomic bubbles.

Negative norms shape individual behaviour: "when you live among wolves you have to be a wolf yourself." If everyone else is littering, you might too. Negative social norms and peer pressure are difficult for individuals to escape because "to be a stranger among your own is to be alone among strangers," and therefore excluded from wider social support. So, in deciding for example on a default provision a principle may be to align a default to a positive social norm. For example, organ donation may be a widely shared and positive social norm, and therefore this could become a default provision.

Authority bias

People defer to authority figures, including politicians and popular celebrities. Authority figures influence social norms for good or bad: "fish go rotten from the head". Related to this, government itself is seen as "authority". Therefore, that something is lawful and regulated can imply that government has mandated it, thereby triggering authority bias and dissuading consumers from rigorous scrutiny of product offerings. From a consumer finance perspective it has on occasion been the case that borrowers decide they can afford loans because someone is willing to lend to them. The willingness to lend money may convey assurance to the borrowers that they can pay it back.

Scarcity bias

The scarcity bias or heuristic (Brannon & Brock 2001) suggests people consider rare products to be of high value or quality.

Salience and vividness

The brain privileges first hand information over abstract symbols. People are over-responsive to rare but vivid and memorable events such as crimes, terrorism, plane crashes, and are under-responsive to less obvious, low salient events such as poor diet that erodes health over time. The cost of taking a taxi is obvious while the through-life cost of owning and running a car less so. It is common food industry practice to reduce package sizes rather than increase prices because a price rise is more obvious and more likely to reduce demand.

Lotto is popular because of the high salience of the jackpot compared to the low vividness of the minute probability of winning. Businesses may sell products/services by reducing the vividness of costs (e.g. "50 cents a day" rather than \$182.50 a year, or "for the price of a cup of coffee a day"). They can also amplify vividness for marketing reasons. High pressure sales tactics exploit visceral factors and the vividness of urgency. So, "cooling off periods" are often required to allow reconsideration of purchases and to counter behavioural tendencies to make early decisions based on sellers contriving a sense of urgency. These cooling off periods may be ineffective because of such factors as the way default provisions are prescribed and procrastination.

When thinking of voters as consumers, policy makers can be tempted to create too many "high visibility" agencies and programmes, even at the expense of higher cost.

Inferential cues

De Steno et al (2004) argue that persuasion is more successful when messages are framed with emotional overtones matching the consumer's emotional state. Social cues of intimacy, trust or reliability, and inferential techniques can be exploited in lawful but misleading ways. Establishment of trust can bring about inertia in buyer-seller relationships (McKechnie 1992). This in turn nudges consumers to the peripheral rather than central route to persuasion. Consumers will therefore process information heuristically rather than systematically (see Chaiken 1984; Harrison & Massi 2008).

Marketers exploit consumer tendencies to draw misleading inferences triggered by cues. These inferential cues may relate to implied significance and implied contrast where an advert states a meaningless fact or a difference between two products implying significance, even where the fact/difference is meaningless. Other consumer inferential tendencies exploited by marketers include implications via ordinary meaning, implied proof, and implication via a reasonable basis for pragmatic inference (see Boush et al 2009).

An example of an inferential technique is to associate cigarette smoking with sport, outdoors life, holidays or personal freedoms. Tobacco companies use brand names

such as 'Freedom', 'Holiday' and 'Horizon' to trigger positive associations and distract attention from health risks. Some failed financial companies had prudent or European-sounding names evoking images of sound banking practices and risk aversion. Their advertisements used popular and trusted sporting or media figures and the trust-based inferences drawn from this were far from the companies' real risk profile.

Present bias and discounted utility

In evolutionary times, ever-present danger and uncertainty over even short-term prospects made human psychology present-centred. It now means that people are likely to be hyperbolic discounters, in that they over-value the present. Over the short run people act as if their discount rate exceeds the interest rate. Myopia and hyperbolic discounting causes all manner of difficulties, such as short-term indebtedness. It is of course understood that sometimes people borrow assuming they will be able to repay in future and are not then able to do so because of unforeseeable events.

Hire purchase markets serve those who cannot defer consumption of durables and instead choose to bear a higher real cost for durables. However, this is at high real cost over the life of purchases. Present bias can be countered by commitment devices, including different mental accounts to limit consumption and support longer-term saving. Market commitment devices include illiquid savings instruments and Xmas clubs. While the market can generate commitment devices it is also effective at undermining them through promoting excessive consumption which can lead to over-indebtedness and the travails this may bring.

