

# SUMMARY REPORT ON THE FTC BEHAVIORAL ECONOMICS CONFERENCE

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This is a summary report on the Federal Trade Commission (FTC) conference “Behavioral Economics and Consumer Policy Conference,” held on April 20, 2007 in Washington, DC. Sponsored by the Bureau of Economics, the conference brought together leading researchers from various fields to present and discuss empirical research on consumer behavior and its relevance to consumer protection policy.<sup>2</sup>

The conference was organized around four basic themes, all with a public policy focus: 1) policy decision rules: how should regulators decide among consumer protection policy options? 2) the role of advertising and other marketing techniques in consumer decisionmaking; 3) mandated disclosures: how consumers process information and how it affects their purchase decisions; and 4) research into how consumers make decisions regarding phone plans and credit cards, especially in reaction to their usage own patterns.

Particular emphasis was placed on the rapidly growing field of Behavioral Economics, which uses insights from psychological research to identify ways in which consumers sometimes fail to behave in their own best interests, due to such behavioral traits as self-control problems, failure to process information objectively, and mispredictions about the costs and benefits of prospective choices. Behavioral economics has a long history and has been applied most frequently to finance issues, where research findings have been used to explain stock market anomalies, variations in the impact of different default rules for investors, and other consequences of behavioral patterns that do not fit conventional interpretations of rationality.

The application of behavioral economics to the kinds of consumer protection policy issues addressed at the conference is relatively recent, but the literature is growing and has attracted increasing attention from both academics and policy makers. An important development in this literature was publication of the Camerer *et al.* (2003) article, “Regulation

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<sup>2</sup> The conference website contains presentations and related papers, as well as a transcript and video of the proceedings. It is located at <http://www.ftc.gov/be/consumerbehavior/index.shtml>.

for Conservatives: Behavioral Economics and the Case for ‘Asymmetric Paternalism,’” which sought to apply behavioral economics findings to a number of consumer policy issues. In particular, the authors developed the concept of “asymmetric paternalism” to identify situations where government action is justified because it yields gains to unsophisticated consumers that outweigh the losses imposed on more sophisticated consumers who do not benefit from the intervention. As discussed later in this report, the asymmetric paternalism decision rule has a direct analogue in the benefit-cost calculus used by the FTC and other consumer protection agencies.

The conference began with general outlines of the basic principles incorporated in the neoclassical economic model and the challenges to this model represented by the behavioral economics paradigm. These discussions set the context for the remainder of the conference, which was devoted to three research areas, all with direct ties to consumer protection policy: marketing, mandated disclosures, and consumer choices among phone plans and credit card programs. The final session consisted of an open-ended discussion of the issues raised at the conference.

This report first summarizes each of the sessions and then concludes with a chapter describing some broad themes from the conference as well as directions for future research.

## **I. BASIC PRINCIPLES: NEOCLASSICAL AND BEHAVIORAL MODELS OF CONSUMER CHOICE**

### **Lazear:**

Edward Lazear (Council of Economic Advisors) described the standard economic approach used in the analysis of public policy issues as put forth in Lazear (2000). He argued that economics is not only a social science but a genuine science in that, like the physical sciences, it uses a methodology that produces refutable implications and tests these implications using statistical techniques. The economic approach utilizes three components that distinguish it from other social sciences: rationality, equilibrium, and efficiency. These three elements combine to allow economists to analyze policy issues in a way that other social sciences cannot. As a result, the economic method has gained increasing acceptance in a number of other fields such as law, biology, sociology, psychology, and political science.

The rationality component – the assumption that agents in economic models are rational and maximizing – is the one tenet directly challenged by the behavioral economists as being an unrealistic depiction of how individuals act. But Lazear views this assumption as essential for the tractability of economic modeling and further states that it is more general than critics maintain. In particular, he views rational behavior in a broad context that incorporates "weird tastes and strange preferences. The task of the economist is not to ignore these preferences but

rather to build them into an economic model where the individuals are still presumed to maximize.”

Lazear sees behavioral economics as an important complement to conventional economics rather than a competitor or replacement of it. Its reliance on psychological experiments has proved useful in identifying particular behavioral patterns that are more difficult to observe outside the laboratory. He notes that the “best thing about experiments is that it allows us to strip away extraneous elements and to focus on exactly the behavior that you are trying to study.”

But the reliance on experimental evidence also lessens its applicability to public policy, because the results cited in the behavioral economics literature often lack external validity. One frequently cited problem is the artificiality of the laboratory setting used for the experiments, which can lead individuals to act in ways that differ from how they respond in actual market situations. This phenomenon has been described in the work of John List and others.<sup>3</sup> Lazear also noted another shortcoming of experimental work – its use of subjects that are not representative of the individuals who actually influence market outcomes. Citing results of his own research, Lazear described experiments where the individuals who opt out of an experiment are those who are, in fact, the most influential decision makers in real world markets. (Lazear *et al.* 2006)

### **Camerer:**

Colin Camerer (California Institute of Technology) provided an overview of behavioral economics ideas by setting out a framework for thinking about how decisions are made and how the decision process might affect markets. He defined behavioral economics as “using facts and methods from other social sciences to understand limits on rationality, will power, and self interest and their implications.” Camerer noted that the type of behavioral economics analysis he utilizes is grounded in the basic economic method outlined by Lazear, with a key difference being the extent to which he sees individuals as varying from even the more general versions of the neoclassical rationality assumption described by Lazear.

Some of the cognitive problems experienced by consumers as they attempt to make decisions in the market place include: numerical mistakes, limited attention, limited strategic thinking (e.g., gullibility), motivated cognition (optimism, wishful thinking), and status quo bias (defaults matter). He described a unifying framework based on Kahneman’s Nobel Lecture (Kahneman 2003) which differentiated between two modes of decisionmaking:

- System 1 – intuition – fast, parallel, automatic, effortless, associative, slow-learning;

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<sup>3</sup> For example, Levitt and List (2006), and List (2005).

- System 2 – reasoning – slow, serial, controlled, effortful, rule-governed, flexible.

System 1 is an intuitive approach where individuals make fast decisions based on limited information and a variety of short-cut decision rules (heuristics). System 1 leads to learning, but that learning occurs slowly as observations of outcomes accumulate. This contrasts with the more deliberative System 2 thinking which more closely resembles the rational man assumption of conventional economics. The two systems are typically always in play and at times in conflict with each other. In terms of FTC policy, Camerer associates System 1 with the “ignorant, unthinking, and incredulous” focus of early FTC policy and asks whether individuals whose judgments are dominated by such reasoning are ignored because of the current emphasis on the “reasonable consumer,” which he associates with System 2 thinking.

