Behavioral Economics and Its Implications on Competition Law

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Rationality

Neo-Classical Economic Theory

- Assumes that humans are
  - rational
  - self-interested beings
  - with perfect willpower

Behavioral Economics

- Characterizes human behavior as defined by three traits:
  - bounded rationality,
  - bounded self-interest, and
  - bounded willpower

Rationality

- Rationality under neo-classical economic theory is narrowly defined.
- Market participants
  - are objective
  - seek out the optimal amount of information
  - readily and continually update their prior factual beliefs with relevant and reliable empirical data
  - choose the best action according to stable preferences

Bounded Rationality

- Reasoning Versus Intuition
  - Heuristics (Mental Shortcuts)
- Consumers Are Not Perfectly Objective
  - Biases & Motivated Reasoning
- Changing Preferences & Prospect Theory

Hypothetical 1a

- Suppose you were given the following two options:
  - **Option A**: $500

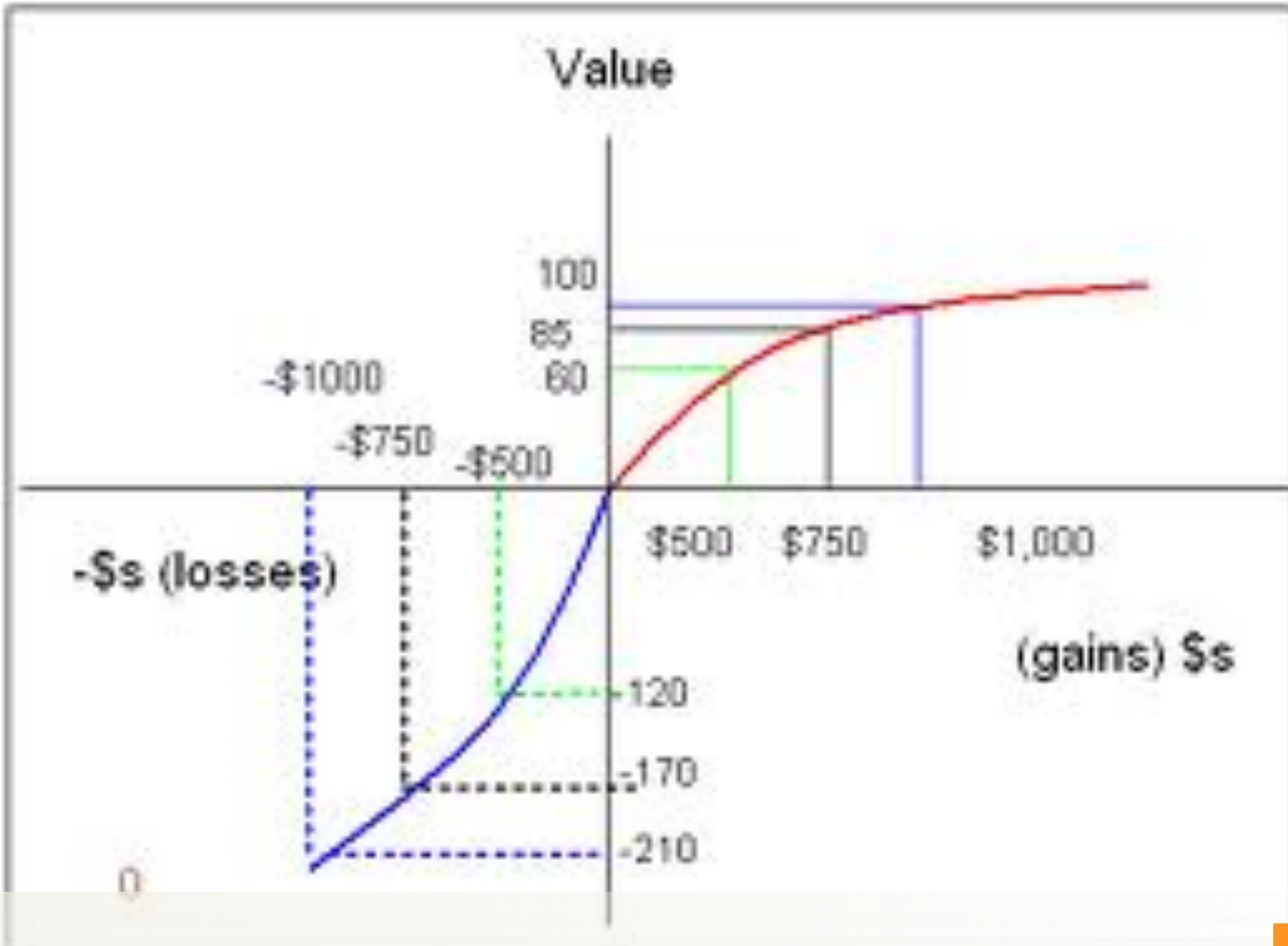
  or

  - **Option B**: A fifty percent (50%) chance of getting $1,100 and a 50% chance of getting nothing (0).
- Which option would you choose?

Hypothetical 1b

- Suppose you get a traffic fine.
- Suppose you were given the following two options:
  - **Option A**: You have to pay a $500 fine.
  - **Option B**: You go immediately to court where you have a fifty percent (50%) chance of not having to pay any fine (0) and a fifty percent (50%) chance of paying a $1,100 fine.
- Which option would you choose?