Procrastination

People often procrastinate and if given a relatively longer time to complete a task will take longer to do so. In business, if consumers are given longer to e.g. back out of a deal then they may be less likely to do so, though of course an extremely tight deadline may also be unfair to consumers. It is often a matter of fairness between two parties. Credit contracts in New Zealand have a three day cooling off period because large sums of money are often the subject of the contract.

Switching between banks and electricity providers where it is obvious consumer utility would be improved may be constrained not only by rational switching costs but by simple procrastination. A gym contract or magazine subscription with direct debit payments from consumers who have to actively opt out has a different outcome to arrangements where consumers have to opt in by actively renewing contracts or subscriptions.

Rationale for applying behavioural psychology in policy

Economic policy should focus on consumers because the ultimate purpose of production is consumption. Consumer interests include allowing producers to operate as efficiently as possible, for example by reducing regulatory burdens that ultimately impose costs on consumers.

Consumer marketing involves often deceptive though lawful use of psychological techniques (Boush 2009). “The only free cheese is in the mousetrap,” and mousetraps are lawful. Producers are concentrated interest groups while consumers are atomistic. Producers also control information framing and choice architecture. So, if policy makers do not act, the default is that producers control the behavioural psychology shaping consumer choice, potentially at the expense of consumer utility.

Furthermore, many consumers need external assistance in self-control and self-regulation. Because of a “restraint bias” people overestimate their capacity for impulse control (see Nordgren et al 2009). In the same way that infants need to be protected from their cognitive limitations, it is argued that “all of us are infants” in some contexts. Odysseus had to tie himself to the mast to avoid the Sirens’ temptations. Even highly trained economists and accountants are vulnerable to cognitive biases and psychological manipulations.

External help in self control can range from behavioural psychology interventions, rigid externally-imposed discipline, including in military and “boot camp” contexts, social norms and peer influence, external belief systems such as religion, or moral philosophy and how it is reflected in legal, political and social rules. Ultimately governments are elected and laws enacted partly because people need external help in achieving self control, and to prevent others’ actions impinging negatively on their lives.

All the above factors mandate a clear role for government agencies and consumer groups in actively extending their use of behavioural psychology in safeguarding consumer interests.

Where there is a role for a policy intervention, the policy applications of behavioural psychology should simply be a normal part of the “tool box” through which individuals can be assisted to exercise self control and make decisions that optimise their utility.

Practical applications of behavioural psychology to consumer issues

Practical applications for consumer product and consumer finance markets might include:

Consumer product markets

Optimal consumer utility implies there is some “right level” of consumption and some ideal balance between an individual’s spending and saving.

Business has every incentive to encourage consumption and therefore sales. This inevitably creates risk of overconsumption of e.g. unhealthy foods, tobacco and alcohol, prestige and status goods, and inevitably excessive indebtedness to support this consumption.

There is an extensive literature on the relationship between psychology, “over-consumption” and associated phenomena such as “status races.” This literature dates at least from Veblen (1899) and broadly includes (Frank 1985, Offer, 2006 and

Bernstein, 2008). Rank status can turn into consumption-based positional competition which can in turn drive inefficient and wasteful utility loss. Status races (“keeping up with the Jones”) are wasteful because resources are spent on positional goods, not on those that confer utility, and because these races cannot ultimately be won as there is no finishing line (see Robert Fuller 2006). A deeper evolutionary perspective on consumption can be found in Saad (2007).

The emerging field of “happiness research” (Layard 2005) decouples consumption from utility and focuses on ultimate utility, well-being or happiness rather than material consumption for its own sake. It suggests that while richer countries are happier than poorer ones, above a threshold of average income increasing income further adds little or nothing to average happiness. Its literature suggests that:

- a person’s happiness rapidly adapts to higher levels of income;
- tastes are greatly culturally determined and can be manipulated;
- above a threshold, higher income does not deliver increased happiness;
- people overestimate the extra happiness they get from extra possessions (see Lowenstein et al 2003);
- advertising makes us feel we need more money than is in fact the case.

Producers respond to consumer “needs” and also shape or create those needs through behavioural psychology. Retailers may reduce the perceived cost of a product by e.g. labelling it \$2.99 rather than \$3. They encourage purchase of excessive quantities by labelling a well stocked product as “limit of ten”. This tactic exploits several cognitive biases – the scarcity bias, a sense of urgency (“buy now before they are sold out”), and the anchoring on an upper limit as a target to aspire to (buying ten not one). Such sales tactics also subtly imply that the retailer has a sense of fairness – rationing products among customers so all have the chance to buy. Exploiting fairness-based cues in such ways may subtly erode trust in society.