Camerer also pointed to a number of empirical issues where additional research can yield significant insights for public policy. One that has so far received insufficient attention in the behavioral economics literature (albeit with some significant exceptions) relates to differences among consumers in their decisionmaking ability. Taking account of such heterogeneity in demand is necessary in order to evaluate the arguments of Alan Schwartz and others that markets often work in such a way that the appearance of sophisticated consumers protect their more naive counterparts.<sup>4</sup>

Other important research topics include investigations into the extent to which consumers collect information most relevant to their particular purchasing situations (“endogeneity of thinking”); the influence of government actions on consumer behavior (“moral hazard,” a topic discussed by Klick below); and the ability of consumers to learn from their past mistakes and the length of time it takes them to do so.

Finally, Camerer discussed joint work with Eric Johnson regarding “eyetracking” method that measure a person’s pupil dilation and its correlation with arousal and cognitive difficulty. As described in Wang, Spezio, and Camerer (2006):

Eyetracking software records where players are looking on a computer screen every 4 minutes. The eyetracking apparatus also measures how much subjects’ pupils “dilate” (expand in width and area due to arousal). Pupils dilate under stress, cognitive difficulty, arousal and pain. Pupillary responses have also been measured in the lie-detection literature for several decades (that’s why poker players often wear sunglasses if they are allowed to). These studies suggest that pupil dilation might be used to infer deceptive behavior because senders find deception stressful or cognitively difficult.

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<sup>4</sup> A much cited article describing this effect is Schwartz and Wilde (1979). Schwartz (2006) provides an updated analysis taking into account some behavioral economics results. See also the Shapiro passage (1995, p. 495] cited in Gabaix and Laibson (2006), which describes a scenario where competitive equipment manufacturers “have a direct incentive to eliminate even the small inefficiency caused by poor consumer information.” (As discussed in the text, Gabaix and Laibson develop models that dispute this prediction).

Camerer suggested that this technology may have a number of consumer policy applications, e.g., in determining whether people literally read the fine print on informed consent documents.

Camerer's talk was followed by comments by Klick, Pautler, and Calfee.

Jonathan Klick (Florida State) set out a number of caveats regarding the application of behavioral economics results to public policy issues. He noted at the outset that his critical remarks were not directed at the writings of economists such as Camerer, but rather at analysts writing in the behavioral law and economics literature, many of whom he believes are too quick to apply the results of behavioral economics research to complex public policy issues.

Klick's principle concern is that paternalistic actions by the government reduces the incentive for consumers to invest in decisionmaking processes designed to protect themselves in the marketplace. Consumers need to learn from their successes and failures. In a similar vein he noted the possibility of the moral hazard that can accumulate when there are bail-out provisions ("ex post paternalism") that allow consumers to get out of contractual commitments deemed unconscionable. Klick agreed with Camerer about the need for economists involved in public policy to gain a better understanding of learning theory and to apply this understanding to empirical studies of how consumers react to the consequences of their past decisions.

Drawing on his work with Gregory Mitchell (Klick and Mitchell 2006), Klick described a model of government decisionmaking for determining the effect of alternative government policies designed to protect consumers. These models direct decisionmakers to consider (1) the efficiency cost of the bias; (2) the extent to which accommodation worsens the bias or, alternatively, the extent to which nonaccommodation improves the bias or has other benefits; and (3) the potential for education or other mechanisms to debias an individual.

Paul Pautler (FTC) described a number of FTC regulations and how the decisionmaking process that underlies them relates to the asymmetric paternalism paradigm described in Camerer *et al.* (2003). In a manner quite similar to decisionmaking at the FTC, asymmetric paternalism can be viewed as a cost-benefit test where government intervention is justified when the benefits to the cognitively impaired will be greater than the cost to those who are cognitively aware. Although the FTC does not use the terminology contained in the Camerer *et al.* calculus, both approaches share an emphasis on counting up the costs and benefits in order to assess the likely impact of an action on consumer welfare.

Pautler went on to describe important cost-benefit considerations for a number of FTC privacy programs and their relevance to the asymmetric paternalism decisionmaking model. He noted the importance attached to the selection of the appropriate default, a key element in the behavioral economics literature. Empirical evaluation of this choice can vary significantly depending on the type of empirical approach. For example, the answers to survey questions that fail to focus on the relevant alternative outcome tend to emphasize the importance of privacy,

while an examination of actual market choices often leads to a much reduced assessment of the value of privacy to consumers.

Many defaults affect the entire market and may affect future availability of choices. If we try to choose defaults to save a subset of consumers from falling victim to a decisionmaking foible, we need to seriously consider whether that default might adversely affect other consumers or lead to a reduction in the number of options available in the future.

Jack Calfee (American Enterprise Institute) drew a distinction between regulations that rely mainly upon rules as opposed to those that are enforced on a case-by-case (rule-of-reason) basis. Although the FTC has a number of well know rules, most of the FTC mission is based on a case-by-case enforcement of unfairness and especially deception case law. Calfee views the latter approach as generally superior to broad rule enforcement and raises the concern that behavioral economics may lead to more per se rules that end up being less efficient.

In regard to research needs, Calfee believes research should focus on the actual effects of regulations. One important area to study here is the impact of information benchmarks, such as the EPA mileage rules or the FTC's tar and nicotine ratings for cigarettes. Both interventions, in Calfee's view, led to less useful information for consumers, because the rules discouraged firms from competing on product dimensions outside of the narrowly defined metrics used in the regulations. Moreover, once the alternative information has been more or less prohibited from the market, the government sanctioned metric tends to get "gamed" by the market as firms modify their product to the test and away from more meaningful performance measures.

## **II. MARKETING**

The conventional economics of consumer protection is grounded by a model of information flows in which advertising and other marketing activities play a prominent part. It is based on modification of the standard neoclassical theory, viewing information as a scarce (and thus not free) resource to be analyzed in ways similar to other commodities in the market place. The information economics approach did not supplant the neoclassical model but rather extended it to include an explicit analysis of how information influences the behavior of both buyers and sellers. Consumers make consistent decisions that enhance their welfare, but do so under constraints that lead them to acquire less than full information. Instead of being endowed with perfect information, they are boundedly rational entities that acquire information up to the point where the marginal benefit equals the marginal cost. The behavior of firms is similarly influenced by the costs of both acquiring and disseminating information.