Prospect Theory



Prospect Theory

- **Graph Characterized by 4 Features:**
  - **Concave in the domain of gains, favoring risk aversion**
  - **Convex in the domain of losses, favoring risk seeking**
  - **Importance of the reference point**
  - **Loss aversion**
    - **the function is sharply kinked at the reference point**
    - **the despair we feel from losses (e.g., losing $100) outweighs the joy we receive for comparable gains (e.g., finding $100) by a factor of about 2 to 2.5**

Willpower

Perfect Willpower

- People take actions that promote their short- and long-term interests
- People eat, drink, exercise, and save the optimal amount

Bounded Willpower

- This term refers to the fact that human beings often take actions that they know to be in conflict with their own long-term interests
- Use "commitment devices"
  - having money automatically deducted from salary into savings account
  - deadlines for papers

Self-Interest

Neo-Classical Self-Interest

- Broadly, to maximize one's utility (interest)
- One common definition of self-interest:
  - People seek to maximize their wealth and other material goals, and generally do not care about other social goals, to the extent they conflict with personal wealth maximization.

Bounded Self-Interest

- People care about treating others, and being treated, fairly.
  - People will incur a cost to punish unfair behavior.
  - Individuals at times act benevolently when it is not in their financial interest.

Hypothetical

- Suppose you and another person volunteer for an experiment, where both of you know the following conditions.
- You are given $100 with one condition.
- You need to share some portion of that $100 with the other person.
- If the other person accepts your offer, then you can keep the balance.
- But if that other person rejects your offer, then both of you get nothing.
- How much should you offer?

Predicted Outcome
Under Neo-Classical Economic Theory

- Offer Smallest Monetary Amount Possible (*e.g.*, one cent)

- Who Behaves this Way?

Actual Results

- Most people offered significantly more than the nominal amount: ordinarily 40 to 50% of the total amount available.
- Recipients about half the time rejected nominal amounts (less than twenty percent of the total amount available).

Implications of Behavioral Economics

Level I – Gap Filler

Level II – Critically Reassess Specific Competition Policy Assumptions

- Merger Review
- Optimal Deterrence Theory and Cartel Prosecutions

Level III – Reconsider Fundamental Assumptions of Competition Policy

- Theory of Competition
- Goals of Competition Law

Level IV – Implications of Behavioral Economics on Convergence

Level I – Gap Filler

- To help explain "real world" evidence that neo-classical economic theory cannot explain.

- At times neo-classical economic theory cannot be easily reconciled with evidence of consumer behavior or the parties' behavior, intent, or post-merger plans.
  - EC's Prosecution of Microsoft for Abusive Tying

Level II--Critically Reassess Specific Competition Policy Assumptions

- Cartel Prosecutions
  - Optimal Deterrence Theory
- Merger Review
  - SSNIP Test
    - Framing Effects – Price Increase v. Price Decrease
    - Drip Pricing
  - Anticompetitive effects are likely to occur only in highly concentrated (not moderately concentrated to unconcentrated) markets
  - Anticompetitive effects are unlikely, absent high entry barriers
  - Many companies merge to generate significant efficiencies

Level III

- Reconsidering Fundamental Assumptions of Competition Theory
  - Reconsidering Theory of Competition
  - Reconsidering Goals of Competition Law
  - Reconsidering the Legal Standards to Promote Those Goals

Rationality Assumption

	Consumers Rational	Consumers *Bounded Rationality*
Firms Rational	**I.**	**II.**
Firms *Bounded Rationality*	**III.**	**IV.**

Level III

- Reconsidering Fundamental Assumptions of Competition Theory
  - Reconsidering Theory of Competition
  - Reconsidering Goals of Competition Law
  - Reconsidering the Legal Standards to Promote Those Goals

Objectives of Competition Law

- In May 2007, the ICN published a survey of 33 members to identify their competition policy's objectives regarding unilateral (monopolistic) anti-competitive behavior.
- What emerged were the following 10 objectives:
  1. Ensuring an effective competitive process
  2. Promoting consumer welfare
  3. Enhancing efficiency
  4. Ensuring economic freedom
  5. Ensuring a level playing field for small and mid-sized enterprises
  6. Promoting fairness and equality
  7. Promoting consumer choice
  8. Achieving market integration
  9. Facilitating privatization and market liberalization
  10. Promoting competitiveness in international markets.

Objectives of Competition Law

- Consumer Welfare > Consumer Surplus
- Consumer Welfare = Consumer Well-Being

Objectives of Competition Law

- Promoting Consumer Well-Being Entails Promoting
  - Material Well-Being
    - Income and wealth, housing, and jobs and earnings
  - Quality of Life
    - Health status, work and life balance, education and skills, social connections, civic engagement and governance, environmental quality, and personal security.

<u>Level IV</u> – Implications of Behavioral Economics on Convergence

- Will behavioral economics foster greater convergence or divergence among competition agencies?
  - Convergence on Theory of Competition
  - Convergence on Antitrust Objectives
  - Convergence on Effects-Based Legal Standards

The Behavioral Antitrust Gambit

- Increasing the transparency of antitrust's legal standards (and bringing them closer to the rule-of-law ideals):
  - *Accuracy* — the standard should minimize false positives and negatives;
  - *Administrability* — the standard should be easy to apply;
  - *Consistency* — the standard should yield predictable results;
  - *Objectivity* — the standard should leave no subjective input from the decision-makers;
  - *Applicability* — the standard should reach as wide a scope of conduct as possible; and
  - *Transparency* — the standard and its objectives should be understandable.