Competition policy is about ensuring consumers have a meaningful range of options and that prices reflect competition between suppliers. Consumer policy aims to achieve consumer well being by ensuring that consumers’ reasonable expectations of transactions are met. It is concerned with reducing the gap between these expectations and outcomes of the transaction.

Consumers are currently protected by legislation governing competition policy and consumer protection. This works at the market structure level (for example relating to monopoly power) and at the micro-market level (notably the Fair Trading Act and the Consumer Guarantees Act). At this latter more detailed level formal claims made for products cannot be grossly misleading. More stringent regulatory requirements may be imposed for high risk products such as pharmaceuticals or to protect vulnerable consumers such as children (e.g. product safety standards).

However, many consumer products have shrouded attributes, such as the through life cost of a durable purchase. Adverts cannot legally be misleading, however should they be legally required to divulge shrouded attributes, to correct false beliefs about material facts, or more generally to divulge facts that would, if divulged, change consumer behaviour?

This might include full information disclosure about a product or service (e.g. all the contractual restraints on a mobile phone contract) and information government can provide on businesses (for example ranking them using such criteria as greenhouse gas emissions and numbers of warnings for misleading behaviour). Consumer Affairs and Consumer NZ fund Powerswitch, an on-line comparison of electricity rates based on usage patterns. Cigarette packets are placed out of view, forcing people to actively ask for them and therefore discouraging new smokers and reducing temptation for those who have quit.

Consumer finance markets

Many consumers bear excessive levels of indebtedness because of their cognitive biases, and how these are exploited. Indebtedness harms individuals and families and aggregates through to macro-economic imbalances, high real interest rates, and to distortions favouring the tradable over the non-tradable sectors. Consumer lending is a core economic function of banks and finance companies, however psychological manipulations can harm consumer interests by encouraging excessive indebtedness and interest costs. Key issues include loan financing and excess credit offers, fringe lending, and excessive credit card use:

Loan financing and excess credit offers

Bertrand et al (2005) show that psychological manipulations affect consumer decisions to take up short term loans. For example, letters displaying a small interest rate and monthly repayment table generated a higher take up rate than offer letters displaying a large table and detailed information about repayment. When people have been offered loans their uptake has been influenced by arbitrary factors such as photos on the letter of offer, deadlines, and other framing tactics even when the interest rate and other conditions are the same (see MED 2006 p 9).

Excessive consumer indebtedness is encouraged by unprompted or unsolicited extension of credit. Consumers entering into a credit contract to buy e.g. whiteware may then receive an unsolicited finance card that extends further credit, accessible by using the finance card.

Harrison & Massi (2008) note that unsolicited letters offering to lift credit limits typically use at least six different psychological manipulations:

- formats that lead to low involvement, trust, and the use of peripheral routes to understanding – the letter offers make them very easy to accept;
- authority bias (citing expertise) that suggests to consumers that an expert (such as a bank senior manager) has mandated the credit offer;
- consumers use heuristic rather than systematic processing;
- use of terms such as “pre-approved” implies psychological ownership and property rights, and therefore exploits status quo bias;
- offers are “loss-framed” to suggest that declining the credit offer will constitute a loss;
- scarcity is suggested in offers, thus increasing consumer desire to accept by exploiting scarcity bias.

Harrison & Massi (2008) note that extra credit offers use positive language such as *flexibility* (triggering positive associations) rather than negative terms such as *debt*.

Retailers may bundle a financial offering with the offer of a product such as a car. The psychological commitment the buyer feels for the car therefore becomes bundled with the associated financing option, to the buyer's detriment. Behaviourally, this means that buyers tend to go with the financial offering rather than shop around for better financing options.

Fringe lending

Fringe lenders ("loan sharks") exploit behavioural psychology and social and cultural protocols to "provide a service to" or "to exploit" typically low income people, depending on how they are seen. MED's *Fringe Lenders Desk Research Project* found that in 2006 there were 185 fringe lending companies, of which 94% offered cash or personal loans, 43% car loans, and 26% debt consolidation loans.

While fringe lending is regulated in the sense that all forms of consumer lending are subject to the Credit Contracts and Consumer Finance Act (the CCCFA), this itself can create an authority bias. The fact that something is allowed and regulated, such as fringe lending, implies that "the government has checked this out, so it must be safe". Consumers may also assume that if a lender is prepared to lend to them they must be able to afford to borrow because who would lend to them otherwise?