The appropriate policy objective from a consumer protection perspective is thus not to make consumers fully informed, an impossible and inefficient solution, but rather to create market conditions in which information is sufficient to allow all welfare-increasing trades to take

place. Competition plays a central role in this context, since it can be the best way to ensure an efficient level of information for consumers. In particular, firms compete by providing consumers with information via advertising and other marketing techniques, as well as by providing consumer with the variety of services and products that best suits their preferences.<sup>5</sup>

The two presentations in the Marketing session explored challenges to the conventional economics view by emphasizing the cognitive limitations of consumers and how they can alter the conventional economics model. Dean Karlan presented the results of a field experiment in the market for credit in South Africa where consumers fall prey to certain “psychological manipulations” that influence the amount they pay for loans. In more of a supply-side analysis, David Laibson presented alternative economic models where firms react to consumer cognitive limitations in ways that do not lead to the welfare maximizing solution predicted by the traditional model.

### **Karlan:**

Dean Karlan (Yale) presented the results of an extensive field experiment involving the marketing of offers for credit to a large sample of consumers in South Africa (Bertrand *et al.* 2005). The credit provider funding the experiment sought to determine how certain variations in photos, the number of borrowing options offered, cell-phone lottery tie-ins, and other features of the interest rate offer altered uptake of the loan offers.

Variations in the offers were accomplished by modifying 50,000 mailers sent out to a random set of consumers. The interest rates offered varied from 3.25% to 11.75% per month. Each letter also contained several marketing manipulations. These were randomized independently of the interest rate randomization, which allowed the authors to quantify the size of the interest rate change needed to achieve the same effect on uptake as the psychological manipulation under study. The experimenters modified four categories of features in the letters: the description of the offer, the comparison of the offer to competitor rates, subtle features (like photos), and suggestion factors. Manipulating these four categories produces a number of predictions that diverge from neoclassical theory. Generally, the key difference from the neoclassical model is the importance of certain marketing approaches that influence uptake over and above the information provided by the interest rate alone.

Consistent with standard economics, Karlan’s analysis showed that the interest rate significantly affected loan uptake – the lower the interest rate offered in the flyer, the greater the rate of uptake. But some of the psychological features also significantly affected uptake, a

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<sup>5</sup> Schwartz and Wilde (1979) provide a general description of the information economics approach as it applies to consumer protection issues. Ippolito (1986) gives a succinct review of the relevant theoretical developments. Rubin (2004) applies the theory to advertising regulation.

finding that Karlan interpreted as being inconsistent with the predictions of neoclassical theory. The average effect of a psychological manipulation was large, equivalent to a one-half percentage point change in the monthly interest rate. Karlan concludes that his results demonstrate how a firm may exploit consumer biases and increase demand without lowering prices. The results also showed that some manipulations worked and some did not, emphasizing that psychological effects can be very context sensitive.

Paul Rubin (Emory) took issue with Karlan's conclusion that the credit experiment demonstrated the importance of psychological elements that are ignored by conventional economics. Rather than indicating consumers succumbing to psychological manipulations, Rubin argued that the effects the researchers did measure may be due to certain formats' success in attracting consumer attention. All of the interest rate offers were below the prevailing market rate, so the successful offers were those that best fought through the clutter of competing claims for a consumer's attention. While a finding that certain marketing presentations are better at catching a consumer's attention than others describes a psychological effect, Rubin maintains it is consistent with the neoclassical conceptualization of a rational consumer seeking to allocate scarce time through the use of efficient filtering rules. The "manipulation" is in terms of packaging the offer in a way that gets the consumer to read the advertisement, but not necessarily to purchase something that he otherwise would not.

However the Karlan results are interpreted, consumers' limited attention span and cognitive resources are clearly relevant to the implementation of consumer protection policies based on informational remedies. One manifestation of this comes in the evaluation of mandated disclosures where the required information can have the effect of directing a reader's attention away from other messages in the ad.<sup>6</sup> Karlan's research is quite relevant to this issue by showing how some formats appear to direct a consumer's attention to the interest rate information, while others (e.g., lottery and cell phone offers) have the opposite effect.

### **Laibson:**

David Laibson (Harvard) discussed his joint work on economic models where a portion of the costs of a product or service is paid in the period following purchase (e.g., the purchase of a printer and follow-on "shrouded" purchases of ink).<sup>7</sup> The demand for these products is made up of consumers who are aware of the costs of the follow-on product (sophisticates) and those who are not (naives). Under a variety of assumptions, Laibson generates a zero-profit

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<sup>6</sup> The disclosure session at the conference amplified this point, especially the Lacko/Pappalardo presentation. See generally, Craswell (2006) and the references cited in footnotes 48 and 51.

<sup>7</sup> Gabaix, *et al.* (2006)

equilibrium in which the price of the base good in the first period is sold at either cost or less than cost, while the follow-on good is priced monopolistically. The sophisticates do well because they are aware of the high priced follow-on good in period one and take precautions by substituting away from it in period two (e.g., by purchasing a generic printer cartridge or by arranging to have large print jobs done at work). But the naives are surprised by the high price in the second period and end up subsidizing the sophisticates and thus suffering injury in the process.

In Laibson's model, shrouding can make education of the naive consumers unprofitable for new entrants and thus the zero-profit, free-entry market equilibrium can result in too many firms, and too high a price for the shrouded attribute. His model shows that informational shrouding can flourish in highly competitive markets, in markets with costless advertising, and when the shrouding generates allocative inefficiencies.

Laibson believes that the problems of cognition and shrouding illustrated in his models are real and that they represent a challenge to the neoclassical model's claims for the ability of competition to protect naive consumers. Yet he is cautious about the ability of public policy to help naive consumers in a way that does not impose net costs on the economy. Beyond public education efforts to make consumers more aware of add-on costs, Laibson is reluctant to advocate more aggressive government interventions due to insufficient information about their effects: "I think the big open question, and I concur with many of the people who have spoken today, is it's one thing to describe and model these problems. It's quite another to know how to fix them, and I certainly don't."<sup>8</sup>

Alan Schwartz (Yale), commenting on Laibson's paper, said that the Laibson models contained important insights and that they point the way toward a number of useful empirical investigations designed to assess the public policy relevance of the shrouded attributes concept. The first factor concerns the proportion of demand accounted for by sophisticated consumers. Although the relationship is probably nonlinear, the greater the share of sophisticates, the more likely it is that firms will compete on the basis of the full multi-period price and will find attempts to shroud the second period attributes unprofitable. Also relevant is the degree to which the sophisticates are able to substitute away from the add-on products. Laibson's models presume some degree of substitutability; otherwise, firms may find it worthwhile to compete for the sophisticates' business by educating them on the extent of downstream costs, which in turn could lead to more competitive second-period pricing.