The hardship provisions of the CCCFA presently allow a consumer to apply to a lender to vary the contract when the consumer faces a situation of unforeseen hardship. This may for example include a job loss or ill health. The variations allowed to be asked for include delay of payments, or smaller payments with a longer time frame. To be able to apply for this relief, the consumer must be up to date with their repayments. If they are not up to date, the lender has no obligation to consider a contract variation. A consumer who was seeking maximum utility would thus approach the lender the moment they suffered the unforeseen circumstance to ensure they would be in a position to negotiate a satisfactory terms of repayment.

However, this has not generally occurred. Community groups have highlighted that in genuine situations of unforeseen hardship, the problems before the consumer can be so great that contacting their lender is not their first concern. An ill family member may take all the bill payer's time and energy. A relationship breakdown can be an extremely difficult process. By the time the consumer is in a position to sort their finances, it may be too late for a contract variation. As such, the policy goal of protecting people in unforeseen hardship circumstances is not always able to be achieved. By acknowledging the behaviour of the consumer in these circumstances (which are usually normal responses to life-affecting circumstances), it has been recommended that consumers are able to apply for a contract variation whilst up to two months in default.

Fringe lenders use a range of debateable practices. They encourage consumers to enter into debt with extreme ease, charge high interest rates (arguably based on a higher risk profile of their clients) and high administration fees which can be difficult to police under the Credit Contracts and Consumer Finance Act. There have been

reports of fringe lenders holding ATM cards, passports, personal effects such as children's toys and family heirlooms for security. They may target mentally disadvantaged people as well as those with low financial literacy and credit-worthiness.

Some fringe lender business models *depend on people failing* rather than fulfilling their utility. An example is cases of payday lending when lenders rely on the borrowers not being able to make the short term repayment, enabling them to then extend or roll over the loan term for a fee. In this type of consumer product profits are designed to come from the consequences of people defaulting on loans. Other social costs arise from fringe lending, such as the demand created by vulnerable people for community law centres and the costs of law enforcement. The total societal cost of fringe lenders is therefore likely to be high especially when factors that result from financial pressures taking their toll such as marital problems, depression, stress and other social problems are taken account of.

On the other hand, fringe lenders service legitimate customer segments, such as people needing an urgent loan for medical reasons or to meet family or cultural obligations. These are legitimate reasons for borrowing money. If a more mainstream lender is not prepared to lend on the basis of risk then the fringe lender is possibly the best solution for some consumers. Restricting or banning some fringe lending practices may force borrowing underground away from the eyes of enforcement agencies. The policy goal should therefore be one of facilitating consumers in the finance market finding the "right" lenders that can meet their needs.

Excessive credit card use

Credit cards are near necessities in modern life, important for the functioning of consumer and other markets. They are integral to changes in financial practice that have substantially lifted productivity over time. However, credit cards are also open-ended facilities that can erode self control and promote a culture of over-consumption. Credit card financing differs from other loans by being:

- unlinked to any asset (and are therefore unsecured);
- oblivious to the nature of what is bought;
- a revolving line of credit.

Marketing campaigns may variously portray credit cards as ways of earning rewards, status symbols or fashion statements, masking the debt burden they can lead to (Harrison & Massi 2008). Consumers have to apply more cognitive resources to exercise self-control against psychological manipulations based on positive and simple messages (Baumeister 2002).

Inherent features of credit cards promote increased indebtedness. Credit card expenditure has immediate and certain benefits while costs are abstracted. Credit card purchases are more psychologically distant from the transactional experience than cash. Cash expenditure has high salience while credit card expenditure is much less so (people are less ready to part with cash in hand). The interest costs may be understood abstractly but are not necessarily perceived as real. Credit cards decouple in time purchases from payment, making the financial cost less vivid.

They also bundle different purchases into the one repayment. Credit cards mean that the psychological experience of handing over cash is removed and therefore any social norms against excessive materialism are removed (Ritzer 2001).

Not surprisingly, the evidence is that consumers with credit cards tend to spend less time and more money when making their purchases than when using cash (Feinberg 1986).

Credit card providers can undermine values of thrift and prudence by creating a demand for excessive credit (where “excessive” is defined in relation to rational utility). Unsolicited increases to credit card credit limits imply an endowment effect (Thaler 1980). Credit card providers may advise a consumer that the credit limit is being increased on a card unless the consumer advises it is not wanted. This exploitation of procrastination and opting out psychology can damage consumers by eroding self-control devices (credit restrictions).

Low interest rate cards typically have higher annual fees. Consumers are more likely to accept “credit” card debt offers with a low introductory interest rate for a short duration even where they would be better off accepting offers with a larger introductory interest rate that lasts longer (O’Donoghue & Rabin 1999).

As at the year ended June 2009 New Zealanders had about \$5 billion owing on personal credit cards, of which around \$3.5 billion was outstanding debt incurring interest charges of e.g. 19%. This means the gap between the OCR and credit card interest rates is commonly around 15%. Since at any one time most credit card debt incurs interest, “credit” cards might be more accurately renamed “debt” cards. If this were done, consumer indebtedness might reduce markedly due to a one word reframing.

Review of the Credit Contracts and Consumer Finance Act 2003

The Credit Contracts and Consumer Finance Act 2003 (CCCFA) is principles-based legislation providing for information disclosure to allow consumers to make informed decisions about consumer finance. It also provides for regulatory protections to protect consumers. The CCCFA governs all forms of credit provided to consumers for personal, domestic or household purposes, including home loans, credit sales, hire purchase, student loans, credit cards, long term leases and housing buy-back schemes. It does not cover financial security offerings.

The CCCFA is under review by the Ministry of Consumer Affairs. Some of the proposals in the 2009 discussion paper *Review of the Operation of the Credit Contracts and Consumer Finance Act* have been developed by applying a deliberate behavioural economic lens to several problem areas identified in the review. While recognising that not all borrowers are the same, the recommendations are the result of an attempt to understand the psychology around consumer behaviours. Some of the recommendations are briefly discussed below:

Information disclosure and framing

The CCCFA provides for disclosure but does not mandate how this information is framed, other than by simple recommendations such as it must be readable.

Disclosure requirements often do not stop businesses exploiting consumer cognitive biases in damaging ways. There has been some concern that lengthy disclosure statements governing for example repayment fees can potentially contribute to information disclosure overload or crowd out more important information. Conversely, some consumers do not read disclosure information and only refer to it when “something goes wrong”. It is possible to require that information disclosure requirements be framed in ways more likely to be useful to consumers.

Personal loan offerings (and for that matter credit cards) are commonly advertised on the basis of their convenience and lifestyle appeal, often masking high interest rates. While there is nothing illegal in such practices, they play on consumer preferences and emotions which possibly reduces the veracity with which a consumer may examine a credit contract.

Where interest rates are actually publicly advertised they have been known to be presented in a fashion such that the less discerning eye does not recognise what they might actually mean. For example weekly rather than annual rates may be advertised (e.g. 8% a week rather than what is actually 416% a year.) Consumers who are used to seeing interest rates advertised on a per annum basis may interpret the weekly figure as such, especially if they miss the “small print” on the advertising or do not read the disclosure information.

Currently, the CCCFA requires disclosure of annual interest rates but does not ban weekly rate advertising that is framed in a technically accurate but cognitively misleading way.

Unsolicited credit offers

MED proposes to amend the CCCFA to ban the extension of credit provision without consumers expressly choosing to opt in. This means financial providers will still be able to offer extra credit but consumers would have to make a conscious decision to “opt in” and accept it. MED considers that the practice of sending consumers “finance cards” after entering into hire purchase agreements can lead to unintended over-indebtedness.

This proposal is an exercise in trying to engage borrowers to ask themselves if they really need to take on additional debt. It is hoped that by requiring an active opt in, consumers will at least consider whether they need or should use the credit on offer.

Minimum credit card repayments

Credit card providers often allow the borrower to make a minimum monthly repayment rather than paying the full outstanding balance. The minimum amount may be a matter of 5% meaning that interest accrues on the unpaid balance.

The “minimum amount” of repayment required for credit cards is significantly less than the full cost of the outstanding monthly balance on the card (2-5% of the

outstanding balance is typical). For example, a \$4000 debt on a card charging 19% might cost over \$19,000 in interest and annual card fees to repay if only paying the minimum payments, and it would take around 60 years to get rid of this debt.

Minimum repayments act as psychological anchors for consumers, who then meet the minimum payment not the financially optimal one. Stewart (2009) found experimentally that minimum-repayment information reduces the size of partial repayments, although it does not reduce the probability of paying the bill in full. This is because the minimum repayment requirement becomes the anchor. He found that removing minimum payment information led to a 70% increase in mean repayments. Generalising to a typical scenario of an average debt of \$4,000 and an annual percentage rate of around 19%, a 2% reduction in minimum repayments roughly quadruples interest charges.