Echoing the point made by others at the conference, Schwartz emphasized the importance of understanding the extent to which consumers learn from their past mistakes. The Laibson model presumes that this rate of learning is low for the naive, or that demand is sufficiently

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<sup>8</sup> <http://www.ftc.gov/be/consumerbehavior/docs/transcript/transcriptb.pdf> at p. 37.

dynamic that other initially naive consumers are constantly entering the market. These assumptions are important and may be empirically testable. Schwartz also asked whether consumer learning may be speeded up if it takes place “across context rather than within a context,” i.e., does the naive consumer who gets stung in the purchase of product X turn into a sophisticate when it comes to the subsequent purchase of product Y?

The idea of “learning” in the context of Laibson’s models hinges, of course, on whether or not consumers realize down the road that they had made a bad purchase because of the unexpected high add-on costs associated with their initial purchase. The field experiment research reported by Miraverte, Driscoll, and Beales shed some light on this issue by examining the extent to which consumers react to information created by their own usage patterns.

### **III. FTC DECISIONMAKING**

Pauline Ippolito (FTC) gave a brief tutorial on consumer protection law at the FTC. Her intention was to provide the conference with a sense about how the agency thinks about the issues presented in the behavioral economics research, as well as the kinds of constraints it works under. Section 5 of the Federal Trade Commission Act provides the agency's general consumer protection authority with the statement "...unfair or deceptive acts or practices in or affecting commerce are declared unlawful." Over time, cases and policy statements have narrowed and defined the concepts of deception and unfairness.

Deception policy is the more straightforward of the two, but even here, the issues are not trivial. The easy cases involve false claims and fraud, which the Act clearly prohibits. The Act also prohibits deceptive claims more broadly, but this policy has evolved substantially over time. Early in the enforcement history of the Act, the agency adopted a very broad interpretation of its authority and brought enforcement actions against many claims, including, for instance, those judged to have the capacity to mislead the "ignorant, unthinking, and credulous." But such a broad interpretation raised serious concerns that most marketing claims might be actionable, given the abbreviated form needed for marketing media, and this could discourage otherwise truthful claims that play an important role in informing consumers and spurring competition. Over time, the development of cases at the agency reflected these concerns, and by 1983, the Deception Policy Statement more precisely defined deception as a "... representation, omission, or practice that is likely to mislead the consumer acting reasonably in the circumstances, to the consumer's detriment."

The agency today assesses deception under this policy by considering the claims consumers receive from an ad, judged in the context of the ad and background information. In that sense, the policy incorporates behavioral problems consumers might have in a particular circumstance. For instance, the agency might find an ad deceptive if the ad frames the claim in a

way that misleads substantial numbers of consumers on a material issue. Similarly, if copy tests show that a significant percentage of consumers misunderstand claims about particular types of risk or intertemporal issues, the agency might require more from the firms making claims on those issues to avoid the deception. These issues are judged from the perspective of targeted consumers, and once a claim is found to be deceptive, injury to consumers is usually assumed to exist.

Consumer testing, typically with controlled copy tests, is a relatively standard part of assessing the claims consumers take away from an ad when the claim is not reasonably obvious in the ad. It is a behavioral test in the sense that if consumers take a claim from an ad, that would be the basis for a case. The test is not whether a claim is a reasonable interpretation of the ad, but rather whether consumers take a misleading interpretation from the ad. The claim is never tested in isolation. It is always tested in the context of the ad, and in that sense the potential importance of framing is accepted.

Unfairness policy at the FTC has also evolved substantially over time in a manner that reflects economic concerns. In its 1964 proposal to regulate cigarettes, the commission set forth criteria to judge "unfairness." These included: (1) whether the practice "offends public policy" as set forth in "statutes, the common law, or otherwise"; (2) "whether it is immoral, unethical, oppressive, or unscrupulous"; or (3) "whether it causes substantial injury to consumers." In the 1970s, the agency initiated a series of rulemakings under these far-reaching criteria, culminating in a proposal to limit television advertising to children, including a possible ban of all advertising to children. This agenda generated considerable hostility from business. Entire industries attempted to get exemptions from the agency's authority. More importantly, Congress became sufficiently agitated that it did not reauthorize the agency for 14 years.

This period of tumult led the agency to reconsider the proper focus of its unfairness authority, ultimately resulting in a move away from "public policy" as a defining criterion and towards consumer injury and consumer choice as the appropriate focus. In December 1980, a unanimous commission formally adopted the Unfairness Policy Statement declaring that injury "must be substantial; it must not be outweighed by countervailing benefits to consumers or competition that the practice produces; and it must be injury that consumers themselves could not reasonably have avoided." The agency noted that it would only consider public policy as subsidiary evidence of likely consumer injury. In 1994, Congress codified the 3-part unfairness test and the limited role of public policy when it finally reauthorized the agency.

#### **IV. DISCLOSURE SESSION**

### **Lacko/Pappalardo:**

Jim Lacko and Jan Pappalardo (FTC) reported on their research into mandated disclosures for mortgages. They conducted 36 in-depth interviews with recent mortgage customers, and quantitative consumer testing with over 800 mortgage customers (Lacko and Pappalardo 2007). Their aim was to examine how consumers search for mortgages, how well consumers understand current mortgage cost disclosures and the terms of their own recently obtained loans, and whether better disclosures could improve consumer understanding of mortgage costs, consumer shopping for mortgage loans, and consumers' ability to avoid deceptive lending practices. Despite a long history of mortgage cost disclosure requirements and many legislative and regulatory proposals, little empirical evidence exists to document the effect of the current disclosures on consumer understanding of mortgage costs, consumer mortgage shopping, or consumer mortgage choice.