Consumer information warning about the dangers of making only minimum repayments is likely to lead to disengagement rather than behaviour adjustment (Loewenstein & O'Donoghue 2006). Warnings about anchoring are ineffective in other domains (Wilson et al 1996). This suggests that even detailed information and warnings about the negative effects on consumers of minimum payment anchoring devices will be ineffective in protecting consumer interests. However manipulations that reduce uncertainty (such as providing tables of alternative repayment scenarios) can attenuate anchoring and reduce its negative effects (Stewart 2009).

Consideration could be given to requiring credit card minimum repayments to be set at an optimal or at least less financially punitive level for consumers. A proposed approach is a trigger to inform the consumer of the effect of paying only the minimum repayment and encourage a better repayment plan. Disclosure of the true cost of the interest that accrues if only the minimum repayments are maintained may be one way to achieve this. Additionally, the provision of a statement of how long it will take to pay off a debt using only minimum repayments may also serve to motivate the borrower.

Policy conclusions

Policy makers and regulators cannot see through consumers' eyes and decide their utility for them. Yet the status quo now prevailing is that consumers may be so affected by cognitive biases and poorly framed choice architectures that they often do not or cannot see where their real interests lie and therefore fail to act in their own best interests. This itself erodes consumer autonomy while causing significant social problems such as over-indebtedness.

Consumer policy might therefore aim to help consumers achieve their desired utility by influencing choice architecture and information framing to ensure consumers have the best possible information on which to base their choices. This means choice should be based on information that is not only fully disclosed but is also undistorted by cognitive biases and psychological manipulations. However, where consumers need to be nudged in a certain direction (say to meet a government policy goal) instruments that take advantage of those biases and behaviours such as opt in or opt out defaults might be used.

The use of behavioural psychology as a complement to other analytical tools used in consumer policy development can therefore enhance rather than degrade liberty, personal autonomy and consumer utility. This suggests that consumer policy might start from a Rawlsian perspective that gives paramount importance to liberty and autonomy. By being rational and reasonable we can better enhance utility and autonomy if we actively design and frame policies to overcome behaviours (resulting e.g. from cognitive biases) that undermine them.

This suggests a need for rules governing information and communication, and specification of default rules that favour consumer over producer interests in cases where there are conflicts between them:

Rules governing fit for purpose information and communication

Information disclosure by itself achieves little unless information is framed in ways that help consumers make decisions that achieve their optimal utility. For example, partial disclosures by those selling financial products can lead to consumers relaxing their vigilance (McAuley 2008). Disclosure of some information may distract consumers from other, more relevant information.

On the assumption that consumer information has the purpose of optimising consumer utility, communication of product information needs to follow fit for purpose rules. Information framing and communication style should overcome or neutralise cognitive biases in ways that optimise consumer utility.

Effective communication between people means a listener or reader must go beyond the literal meaning of language and understand the wider context. From this precept, Grice (1975) developed communication maxims (“the Gricean principles”)¹. These maxims stipulate that effective communication is determined by:

1. Quantity: the speaker/writer must make the message as informative as possible, and not more so (reducing risks of information overload).
2. Quality: A message needs to be high quality, that is with the veracity and validity to be fit for purpose.
3. Relevance: the speaker/writer should communicate only relevant information.
4. Manner: the speaker/writer needs to be brief, clear, and avoid ambiguity and obscurity.

The above principles are of course violated by the behavioural psychology manipulations embedded in almost all consumer advertising. The Gricean principles might well guide how consumer information is framed so consumers can fulfil their utility as realised if their cognitive biases were overcome, or at least not actively manipulated by producers.

Framing of consumer product information might also be influenced by the “golden rule” principle. The aim would be for producers to frame product information in the manner in which they would frame it if they themselves were consumers. From this

¹ An application of the Gricean principles in evolutionary theory (and literary criticism) is at: http://cogweb.ucla.edu/Debate/CEP_Gould.html

principle, policy makers and regulators might therefore design consumer rules as if they themselves were in the position of consumers.

Specification of default rules

Default rules specified in consumer protection policy could actively favour the consumer interest and promote positive social norms. This might apply over a vast range of policy settings, ranging from Kiwisaver through to organ donor rules. A key safeguard would be the right to opt out and choose another default provision if those favoured in policy or regulation were not supported by consumers.

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