The potential for improving consumer understanding of mortgage costs through better disclosures was tested using prototype disclosures developed for the study. The prototype disclosures were developed for fixed-rate loans, including those with interest-only and balloon payments, but could be extended to incorporate the key features of adjustable-rate, hybrid, and payment option loans. The study's key findings:

- Current mortgage cost disclosures failed to convey key mortgage costs to many consumers.
- Prototype disclosures developed for the study significantly improved consumer recognition of mortgage costs, demonstrating that better disclosures are feasible.
- Both prime and subprime borrowers failed to understand key loan terms when viewing the current disclosures, and both benefitted from improved disclosures.
- Improved disclosures provided the greatest benefit for more complex loans, where both prime and subprime borrowers had the most difficulty understanding loan terms.

Lacko and Pappalardo drew two inferences from their work that may apply to the behavioral economics literature. First, consumer decisions that appear irrational may in fact be a rational response to a poorly designed disclosure. A second and related point is that designing information policies intended to fine-tune and counteract behavioral biases is a difficult undertaking that needs to be fully researched before being implemented. Otherwise the regulatory cure may be worse than the problem it was intended to fix.

In his comment on Lacko/Pappalardo, Eric Johnson agreed that the design of mandated disclosures can be a very tricky endeavor that requires a good deal of prior research, as well as retrospective studies of their effect. But he would go further and, citing his experience as a

marketing researcher, suggested that the FTC and other government agencies consider doing “partial rollouts” to assess the impact of the disclosures.

Johnson also emphasized the importance of understanding that consumers have a “cost of thinking” which at times may mean that the appropriate government policy is to minimize these costs by either legislating the choice for the consumer or by setting up defaults that allow consumers to avoid making hard choices.

### **Sydnor:**

Justin Sydnor (Case Western) began with a brief overview of his research regarding how consumers make the choice of deductible level for their property insurance (Sydnor 2006). Using a sample of 50,000 home insurance policies from a standard home insurance company, Sydnor sought to explain why a significant proportion of customers elected to pay an additional premium of \$95 for a \$500 deductible policy (compared to a \$1,000 deductible policy) when the expected value of the extra \$500 in coverage amounted to less than \$20 (based on a 4 percent claim rate).

Such a decision is a very poor bet from an expected value standpoint and suggests an implausibly large risk premium when analyzed using a standard expected utility of wealth model. But Sydnor found that the deductible decision could be explained using a variant of prospect theory using laboratory results to parameterize the degree of loss aversion and probability weighting to generate predictions from the model.

Although the prospect theory model used by Sydnor comes out of the behavioral economics literature, he points to a number of factors suggesting that at least in the case of new customers his findings may describe rational behavior in which consumers are making informed choices. First, the choices are consistent with a version of prospect theory using parameter estimates from controlled laboratory experiments. Second, patterns of price responsiveness in the data suggest that (at least some) customers are responding to the available menu. Third, there appears to be no meaningful difference in deductible choice for customers choosing online, where the menu can be explored very simply.

On the other hand, Sydnor’s analysis of the insurance renewal decision indicates that the increased prevalence of low deductibles for those insured with the company for long periods may reflect consumer inertia, rather than active choices/real preferences. The fact that customers are not presented with the full available menu when renewing their contracts may lead them to stick with low deductibles for too long. This in turn suggests a possible disclosure remedy where consumers are presented these menus on renewal. The other reason that consumer inertia may come into play is the more standard behavioral economics one: that people procrastinate. This latter factor also suggests the need for disclosure, but is more difficult to implement successfully since the task involves attempting to change a consumer’s reasoning process, not

just his information set.

Eric Durbin (FTC), commenting on Sydnor's work agreed that consumers' choice of low deductible policies is not necessarily a mistake but rather may be consistent with their true preferences. This led Durbin to question his own advice to friends that extended warranty contracts (a form of insurance not unlike the property insurance types studied by Sydnor) are a bad deal to be avoided. Inviting reactions from the audience and the panel, Durbin asked whether the popularity of extended warranties reveals consumers true preference or whether it is a result of framing.

Comments from the audience suggested that framing was indeed important, with a number of individuals giving personal examples where one's preference for an extended warranty was dictated by how the information about the warranty was presented. Alan Schwartz stated that people respond much more to scenario information than to probability information. For example, talking to insurance customers about a deductible may trigger in their mind a scenario about an accident and thus a greater inclination to purchase more complete insurance.

Although all agreed that how the information is presented to consumers influences their choices of insurance packages (and other products and services involving probabilistic reasoning), no consensus formed regarding whether a particular frame could be adopted that would reveal one's "true" preference. As a result, behavioral research investigations such as Sydnor's raises challenging policy questions that require further work to answer.

## **V. PHONE CARDS**

### **Miravete:**

The next two sessions reported on research into how consumers make decisions, and in particular how they respond to new information generated by their own usage patterns. Eugenio Miravete (Texas) led off with a discussion of consumer choice among phone plans. The data came from an experiment conducted in the mid-1980s for new calling plans and differing flat rate or measured tariffs in Kentucky (Miravete and Palacios-Huerta 2004). Miravete used a panel dataset that allowed him to observe how households reacted to the choice to remain on a flat rate scheme, previously the only one available, or to switch to a new measured tariff scheme. To minimize their phone charges, households had to determine each month whether their expected demand the following month would be above or below a certain threshold. He found that households learn rapidly to undertake optimal decisions, make no systematic mistakes, and react to potential savings of very small magnitude, typically about \$5.00 per month. He found no support for models where consumers responses are determined by inertia, inattention, or impulsiveness.

Miravete also described research analyzing the impact of the introduction of a second rival in cellular markets during the 1984-92 period on the types of rate plans offered by the

sellers (Miravete 2007). He finds that competition tends to result in a more useful set of options for consumers rather than “fogging” or confusing them. In particular, competition “induces firms to offer simpler tariffs and reduces the proportion of tariff options that are totally dominated by another plan or combination of tariff plans offered by the same firm (characterized as “deceptive”).

Discussant Tim Brennan (University of Maryland) described his recent research in electricity markets where the evidence on consumer choice is less encouraging (Brennan 2007). He reports that residential consumers remain reluctant to choose new electricity suppliers. Even the most successful jurisdictions, four U.S. states and other countries, have had to adopt extensive consumer education procedures that serve largely to confirm that choosing electricity suppliers is daunting. Electricity is not unique in this respect; numerous studies find that consumers are generally reluctant to switch brands, even when they are well-informed about product characteristics. If consumers prefer not to choose, opening regulated markets can reduce welfare, even for some consumers who do switch, as the incumbent can exploit this preference by raising price above the formerly regulated level.

Brennan’s comments generated a spirited discussion about the potential for information overload and the extent to which a lack of switching activity in some deregulated markets may suggest a revealed preference by consumers not to choose. We return to this issue in the concluding section.

## **I. CREDIT CARDS**

### **Driscoll:**

Both papers presented in this session analyze credit card decisions for a large panel of consumers over time. John Driscoll (Federal Reserve Board) began with a report on his joint analysis of a three-year panel dataset representing four million monthly credit card statements. His research focused on the fees charged customers and their reaction to them over time (Gabaix *et al.* 2006).

Driscoll finds that learning occurs (so if customers pay a fee one month, they tend to avoid paying fees in subsequent periods), but forgetting or backsliding also emerges over time. He estimates that monthly fee payments fall by 75% during the first four years of account life (controlling for account fixed effects). However, this knowledge depreciates approximately 15% per month. Fee payments generate maximal learning when the fee payment was made last month. As negative feedback recedes into the distant past, consumer behavior tends to backslide. Like rational agents, consumers learn, but like myopic agents, consumers respond to recent events more than events that occurred just a few months ago.

Joel Schrag (FTC) discussed the relevance of Driscoll’s findings for FTC disclosure policy. He noted that there are two explanations for the backsliding effect, each with different

disclosure implications. The first is that consumers learn the information about fees through the disclosures in the monthly statement and then forget the information later in the relationship – or they fail to take notice of the disclosure information in the beginning. In either case, mandating more prominent fee disclosures may help.

But such an informational remedy may be insufficient if the backsliding effect is due to procrastination or some other issue that is interfering with consumers' ability to make wise financial decisions. In this instance there may be a need for some type of decision aid to help consumers overcome whatever cognitive problem is holding them back from reacting to the fee information. One possibility is the setting up of automatic reminders that makes the consumer aware of the fees that are being generated.

### **Beales:**

Howard Beales (George Washington University) analyzed a unique set of panel data in order to test behavioralist predictions in the market for new credit cards (Beales and Plache 2007) The data comes from a long-running survey of 1,600 consumers commissioned by VISA USA. In addition to basic demographic information, the questionnaire generated information about the terms of each payment card the household owns, including the annual percentage rate (“APR”), the annual fee, any rewards feature, and whether the card is a gold or platinum card. Consumers reported the balance on each card after their last payment, using a series of balance categories. Finally, consumers completed a diary detailing each transaction and the payment method used for that transaction. The analysis presented by Beales utilized data from 1994, when the panels began, through 2003.

As described by Beales, rational choice and the behavioralist approach predict different consumer behavior with respect to cards with and without a rewards feature (such as cash back or airline miles). Moreover, they predict different balances over time. Beales sought to test these hypotheses to determine whether the conventional rational choice model or the behavioralist alternative can best explain the observed patterns of revolving behavior. He finds that carrying balances on the card (“revolving behavior”), when the consumer previously had not, is consistent with the predictions of the rational choice model, and, on two key variables,

contradicts the predictions of the behavioralist approach.

Beales emphasized the following predictions of the behavioral model and how they fared in his analysis:

a) Hyperbolic discounting, the overemphasis on short-term benefits and neglect of long-term costs, implies that consumers with new rewards cards should be particularly likely to revolve. In fact, consumers with new rewards cards are significantly less likely to revolve than consumers who acquire other kinds of cards.

b) Cumulative cost neglect implies that, as consumers neglect or discount the future consequences of their actions, they should become increasingly likely to revolve on a new credit card over time. The opposite effect is observed: the longer consumers have had a new card, the less likely they are to revolve on the card, whether or not it is a rewards card.

c) Together, cumulative cost neglect and hyperbolic discounting imply that consumers should be particularly likely to increase revolving behavior over time on rewards cards. No statistically significant effects are observed. The time trend of revolving behavior is not significantly different for rewards cards and other cards, although the direction is consistent with the behavioral prediction

The Beales presentation generated a good deal of discussion. In his prepared remarks, Ron Borzekowski (Federal Reserve Board) brought up a number of sample selection issues that may confound interpretation of the Beales results. Those in possession of reward cards, as well as revolving credit, are not exogenously determined but rather reflect certain dynamics about credit use that in turn might influence the observed results. Borzekowski cited recent research by Ching and Hayashi (2006) that individuals with rewards cards exhibit a number of distinct characteristics. The Beales analysis controls for some of these factors but, for example, does not control for education, which appears to be a significant predictor of rewards card use.

Justin Sydnor and Rob Letzler questioned whether Beales had successfully created an empirical test that distinguishes between the behavioral and rational actor models. They suggested a number of alternative scenarios where the results observed by Beales would be consistent with predictions from a behavioral economics model. Beales agreed that alternative models based on behavioral principles could be developed, but he believed that the one he employed was more consistent with the literature. He also noted that the multitude of possible behavioral theories, each with different predicted effects, makes it difficult to use any one of them as the basis of public policy interventions.

## VII. ROUNDTABLE SUMMARY

The conference ended with a roundtable discussion of the public policy issues and consumer policy by Joel Winston (FTC), Matthew Rabin (Berkeley), Pauline Ippolito (FTC), Colin Camerer (Cal Tech), and moderator William Kovacic (FTC).

Joel Winston provided comments from his perspective as a long time consumer protection attorney at the FTC, including his current position as Associate Director of the Division of Privacy and Identity Protection. In regard to deception policy, Winston pointed out that the law is quite broad in its application so that agency officials use a common sense approach in deciding which cases to bring. Thus the agency does not bring every case where a deception charge could be made, but rather decides whether the interpretations of a claim are “reasonable” in light of overall injury and the net effects of taking action.

Winston then went on to discuss his current work in the FTC’s privacy program, where the agency spends considerable resources in attempting to determine consumers’ preferences about privacy and how best to communicate relevant information to them. The agency’s experience in this area points out the difficulties of applying the traditional “notice and choice” approach toward deception. This approach remains sound, but can be difficult to implement in an area such as privacy where consumers appear conflicted about the degree to which they value privacy. While the FTC has had success in designing useful disclosure notices that appear to communicate useful messages to consumers in test settings, there remains the real world problem of getting them to read the notices. Winston also pointed out that researchers need to understand the legal context in which the FTC operates, such as statutes requiring certain disclosures be made in certain ways.

Matthew Rabin made a call for the generation of more data to be used in the testing of theories arising out of the behavioral economics literature. He argued that agencies such as the FTC need to take the lead in obtaining such data because the information released by companies to researchers may be biased toward areas where consumer problems are less likely to be found.

Rabin also argued that the welfare conclusions that come out of neoclassical theory are based on the assumption of unbounded rationality, and thus do not necessarily apply in modifications of that theory where consumers operate under a number of cognitive constraints. The idea that markets will be efficient if people find it difficult to think things through is untested theoretically, and untested empirically. The only people who are attempting to answer the question of whether the normative implications of the traditional models are relevant in the case of bounded rationality are the behavioral economists.

Colin Camerer emphasized the importance for consumer policy of doing a better job of identifying different kinds of cognitively challenged or inexperienced consumers. One potentially important identifying factor here is age. Citing the research conducted by David

Laibson and others, he described a U-shaped relationship between decisionmaking ability and age, with the most problems being experienced by the young and the old.

In terms of research possibilities, Camerer did not see any immediate empirical project that “plugs right into policy and interpretation of policy,” but went on to suggest a number of more general research directions that can provide important insights into consumer policy issues. One of these would be to conduct longitudinal lab experiments to assess the importance of learning and to test for the kind of “disclosure fatigue” discussed at the conference.

Pauline Ippolito talked about attempts by firms to promote their products by overcoming the various consumer behavioral biases described at the conference. Firms need to be able to motivate consumers in ways that, from a conventional economics view, may seem deceptive but are not once behavioral considerations are recognized. It is worth noting, for example, that many diet-disease issues involve sacrifices in taste today for health benefits far in the future. Behavioral economists hypothesize that consumers sometimes underweight these future payoffs. Advertisers used a variety of approaches to make the future benefits more salient as they attempted to sell healthier choices (e.g., visual images of wanting to walk a young daughter down the aisle, enjoying grandchildren in retirement, etc.), potentially helping to address these issues.

William Kovacic ended the discussion by exploring the links between the consumer issues discussed at the conference and competition policy. He noted that the Laibson model of “shrouded attributes” can be used to inform the debate over vertical bundling issues, e.g., the need to ensure open competition among follow-on products such as printer cartridges. We should question whether the incumbent should be allowed to keep out a generic ink seller who could profitably provide the information on the shrouded attribute.

Kovacic also talked about using competition policy to encourage the use of intermediaries in providing information to consumers. Education by independent firms who serve as these intermediaries of information occurs in many markets and we need to encourage more of it. There may be instances where the possessors of the information try to resist efforts by intermediaries to gather and broadcast it to consumers. Thus a competition policy implication is that the holders of the information should not be able to decide collectively that they will not deal with those who are trying to be the personal trainers and guides for people.

## **VIII. CONCLUDING NOTES**

The conference did not point to immediate changes in consumer or competition policy. This is perhaps not surprising considering that behavioral economists have only recently addressed the implications of their work for consumer protection policy. While a number of research results presented at the conference suggested possible policy initiatives, there was

general agreement that more evidence based on market settings is required to justify such actions. In this latter regard, there was a call for greater use of field experiments, which allow for controlled testing of behavioral hypotheses in market situations. Participants also noted the importance of not only using research to identify instances of consumer injury, also to evaluate the effectiveness of potential remedies for them.

By bringing together researchers and regulators of varying backgrounds and perspectives, we hope that the conference led to a better understanding of the empirical, theoretical, and legal issues relevant to consumer protection policy at the FTC and similar agencies. Building on that discussion, this section outlines a number of policy areas where the ideas produced at the conference can be fruitfully applied in the future.

### **Choice Overload:**

The debate over whether consumers are getting “overloaded” with too much information predates the recent behavioral economics literature, going back at least to the 1970s. In his 1983 review paper, Rudd addressed the question: “Does the provision of more information improve consumer decision making or does it instead produce information ‘overload,’ and thus confusion and poorer decisions?” (p. 465). Rudd’s evaluation of the relevant research led him to conclude that the disclosures have had a net positive effect, but he also recommended that policy makers shift their emphasis from the *quantity* of the information supplied to its *quality* – defined as including presentation format, the ease with which it can be processed by consumers, and the likelihood that consumers can be motivated to use it (p. 470).

Discussion at the conference indicated that the issues raised by Rudd are far from resolved. Two strands of thought at the conference regarding the manageability of choices facing consumers were apparent. The first described an increasingly diverse and confusing set of choices facing consumers, especially in the credit area and in some recently deregulated sectors such as telecom and electricity. Tim Brennan cited his research in electricity markets suggesting that the low rate of switching there may indicate a revealed preference among consumers not to choose. In contrast Eugenio Miravete and Alan Schwartz pointed out instances where increases in competition leads to a more coherent set of choices for consumers that better matches their preferences.

These contrasting views do not necessarily conflict, since they are often based on different sectors and markets, as well as different research methods. But nevertheless there are striking differences in their policy inferences that deserve further study. For example, contrast the Miravete finding that the introduction of competition into cellular markets lifted the “fog” on prices by inducing firms to offer simpler and less deceptive tariffs to the Wilson and Waddams (2005) finding for UK electricity markets that “consumers make more efficient decisions in markets with fewer competitors.” The UK may be an especially fruitful area of research due to

the recent regulatory changes there and to a large database of information on switching behavior generated by extensive Ofcom surveys.<sup>9</sup>

Aside from information provided by the firms selling products and services, the government and third-party entities also provide information that can help simplify the purchase process for consumers (and create important feedback incentives for firms to alter their offerings). In regard to the former, Tim Brennan's examples of government attempts to "help" consumers in a number of deregulated markets does not inspire much confidence.<sup>10</sup> It would be interesting to find out just what went wrong in these cases. Possible reasons include a) the gains from switching were small in any event so the regulators did not put much energy into explaining them; b) regulatory constraints required excessive detail; and c) insufficient incentives for the regulators to do a good job. Hopefully Brennan's examples are located at the tail of the distribution so it is possible to examine differences in informational performance among government agencies – with behavioral as well as more conventional models of regulation in hand (Rachlinski and Farina, 2002).

Third-party information entities offer another source of help to consumers. The most cited example is Consumer Reports, but its reach remains limited (due in part to the organization's ban on firms spreading favorable test results via their advertising). More help may come from explicitly commercial information providers that have evolved via the internet. One interesting example is the case of online insurance broker sites that give a clear comparison of rates and provide direct access to the various insurance companies. The policy challenge here is to create environments that allow use of the comparison site business model in markets, such as electricity and telecoms, where more useful consumer information is needed.

Another important source of information comes from product reviews generated by consumers themselves. As described by Ghose and Panagiotis (2006):

In offline markets, consumers' purchase decisions are heavily influenced by word-of-mouth. With the rapid growth of the Internet these conversations have migrated to online markets, creating active electronic communities that provide a wealth of product information. Consumers now rely on online product reviews, posted online by other consumers, for their purchase decisions. Reviewers contribute time, energy, and other resources, enabling a social structure that provides benefits both for the users and the companies that host electronic markets. Indeed, the provision of a forum facilitating social exchanges in the form of consumer product reviews is an important part of many electronic markets, such as Amazon.com.

Important research and policy questions here revolve around whether this new kind of

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<sup>9</sup> Ofcom is the regulator for the UK communications industries, including television, radio, telecommunications and wireless communications services.

<sup>10</sup> <http://www.ftc.gov/be/consumerbehavior/docs/slides/Brennan.pdf>

information available to consumers simplifies their choices or makes them even more difficult and leads to yet more biased decisionmaking. Ghose and Panagiotis (2006) provides a number of useful cites to the emerging literature in this area which suggest that the issue is far from settled.

### **Cooling-off Rules:**

Cooling-off regulations, such as the FTC's door-to-door sales rule and similar ones promulgated in the credit area, are often cited as examples of laws that successfully incorporate behavioral economics insights. In particular, there is the observation that consumers at times make purchases in emotionally or biologically "hot" states that, in a cooler and more rational state, they would not make. Mandating a cooling-off period allows consumers to reframe their choices and to give them an opportunity for rational reconsideration to overcome the influence of impulsive choice.

Notwithstanding the apparent widespread acceptance of cooling-off rules, they do not appear to have been subjected to the kind of asymmetric paternalism or unfairness analysis discussed at the conference. For example, the FTC rule appears to have been created without the benefit of any systematic research to document its value (McChesney 1984). While there has been some research into the rule's impact, it has been fairly limited in scope.<sup>11</sup>

From a behavioral standpoint, we know relatively little about how consumers respond to cooling-off rules. The ideal is that they allow consumers to cancel those contracts that, in a more rational state, they realize are not for them. Over time as consumers cancel bad contracts, firms should be deterred from making such deceptive offers in the first place. But the existence of a cooling-off period can have the opposite effect of inducing more welfare-reducing purchase decisions. This would occur if the existence of a cooling-off period leads consumers to make more impulsive purchase decisions because they exaggerate their ability to revisit the contract terms in a cooler state.

The latter behavioral story is similar to that applied to consumer rebates where consumers make a purchase based on the false assumption that they will redeem the rebate in order to get the price discount. Research in this area by Silk (2006) and others suggest that the likelihood of redeeming a rebate may be **inversely** related to the length of the rebate period.<sup>12</sup>

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<sup>11</sup> Examples include Shanklin and King (1977), McChesney (1984) and the FTC's review of its rule, located at <http://www.ftc.gov/opa/1995/10/cooling2.shtm>.

<sup>12</sup> Information presented at a recent FTC conference on rebates indicates that a number of firms are streamlining the redemption process, with some eliminating rebates entirely. This suggests consumer dissatisfaction with rebate promotions and thus learning from past failures to follow through on redemption intentions. See the FTC Rebate Debate Conference at <http://www.ftc.gov/bcp/workshops/rebate Debate/index.shtml>. See also Edwards (2007) for a review of the consumer protection issues raised by rebates.

This result is consistent with theories in the marketing and behavioral economics literature suggesting that as the time allotted to perform a (simple) task increases, so does the likelihood of failing to complete the task. (See Ariely and Weterbroch (2002) and Zauberma and Lynch (2005)).

The current research record is relatively sparse and does not shed much light on these two competing theories. Most of the available evidence concerns cancellation rates, which appear to be low. Also an early study of the FTC rule found that cancellation rates fell after the rule was implemented (Shanklin and King 1977). The fact that relatively few consumers cancel during the cooling-off period is consistent with the behavioral lulling story, but it is also consistent with one in which cooling-off rules result in less deceptive practices and hence less need to cancel (or indeed with the assertion that there was no need for the rule in the first place).

In addition to the general issue of how consumers use cooling-off periods, there is the question of how they react to variations in the length of such periods. As illustrated in the rebate discussion, lengthening the period given to consumers for making a post-purchase action can – after some point – lead them to be less likely to follow through on their intentions. In this sense, increasing the length of the cooling-off period is similar to increasing the time given consumers to redeem their rebates.

Finally, the rise in the use of liberal return policies by retailers can be viewed as a market equivalent to mandated cooling-off periods. Both allow the consumer to opt out of a purchase within a certain period of time. While the products and services that come under each provision differ, the use of liberal return policies lends credence to the idea that cooling off periods can induce greater sales by reducing perceived risk of getting stuck with a bad purchase – whether or not that perception turns out to be correct.

### **Fraud:**

The FTC's fraud program, which accounts for a significant portion of its consumer protection enforcement activity, deals with consumers whose decision patterns often stray far from those predicted by the rational actor model. Past cases have involved claims for products that strain credulity, such as pain-relieving ionized bracelets, weight-reducing shoe insoles or ear clips, "structured water" globes to wash clothes without soap, etc., etc. Fraudulent weight-loss products are particularly popular at present, leading the Commission to provide a guide to the media and industry listing a number of "obviously" false claims.<sup>13</sup>

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<sup>13</sup> FTC Releases Guidance to Media on False Weight-Loss Claims (2003), located at <http://www.ftc.gov/opa/2003/12/weightlossrpt.shtm>. Note, however, that there were disputes at the conference on the per se falsity of some claims.

Reaching these consumers is quite difficult and is an area where behavioral economics research could help. Interestingly, there does not appear to be much of a focus on the types of individuals most susceptible to fraudulent claims in behavioral economics research, which seems to deal with more with “normal” people who go off the tracks in certain predictable ways. An FTC report (Anderson 2004) on fraud activity provides a general profile of those most likely to be victimized by fraud, which can serve as a starting point for identifying the types of subjects that are most relevant to psychological research.

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